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Norm Coleman, Chairman
Carl Levin, Ranking Minority Member

THE ROLE OF PROFESSIONAL FIRMS IN THE U.S. TAX SHELTER INDUSTRY

REPORT

PREPARED BY THE

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

OF THE

COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS

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THE ROLE OF PROFESSIONAL FIRMS IN THE U.S. TAX SHELTER INDUSTRY

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I. INTRODUCTION

In October 2002, the U.S. Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, began an investigation into the development, marketing, and implementation of abusive tax shelters by accountants, lawyers, financial advisors, and bankers. The Subcommittee's Minority Staff initiated this investigation, at the direction of Senator Carl Levin, with the concurrence and support of Subcommittee Chairman Norm Coleman. The information in this report is based upon the ensuing bipartisan investigation by the Subcommittee's Democratic and Republican staffs.

In its broadest sense, the term "tax shelter" is a device used to reduce or eliminate the tax liability of the tax shelter user. This may encompass legitimate or illegitimate endeavors. While there is no one standard to determine the line between legitimate "tax planning" and "abusive tax shelters," the latter can be characterized as transactions in which a significant purpose is the avoidance or evasion of Federal, state or local tax in a manner not intended by the law.

The abusive tax shelters investigated by the Subcommittee were complex transactions used by corporations or individuals to obtain substantial tax benefits in a manner never intended by the federal tax code. While some of these transactions may have complied with the literal language of specific tax provisions, they produced results that were unwarranted, unintended, or inconsistent with the overall structure or underlying policy of the Internal Revenue Code. These transactions had no economic substance or business purpose other than to reduce taxes. Abusive tax shelters can be custom-designed for a single user or prepared as a generic tax product sold to multiple clients. The Subcommittee investigation focused on generic abusive tax shelters sold to multiple clients as opposed to a custom-tailored tax strategy sold to a single client.

Under present law, generic tax shelters sold to multiple clients are not illegal *per se*. They are potentially illegal depending on how the purchasers use them and report their tax liability on their tax returns. Certain statutory provisions, judicial doctrines, and IRS administrative guidance define and identify abusive tax shelters that may violate federal tax law. Over the last 5 years, the IRS and the Treasury Department have begun to publish legal guidance on transactions they consider to be abusive. This guidance warns taxpayers that use of such "listed transactions" may lead to an audit and assessment of back taxes, interest, and penalties for using an illegal tax shelter.

After a one-year investigation, the Permanent Subcommittee on Investigations held 2 days of hearings on November 18, 2003, and November 20, 2003, entitled *U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals.*

At the November 18 hearing, the Subcommittee heard testimony from three tax experts: Debra Peterson, Tax Counsel, California Franchise Tax Board; Mark Watson, Former Partner, KPMG LLP; and Calvin Johnson, Professor, The University of Texas at Austin School of Law. The Subcommittee also heard testimony from numerous tax professionals from various accounting firms. Tax professionals from KPMG LLP included: Philip Wiesner, Partner in Charge, Washington National Tax Client Services; Jeffrey Eischeid, Partner, Personal Financial Planning; Lawrence DeLap, retired National Partner in Charge, Department of Professional Practice-Tax; Lawrence Manth, former West Area Partner in Charge, Stratecon; and Richard Smith Jr., Vice Chair, Tax Services. Accounting firm PricewaterhouseCoopers was represented by Richard Berry, Jr., Senior Tax Partner. Accounting firm Ernst & Young LLP was represented by Mark Weinberger, Vice Chair, Tax Services.

At the November 20 hearing, the Subcommittee heard testimony from three lawyers: Raymond Ruble, former Partner, Sidley Austin Brown & Wood LLP; Thomas Smith, Jr., Partner, Sidley Austin Brown & Wood LLP; and N. Jerold Cohen, Partner, Sutherland Asbill & Brennan LLP. The Subcommittee also heard testimony from William Boyle, former Vice President, Structured Finance Group, Deutsche Bank AG; Domenick DeGiorgio, former Vice President, Structured Finance, HVB America, Inc.; John Larson, Managing Director, Presidio Advisory Services; and Jeffrey Greenstein, Chief Executive Officer, Quellos Group LLC, formerly known as Quadra Advisors LLC. Lastly, the Subcommittee heard testimony from three regulatory and oversight agencies: Mark Everson, Commissioner, Internal Revenue Service; William McDonough, Chairman, Public Company Accounting Oversight Board; and Richard Spillenkothen, Director, Division of Banking Supervision, & Regulation, The Federal Reserve.

