STATEMENT OF SENATOR CARL LEVIN (D-MICH)
BEFORE
U.S. SENATE
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
ON
U.S. TAX SHELTER INDUSTRY:
THE ROLE OF ACCOUNTANTS, LAWYERS, AND FINANCIAL PROFESSIONALS

November 18, 2003

Almost a year ago, the Permanent Subcommittee on Investigations opened an in-depth investigation into the development, marketing and implementation of abusive and illegal tax shelters by professional firms like accounting firms, banks, investment advisors, and law firms. I was then the Subcommittee Chairman and initiated this effort following our Enron investigation which, among other misconduct, disclosed that company's use of elaborate tax dodges. We have continued this investigation with the support of the Subcommittee Chairman Norm Coleman, for which we thank him.

Unlike legitimate tax shelters, abusive tax shelters have no real economic substance, are designed to provide tax benefits not intended by the tax code, and are almost always convoluted and complex. Crimes like terrorism, murder, fraud and embezzlement produce instant recognition of the immorality involved. But abusive tax shelters are MEGOs – that means "My Eyes Glaze Over." Those who cook up these concoctions count on their complexity to escape scrutiny and public ire.

The tax shelter industry of today is fundamentally different than it was a few years ago. Instead of individuals and corporations going to their accountant or lawyer and asking for tax advice, the engine driving the tax shelter industry today is the effort of a horde of tax advisors cooking up one complex scheme after another – so-called "tax products"that are unsolicited by any client – and then using elaborate marketing schemes to peddle these products across the country.

In order to gain a deeper understanding of the issues involved in the marketing of these tax products, the Subcommittee conducted in-depth case studies examining four tax products designed, marketed and sold by a leading accounting firm, KPMG, to individuals or corporations to help them reduce or eliminate their U.S. taxes. These four products are known to KPMG and its clients as BLIPS, FLIP, OPIS, and SC2. We are releasing a 125-page Minority Staff Report today detailing what we found in these four case histories.

The testimony today will disclose a tawdry tale: a highly compromised internal review and approval process at KPMG, highly aggressive marketing efforts to sell tax schemes aimed at producing paper tax losses, and schemes which attempt to disguise tax reduction scams as business activity in the case of BLIPS or a charitable donation in the case of SC2.

An excerpt from a long email by a top KPMG tax professional on whether KPMG should approve BLIPS for sale to clients illustrates the skewed priorities. He said the decision on BLIPS came down to this:

> "My own recommendation is that we should be paid a lot of money here for our opinion since the transaction is clearly one that the IRS would view as falling squarely within the tax shelter orbit."

Being paid "a lot of money" for a dubious tax scheme – that's what it all comes down to.

The testimony today will pull back the curtain on the pressure cooker environment within KPMG to mass market its tax products to multiple clients. Again, one detail illustrates the extent of the problem: the full-fledged telemarketing center that KPMG has maintained in Fort Wayne, Indiana and staffed with people trained to make cold calls to find buyers for specific tax products. The telemarketing scripts, the thousands of cold calls made to sell the tax product known as SC2, the re-visits to potential buyers who said no the first time, all show KPMG pushing its so-called tax products.

The testimony today will also show the lengths to which KPMG went to hide its tax products and its sales efforts from the IRS. Despite its 2003 inventory of 500 active tax products, KPMG has never registered, and thereby disclosed to the IRS the existence of, a single one of its tax products. It has claimed in court and to the Subcommittee staff that it is not a tax shelter promoter. Today's testimony will disclose, however, that some tax professionals within the firm advised the firm, to no avail, to register some of its products as tax shelters. You will also hear about improper tax return reporting by KPMG, file cleanups, and other efforts to hide their activities from the IRS and public scrutiny.

Finally, you will hear today and in the hearing on Thursday that, in ventures as large and profitable as the marketing of these tax shelters, there were many professionals ready to join forces with KPMG to carry out the complex financial structures required to camouflage the tax schemes behind a facade of economic substance. These professionals included:

–Banks which financed the loans for sham transactions designed to create a veneer of economic substance;
–Investment advisory firms which cooked up phony financial transactions to create the appearance of a business purpose; and
–Law firms which wrote boiler plate legal opinions to justify dubious tax schemes and shield taxpayers from penalties.

With such a formidable array of talent and expertise, potential clients were persuaded to buy and use the deceptive shelters KPMG was peddling and the U.S. Treasury was effectively defrauded of taxes owed as a result.

BLIPS and SC2 Case Studies

We are going to focus on two shelters, BLIPS and SC2. Let's first look at BLIPS, which stands for "Bond Linked Issue Premium Structure."

Inside KPMG, BLIPS was called a "loss generator," because the intent of the tax product was to generate a paper loss that the buyer could then use to offset other income and shelter it from taxation. For this example, we'll suppose the BLIPS buyer – let's call him the "taxpayer"– has a taxable gain or taxable income of $20 million that the BLIPS transaction is intended to shelter by creating a $20 million paper loss.

First Slide

The first step is the BLIPS taxpayer sets up a shell corporation, called a Limited Liability Company or LLC. The taxpayer gives this shell company out-of-pocket cash equal to 7% of the $20 million paper loss he wants to create. In this case, that means the taxpayer provides $1.4 million. This money will be used for fees for the firms that are part of this scheme and for an investment program set up as the fig leaf of economic substance to hide what is really a tax scam.

Second Slide

The next thing that happens is a bank makes a so-called “7-year loan”of $50 million to the shell company (LLC). The BLIPS taxpayer agrees to pay an above market interest rate on the “loan,” say 16%. Because he is willing to pay such a high interest rate, the bank also credits him with a so-called $20 million “loan premium” that, not coincidentally, is equal to the tax loss that the taxpayer is buying from KPMG. (If the taxpayer later pays off the “loan” early, as planned, the bank will charge a prepayment penalty that, not coincidentally, will approximate the “loan premium” and make sure it is repaid.) The bank credits the taxpayer’s account, which stays at the bank, with the $50 million “loan” and the $20 million “premium” for a total of $70 million.

There are more wrinkles. For instance, in order to get the $70 million, the taxpayer and his shell company have to agree to severe restrictions on how the “loan proceeds” can be used and to maintain “collateral” in cash or liquid securities in an account at the same bank equal to least 101% of the “loan” and “premium” amount, meaning about $70.8 million.

Think about that for a moment, because this collateral requirement is one key to understanding why this “loan” is a sham. A cash collateral requirement of 101% means, in effect, that none of the “loan proceeds” can really be put at risk. That money – more than the amount of the “loan” itself – has to be kept safe in an account at the bank which on paper “loaned” it.

Third Slide

Enter Presidio. They are the investment advisory firm that works hand in glove with KPMG and handles a lot of the leg work of the transaction. Presidio directs two companies it controls, Presidio Growth and Presidio Resources, to participate in the transaction.

Fourth Slide

Next, Presidio and the taxpayer’s shell company form a partnership called a Strategic Investment Fund (SIF). The taxpayer’s shell company (LLC) contributes all of its assets to the partnership–the $1.4 million in cash from the taxpayer and the $70 million credit from the so-called “loan” and “loan premium.” The Presidio companies contribute about $140,000. Based on these contributions, the taxpayer has a 90% interest and Presidio collectively has a 10% interest in the Fund.

Fifth Slide

Here’s the switcheroo. The shell company decides, with the consent of the bank, to assign or transfer the so-called bank “loan” to the Fund (SIF).