This report is based upon the information gathered by the Subcommittee during these two hearings and the course of its investigation to date, including a report prepared by Senator Levin and released in connection with the November hearings,[1] review of over 250 boxes of documents and electronic disks, numerous interviews, three depositions, testimony presented by the 20 witnesses at two hearings, and supplemental post-hearing information.

II. OVERVIEW OF U.S. TAX SHELTER INDUSTRY

Under current law, no single standard defines an abusive tax shelter. Abusive tax shelters are governed by statutory provisions, judicial doctrines, and administrative guidance used to identify transactions in which a significant purpose is the avoidance or evasion of income tax in a manner not intended by the law.

[1] See "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals, Four KPMG Case Studies: FLIP, OPIS, BLIPS, and SC2," Minority Staff Report of the U.S. Senate Permanent Subcommittee on Investigations (11/18/03) (hereinafter "Levin Report"), S. Prt. 108-34, reprinted in "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals," Subcommittee hearings (11/18/03 and 11/20/03) (hereinafter "Subcommittee hearings"), S. Hrg. 108-473, at 145-274. This Subcommittee Report confirms the factual findings of the earlier Levin Report and draws heavily from its text.

Over the past ten years, Federal statutes and regulations prohibiting illegal tax shelters have undergone repeated revision to clarify and strengthen them. Today, key tax code provisions not only prohibit tax evasion by taxpayers, but also penalize persons who knowingly organize or promote illegal tax shelters[2] or who knowingly aid or abet the filing of tax return information that understates a taxpayer's tax liability.[3] Additional tax code provisions now require taxpayers and promoters to disclose to the IRS information about certain potentially illegal tax shelters.[4]

In 2003, the IRS issued regulations to clarify and strengthen the law's definition of a tax shelter promoter and the law's requirements for tax shelter disclosure.[5] For example, these regulations now make it clear that tax shelter promoters include "persons principally responsible for organizing a tax shelter as well as persons who participate in the organization, management or sale of a tax shelter" and any person who is a "material advisor" on a tax shelter transaction.[6] Disclosure obligations, which apply to both taxpayers and tax shelter promoters, require disclosure to the IRS, under certain circumstances, of information related to six categories of potentially illegal tax shelter transactions. Among others, these categories of disclosure include any transaction that is the same or similar to a "listed transaction," which is a transaction that the IRS has formally determined, through regulation, notice, or other published guidance, "as having a potential for tax avoidance or evasion" and is subject to the law's registration and client list maintenance requirements.[7] The IRS has stated in court that it "considers a 'listed transaction' and all substantially similar transactions to have been structured for a significant tax avoidance purpose" and refers to them as "potentially abusive tax shelters."[8] The IRS has also stated in court that "the IRS has concluded that taxpayers who engaged in such [listed] transactions have failed or may fail to comply with the internal revenue laws."[9] As of March 2004, the IRS had published 31 listed transactions.[10]

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[2] 26 U.S.C. § 6700.

[3] 26 U.S.C. § 6701.

[4] See, e.g., 26 U.S.C. §§ 6011 (taxpayer must disclose reportable transactions); 6111 (organizers and promoters must register potentially illegal tax shelters with IRS); and 6112 (promoters must maintain lists of clients who purchase potentially illegal tax shelters and, upon request, disclose such client lists to the IRS).

[5] See, e.g., Treas. Reg. Sec. 301.6112-1 and Sec. 1.6011-4, which took effect on 2/28/03.

[6] Petition dated 10/14/03, "United States' *Ex Parte* Petition for Leave to Serve IRS 'John Doe' Summons on Sidley Austin Brown & Wood," (D.N.D. Ill.), at ¶ 8.

[7] Id. at ¶ 11. See also "Background and Present Law Relating to Tax Shelters," Joint Committee on Taxation (JCX-19-02), 3/19/02 (hereinafter "Joint Committee on Taxation report"), at 33; "Challenges Remain in Combating Abusive Tax Shelters," testimony by Michael Brostek, Director, Tax Issues, General Accounting Office (GAO) before the U.S. Senate Committee on Finance, No. GAO-04-104T (10/21/03) (hereinafter "GAO Testimony") at 7. The other five categories of transactions subject to disclosure are transactions offered under conditions of confidentiality; including contractual protections to the "investor"; resulting in specific amounts of tax losses; generating a tax benefit when the underlying asset is held only briefly; or generating differences between financial accounts and tax accounts greater than $10 million. GAO Testimony at 7.

[8] Petition dated 10/14/03, "United States' *Ex Parte* Petition for Leave to Serve IRS 'John Doe' Summons on Sidley Austin Brown & Wood," (D.N.D. Ill.), at ¶¶ 11-12.

[9] Id. at ¶ 16.

In addition to statutory and regulatory requirements and prohibitions, federal courts have developed over the years a number of common law doctrines to identify and invalidate illegal tax shelters, including the economic substance,[11] business purpose,[12] substance-over-form,[13] step transaction,[14] and sham transaction[15] doctrines. A study by the Joint Committee on Taxation concludes that "[t]hese doctrines are not entirely distinguishable" and have been applied by courts in inconsistent ways.[16]

Bipartisan legislation to clarify and strengthen the economic substance and business purpose doctrines, as well as other aspects of federal tax shelter law, has long been advocated by the Senate Finance Committee and approved by the Senate on multiple occasions, but not adopted by the House of Representatives. During the 108th Congress, as a result of the Subcommittee investigation, Senators Levin and Coleman introduced S. 2210, the Tax Shelter and Tax Haven Reform Act, to strengthen penalties on tax shelter promoters, prevent abusive tax shelters, deter uncooperative tax havens, and codify the economic and business purpose doctrines. This bill was referred to the Senate Finance Committee which subsequently reported a more comprehensive tax bill, S. 1637. This bill included some of the tax shelter provisions in S. 2210. In May, the Senate considered and adopted S. 1637. During the Senate debate, a Levin-

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[10] In September 2004, the number of listed transactions was modified by the IRS and reduced to 30. See IRS Notice 2004-67 (9/23/04).

[11] See, e.g., Gregory v. Helvering, 293 U.S. 465 (1935); ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998), cert. denied 526 U.S. 1017 (1999); Bail Bonds by Marvin Nelson, Inc. v. Commissioner, 820 F.2d 1543, 1549 (9th Cir. 1987) ("The economic substance factor involves a broader examination of ... whether from an objective standpoint the transaction was likely to produce economic benefits aside from a tax deduction.").

[12] See, e.g., Gregory v. Helvering, 293 U.S. 465 (1935); Commissioner v. Transport Trading & Terminal Corp., 176 F.2d 570, 572 (2nd Cir. 1949), cert. denied 339 U.S. 916 (1949) (Judge Learned Hand) ("The doctrine of Gregory v. Helvering ... means that in construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation.").

[13] See, e.g., Weiss v. Stearn, 265 U.S. 242, 254 (1924) ("Questions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participants; and when applying the provisions of the Sixteenth Amendment and income laws ... we must regard matters of substance and not mere form.").

[14] See, e.g., Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945) ("The transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another using the latter as a conduit through which to pass title."); Palmer v. Commissioner, 62 T.C. 684, 692 (1974).

[15] See, e.g., Gregory v. Helvering, 293 U.S. 465 (1935); Rice's Toyota World v. Commissioner, 752 F.2d 89, 91-92 (4th Cir. 1985); United Parcel Service of America, Inc. v. Commissioner, 78 T.C.M. 262 at n. 29 (1999), rev'd 254 F.3d 1014 (11th Cir. 2001) ("Courts have recognized two basic types of sham transactions. Shams in fact are transactions that never occur. In such shams, taxpayers claim deductions for transactions that have been created on paper but which never took place. Shams in substance are transactions that actually occurred but which lack the substance their form represents.").

[16] Joint Committee on Taxation report at 7.

Coleman amendment was accepted to further strengthen federal penalties on promoters, aiders and abettors of abusive tax shelters. In October 2004, after a House-Senate conference, Congress enacted into law H.R. 4520, the American Jobs Creation Act. This tax legislation included a number of tax shelter reforms supported by the Subcommittee's investigation and the Senate Finance Committee, including stronger penalties on promoters of abusive tax shelters.[17] Other tax shelter reforms, such as the codification of the economic substance and business purpose doctrines and stronger penalties on aiders and abettors of tax shelters, were not included in the final bill.

In December 2004, the Public Company Accounting Oversight Board (PCAOB) proposed rules to strengthen auditor independence and restrict the tax services that accounting firms may provide to their audit clients.[18] Among other provisions, the proposed rule would require any accounting firm that audits a publicly traded company to maintain strict independence from that company throughout the auditing engagement. The proposed rule would also bar such accounting firms from: (1) entering into a contingent fee arrangement with an audit client for tax services; (2) providing tax services to certain executives of an audit client; and (3) planning, marketing, or opining on aggressive tax positions with respect to an audit client, as further defined by the rule. The proposed rule would also require accounting firms, before providing any tax service to an audit client, to disclose detailed information about the tax service to the company's audit committee and obtain the committee's approval. This proposed rule, like the legislation enacted by Congress, represents a renewed effort to rein in abusive practices within the U.S. tax shelter industry.

III. FINDINGS AND RECOMMENDATIONS

The Subcommittee's investigation to date has determined that in 2003, the U.S. tax shelter industry no longer focused solely on providing individualized tax advice but had expanded its focus to include generic "tax products" aggressively marketed to multiple clients. The investigation also found that numerous respected members of the American business community were heavily involved in the development, marketing, and implementation of generic tax products whose principal objective was to reduce or eliminate a client's U.S. tax liability. These tax shelters required close collaboration between accounting firms, law firms, investment advisory firms, and banks.

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[17] See Amendment No. 3120 to S. 1637. The Levin-Coleman bill, S. 2210, had advocated a penalty equal to 150% of the gross income derived, or to be derived, by a promoter, aider, or abettor of an abusive tax shelter. S. 1637, in contrast, had proposed a 50% penalty solely on promoters. The Levin-Coleman amendment compromised by increasing S. 1637's penalty to 100% of the gross income derived, or to be derived, by a promoter, aider or abettor of an abusive tax shelter. Unfortunately, the final bill approved by Congress, H.R. 4520, adopted only the lower 50% penalty and confined it to promoters, leaving the penalty for aiders and abettors still in need of reform.

[18] See PCAOB Release 2004-15 (12/14/04).

A. FINDINGS

Based upon its investigation, the Subcommittee makes the following findings:

(1) The sale of potentially abusive and illegal tax shelters is a lucrative business in the United States, and some professional firms such as accounting firms, banks, law firms, and investment advisory firms have been major participants in the development, mass marketing, and implementation of generic tax products sold to multiple clients.

(2) During the period 1998 to 2003, KPMG devoted substantial resources and maintained an extensive infrastructure to produce a continuing supply of generic tax products to sell to clients, using a process which pressured its tax professionals to generate new ideas, move them quickly through the development process, and approve, at times, illegal or potentially abusive tax shelters.

(3) KPMG used aggressive marketing tactics to sell its generic tax products by turning tax professionals into tax product salespersons, pressuring its tax professionals to meet revenue targets, using telemarketing to find clients, developing an internal tax sales force, using confidential client tax data to find clients, targeting its own audit clients for sales pitches, and using tax opinion letters and insurance policies as marketing tools.

(4) KPMG was actively involved in implementing the tax shelters which it sold to its clients, including by enlisting participation from banks, investment advisory firms, and tax exempt organizations; preparing transactional documents; arranging purported loans; issuing and arranging opinion letters; providing administrative services; and preparing tax returns.

(5) KPMG took steps to conceal its tax shelter activities from tax authorities, including by claiming it was a tax advisor and not a tax shelter promoter, failing to register potentially abusive tax shelters, restricting file documentation, imposing marketing restrictions, and using improper tax return reporting to minimize detection by the IRS or others.

(6) Since Subcommittee hearings in 2003, KPMG has committed to cultural, structural, and institutional changes to dismantle its abusive tax shelter practice, including by dismantling its tax shelter development, marketing and sale resources, dismantling certain tax practice groups, making leadership changes, and strengthening tax services oversight and regulatory compliance.

(7) During the period 1998 to 2002, Ernst & Young sold generic tax products to multiple clients despite evidence that some, such as CDS and COBRA, were potentially abusive or illegal tax shelters.

(8) Ernst & Young has committed to cultural, structural, and institutional changes to dismantle its tax shelter practice, including by eliminating the tax practice group that promoted its tax shelter sales, making tax leadership changes, and strengthening its tax services oversight and regulatory compliance.

(9) During the period 1997 to 1999, PricewaterhouseCoopers sold generic tax products to multiple clients, despite evidence that some, such as FLIP, CDS, and BOSS, were potentially abusive or illegal tax shelters.

(10) PricewaterhouseCoopers has committed to cultural, structural, and institutional changes intended to dismantle its abusive tax shelter practice, including by establishing a centralized quality and risk management process, and strengthening its tax services oversight and regulatory compliance.

(11) Sidley Austin Brown & Wood, through its predecessor firm Brown & Wood, provided legal services that facilitated the development and sale of potentially abusive or illegal tax shelters, including by providing design assistance, collaboration on allegedly independent tax opinion letters, and hundreds of boilerplate tax opinion letters to clients referred by KPMG and others, in return for substantial fees.

(12) Sutherland Asbill & Brennan provided legal representation to over 100 former KPMG clients in tax shelter matters before the IRS, despite a longstanding business relationship with KPMG and without performing any conflict of interest analysis prior to undertaking these representations.

(13) Deutsche Bank, HVB Bank, and UBS Bank provided billions of dollars in lending critical to transactions which the banks knew were tax motivated, involved little or no credit risk, and facilitated potentially abusive or illegal tax shelters known as FLIP, OPIS, and BLIPS.

(14) First Union National Bank promoted to its clients generic tax products which had been designed by others, including potentially abusive or illegal tax shelters known as FLIP, BLIPS, and BOSS, by introducing and explaining these products to its clients, providing sample opinion letters, and introducing its clients to the promoters of the tax products, in return for substantial fees.

(15) Some investment advisors, including Presidio Advisory Services and the Quellos Group, helped develop, design, market, and execute potentially abusive or illegal tax shelters such as FLIP, OPIS, and BLIPS.

(16) Some charitable organizations, including the Los Angeles Department of Fire and Police Pensions and Austin Fire Fighters Relief and Retirement Fund, participated as counter parties in a highly questionable tax shelter

known as SC2, which had been developed and promoted by KPMG, in return for substantial payments in the future.

B. RECOMMENDATIONS

Based upon its investigation and the above factual findings, the Subcommittee makes the following recommendations:

(1) The Internal Revenue Service and the Department of Justice should continue enforcement efforts aimed at stopping accounting firms and law firms from aiding and abetting tax evasion, promoting potentially abusive or illegal tax shelters, and violating federal tax shelter regulations, and should impose substantial penalties on wrongdoers to punish and deter such misconduct.

(2) Congress should enact legislation to increase the civil penalties on aiders and abettors of tax evasion and promoters of potentially abusive or illegal tax shelters, to ensure that they disgorge not only all illicit proceeds from such activities, but also pay a substantial monetary fine to punish and deter such misconduct.

(3) Congress should appropriate additional funds to enable the IRS to hire more enforcement personnel and increase enforcement activities to stop the promotion of potentially abusive and illegal tax shelters by lawyers, accountants, and other financial professionals.

(4) Congress should enact legislation to clarify and strengthen the economic substance doctrine and to strengthen civil penalties on transactions with no economic substance or business purpose apart from their alleged tax benefits.

(5) Congress should enact legislation authorizing the IRS to disclose relevant tax shelter information to other federal agencies, such as the Public Company Accounting Oversight Board, federal bank regulators, and the Securities and Exchange Commission (SEC), to strengthen their efforts to stop the entities they oversee from aiding or abetting tax evasion or promoting potentially abusive or illegal tax shelters.

(6) The Public Company Accounting Oversight Board should strengthen and finalize proposed rules restricting certain accounting firms from providing aggressive tax services to their audit clients, charging companies a contingent fee for providing tax services, and using aggressive marketing efforts to promote generic tax products to potential clients.

(7) Federal bank regulators, in consultation with the IRS, should review tax shelter activities at major banks, and clarify and strengthen rules preventing

banks from aiding or abetting tax evasion by third parties or promoting potentially abusive or illegal tax shelters.

(8) The SEC, in consultation with the IRS, should review tax shelter activities at investment advisory and securities firms it oversees, and clarify and strengthen rules preventing such firms from aiding or abetting tax evasion by third parties or promoting potentially abusive or illegal tax shelters.

(9) The IRS should further strengthen federal tax practitioner rules issued under Circular 230 regarding the issuance of tax opinion letters to ensure that such practitioners, including law firms and accounting firms, have written procedures for issuing tax opinions, resolving internal disputes over legal issues addressed in such opinions, and preventing practitioners or their firms from aiding or abetting tax evasion by clients or promoting potentially abusive or illegal tax shelters.

(10) The IRS should review tax shelter activities at charitable organizations, and clarify and strengthen rules preventing such organizations from aiding or abetting tax evasion by third parties or promoting potentially abusive or illegal tax shelters.

IV. EXECUTIVE SUMMARY

This report details the Subcommittee's investigation of the U.S. tax shelter industry. First, this report examines the development of mass-marketed generic tax products sold to multiple clients using prominent accounting firms, banks, lawyers, and investment firms. Second, as a result of the Subcommittee's investigation, this report describes the commitments made by the accounting firms examined during this investigation to end their involvement with abusive tax shelters.

The investigation found that by 2003, the U.S. tax shelter industry was no longer focused primarily on providing individualized tax advice to persons who initiate contact with a tax advisor. Instead, the industry focus has expanded to developing a steady supply of generic "tax products" that can be aggressively marketed to multiple clients. In short, the tax shelter industry had moved from providing one-on-one tax advice in response to tax inquiries to also initiating, designing, and mass marketing tax shelter products.

Also, the investigation found that numerous respected members of the American business community had been heavily involved in the development, marketing, and implementation of generic tax products whose objective was not to achieve a specific business or economic purpose, but to reduce or eliminate a client's U.S. tax liability. By 2003, dubious tax shelter sales were no longer the province of shady, fly-by-night companies with limited resources. They had become big business, assigned to talented professionals at the top of their fields and able to draw upon the vast resources and reputations of the country's largest accounting firms, law firms, investment advisory firms, and banks.

This report focuses on generic tax products developed and promoted by KPMG, PricewaterhouseCoopers, and Ernst & Young, auditors and tax experts comprising three of the top four accounting firms in the United States. During the 1990s, in response in part to the stock market boom and the proliferation of stock options, these firms and others designed and developed tax products used to generate large paper losses that could be used to offset or shelter gains from taxation. Tax products examined by the Subcommittee include: KPMG's Bond Linked Issue Premium Structure (BLIPS), Foreign Leveraged Investment Program (FLIP), and Offshore Portfolio Investment Strategy (OPIS); PricewaterhouseCooper's Bond and Option Sales Strategy (BOSS); and Ernst & Young's Contingent Deferred Swap (CDS) tax product. Each of these products generated hundreds of millions of dollars in phony paper losses for taxpayers, using a series of complex, orchestrated transactions, structured finance, and investments with little or no profit potential. All of these tax products have been "listed" by the IRS as potentially abusive tax shelters.[19]

Additionally, the Subcommittee examined a fourth tax product, S-Corporation Charitable Contribution Strategy (SC2), developed by KPMG. SC2 is directed at individuals who own profitable corporations organized under Chapter S of the tax code (hereinafter "S Corporations"), which means that the corporation's income is attributed directly to the corporate owners and taxable as personal income. SC2 was intended to generate a tax deductible charitable donation for the corporate owner and, more importantly, to defer and reduce taxation of a substantial portion of the income produced by the S Corporation, essentially by "allocating" but not actually distributing that income to a tax exempt charity holding the corporation's stock. Recently, the IRS listed SC2 as a potentially abusive tax shelter.[20]

As a result of the Subcommittee's hearings and investigation, each accounting firm has committed to cultural, structural, and institutional reforms and changes to end the promotion, development, implementation, and offering of mass-marketed abusive tax shelters. KPMG informed the Subcommittee that the firm has dismantled its development, marketing, and sales infrastructure used for offering mass-marketed tax shelters. In addition, KPMG indicated that it has dismantled various tax practice groups, made leadership changes, and strengthened oversight and compliance. KPMG indicated that these changes reflect a firm-wide commitment to attain the highest degree of trust from the firm's clients, regulators, and the public at large. Similarly, Ernst & Young told the Subcommittee that the firm has instituted new oversight and leadership changes, IRS compliance and monitoring systems, and firm-wide policies to ensure the highest standards of professionalism. Lastly, PricewaterhouseCoopers told the Subcommittee that the firm has instituted new leadership positions, and a centralized product development process to monitor all tax services to ensure that mass-marketed abusive tax shelters would not be marketed by the firm in the future.

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[19] FLIP and OPIS are covered by IRS Notice 2001-45 (2001-33 IRB 129) (8/13/01); while BLIPS is covered by IRS Notice 2000-44 (2000-36 IRB 255) (9/5/00). PricewaterhouseCooper's BOSS transaction is covered by IRS Notice 99-59 (1999-52 IRB 761) (12/27/99). Ernst & Young's CDS transaction is covered by IRS Notice 2002-35 (2002-21 IRB 992) (5/28/02).

[20] See IRS Notice 2004-30 (4/1/04).

The investigation also examined a number of professional firms that assisted in the development, marketing, and implementation of tax shelters promoted by the three accounting firms. Leading banks, including Deutsche Bank, HVB, and UBS, provided multi-billion dollar credit lines essential to the orchestrated transactions. Wachovia Bank, acting through First Union National Bank, made client referrals to KPMG and PricewaterhouseCoopers, playing a key role in facilitating the marketing of potentially abusive or illegal tax shelters. Leading law firms, such as Brown & Wood, which later merged with another firm to become Sidley Austin Brown & Wood, provided favorable tax opinions on these tax shelters, advising that they were permissible under the law. The evidence also suggests collaboration between Sidley Austin Brown & Wood and KPMG on the OPIS and BLIPS tax shelters, including the issuance of allegedly independent opinion letters on BLIPS containing numerous virtually identical paragraphs. Two investment advisory firms, Presidio Advisory Services and Quellos Group, formerly doing business as Quadra Capital Management LLP and QA Investments LLC, assisted in the design, development, marketing, and implementation of tax shelters promoted by KPMG. Additionally, Quellos served as the investment advisor for PricewaterhouseCooper's version of FLIP.

The following pages provide more detailed information about these and other problems uncovered during the Subcommittee investigation into the role of professional firms in the tax shelter industry.

V. ROLE OF ACCOUNTANTS

The Subcommittee's investigation of the U.S. tax shelter industry found that leading U.S. accounting firms were focused on developing generic "tax products" aggressively marketed to multiple clients from the late 1990's to as late as 2003, despite increasing IRS enforcement efforts to halt the tax shelters they were promoting. Accounting firms were devoting substantial resources to develop, market, and implement tax shelters, costing the Treasury billions of dollars in lost tax revenues.[21] To illustrate the problems, the Subcommittee developed case histories focused on tax shelters promoted by KPMG, PricewaterhouseCoopers, and Ernst & Young. The investigation also uncovered evidence that these firms took steps to conceal their tax shelter activities from tax authorities and the public, including by failing to register potentially abusive tax shelters with the IRS.

A. KPMG

The Subcommittee conducted its most detailed examination of four potentially abusive or illegal tax shelters that were developed, marketed, and implemented by KPMG. KPMG International is one of the largest public accounting firms in the world, with over 700 offices in

[21] According to the General Accounting Office, a recent IRS consultant estimated that for the six year period, 1993-1999, the IRS lost on average between $11 and $15 billion each year from abusive tax shelters. See GA0-04-104T, at 3 (2003). GAO estimates potential tax losses of about $33 billion from transactions listed by the IRS as potentially abusive, and another $52 billion from non-listed abusive transactions, for a combined total of $85 billion. Id. at 10.

152 countries.[22] In 2002, it employed over 100,000 people and had worldwide revenues of $10.7 billion. KPMG International, organized as a Swiss "non-operating association," functions as a federation of partnerships around the globe, and maintains its headquarters in Amsterdam.

KPMG LLP (hereinafter "KPMG") is a U.S. limited liability partnership and a member of KPMG International. KPMG is the third largest accounting firm in the United States, and generates more than $4 billion in annual revenues. KPMG was formed in 1987, from the merger of two long-standing accounting firms, Peat Marwick and Klynveld Main Goerdeler, along with their individual member firms. KPMG maintains its headquarters in New York and numerous offices in the United States and other countries.

KPMG's Tax Services Practice is a major division of KPMG. It provides tax compliance, tax planning, and tax return preparation services. The Tax Services Practice employs more than 10,300 tax professionals and has generated more than $1.2 billion in annual revenues for the firm. These revenues have been increasing rapidly in recent years, including a 45% cumulative increase over four years, from 1998 to 2001.[23] The Tax Services Practice is headquartered in New York, has 122 U.S. offices, and maintains additional offices around the world. The head of the Tax Service during the period of the investigation was Vice Chairman for Tax, Richard Smith Jr.

The Tax Services Practice has over two dozen subdivisions, offices, "practices," or "groups" which over the years have changed missions and personnel. Many played key roles in developing, marketing, or implementing KPMG's generic tax products, including the four KPMG products featured in this Report. One key group is the Washington National Tax (WNT) Practice which provides technical tax expertise to the entire KPMG firm. During the course of the Subcommittee's investigation, a WNT subgroup, the Tax Innovation Center, led KPMG's efforts to develop new generic tax products. Another key group is the Department of Professional Practice (DPP) for Tax, which, among other tasks, reviews and approves all new KPMG tax products for sale to clients. KPMG's Federal Tax Practice addresses federal tax compliance and planning issues. KPMG's Personal Financial Planning (PFP) Practice focused on selling "tax-advantaged" products to high net worth individuals and large corporations.[24] Through a subdivision known as the Capital Transaction Services (CaTS) Practice, later renamed the Innovative Strategies Practice, PFP led KPMG's efforts on FLIP, OPIS, and BLIPS.[25]

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[22] The general information about KPMG is drawn from KPMG documents produced in connection with the Subcommittee investigation; Internet websites maintained by KPMG LLP and KPMG International; and a legal complaint filed by the U.S. Securities and Exchange Commission (SEC) in SEC v. KPMG LLP, Civil Action No. 03-CV-0671 (D. S.D.N.Y.) (1/29/03).

[23] Internal KPMG presentation dated 7/19/01, by Rick Rosenthal and Marsha Peters, entitled "Innovative Tax Solutions." A chart included in this presentation tracks increases in the Tax Service's gross revenues from 1998 until 2001, showing a cumulative increase of more than 45% over the four-year period, from 1998 gross revenues of $830 million to 2001 gross revenues of $1.24 billion.

[24] Minutes dated 11/30/00, Monetization Solutions Task Force Teleconference, Bates KPMG 0050624-29, at 50625.

[25] Document dated 5/18/01, "PFP Practice Reorganization Innovative Strategies Business Plan – DRAFT," Bates KPMG 0050620-23, at 50621.