Sixth Slide

Next comes the fig leaf. The Fund takes the money it has and supposedly engages in foreign currency investments. The Fund takes the so-called "loan proceeds" – the $70 million – and simply converts it into Euros and puts it in what one bank calls a "Synthetic Dollar Account." The Fund also signs a contract to guarantee it can convert the Euros back to the same number of dollars at no risk in 30 or 60 days. The Fund also puts at risk a very small amount of money – never more than what the taxpayer has contributed – by shorting foreign currencies pegged to the U.S. dollar. Not much of an investment program. While the BLIPS "loan" is supposed to last 7 years, every taxpayer that has bought it – 186 out of 186 – pulled out early – as planned. They quit because the point of BLIPS is not to invest money, but to generate a paper loss for tax purposes before the end of the tax-year.

Seventh (Last) Slide

Now we're at the unwind. At day 60, the taxpayer pulls out of the partnership. The partnership – the Fund – repays the "loan" to the bank plus a "prepayment penalty" to cover the "premium," so that the whole $70 million is returned to the bank. The Fund then distributes any remaining assets to its partners, which usually is little or nothing.

The taxpayer's $1.4 million is usually mostly gone in fees, but that's a price he was more than willing to pay for a $20 million tax loss. Because of the way the loan was structured, KPMG told the taxpayer he can claim that his "cost basis" to participate in the partnership is equal to the $20 million "loan premium" and the $1.4 million in cash that he contributed to the partnership. That means he supposedly can claim a $21.4 million loss on his tax return.

If this doesn't make sense to you, it's because the whole transaction is an elaborate concoction to create the impression of economic substance. The taxpayer didn't use the $70 million "loan proceeds" at all – due to the collateral requirement, he parked that $70 million in a Synthetic Dollar Account at the bank and used his own money to make a few, safe currency transactions. He could have made those without any "loan" at all. The point of the "loan" was simply to generate a tax loss to shelter the taxpayer's other income.

KPMG approved BLIPS for sale in October 1999, and sold it to 186 people until, in September 2000, the IRS listed it as a potentially abusive tax shelter. In one year, KPMG obtained at least $53 million in fees, making it one of KPMG's top revenue producing tax products.

Now let's look at the second shelter, SC2, which stands for S-Corporation Charitable Contribution Strategy. An S-corporation is organized under Subchapter S of the tax code, and its income is attributed to its shareholders and taxed as ordinary individual income instead of corporate income. Instead of generating a phony paper loss, this tax product generated a phony charitable donation.

First Slide:

The first step is that KPMG approaches an existing S-Corporation, usually owned by one person, with a purported "charitable donation strategy."

The corporation takes several steps to prepare for the SC2 transaction.

First, let's assume that the S-Corporation had 100 shares of common stock. On KPMG's advice, the S-Corporation issues and distributes to its sole shareholder an additional 900 non-voting shares plus 7,000 warrants to buy 7,000 more shares of the company stock in the future. The corporation also issues a "non-distribution" resolution stating that the company will not distribute any of its income to its shareholders for a specified period of time, usually 2 or 3 years.

Next, KPMG introduces the individual-shareholder to a qualified tax-exempt charity, and the individual donates the 900 non-voting shares to this charity. The charity signs a redemption agreement with the corporation which allows the charity to require the corporation to buy back the donated stock after a specified period of time -- usually the same amount of time specified in the corporation's non-distribution resolution.

At the time the charity signs the redemption agreement, it understands that the S-Corporation has issued warrants to the individual-shareholder, which, if exercised, would dilute the value of the charity's stock in the company. The charity also knows that the S-Corporation is planning to distribute little or no income while the charity is a stockholder.

The individual-shareholder also provides the charity with a pledge stating that if, on the date of redemption, the value of the non-voting stock has fallen below what it was when donated, the individual will personally make up the difference with a cash contribution to the charity. The pledge essentially provides the charity with a floor, but not a ceiling, on the amount it will receive on the redemption date.

The redemption agreement and non-distribution resolution are the keys to understanding why SC2 is a sham. Everyone participating in this situation knows from the outset that the stock donation is not intended to be permanent. It is intended to be temporary. The clear understanding of all of the parties is that the charity will be selling the donated stock back to the donor in a few years.

But the appearance for the moment is that the S-corporation now has two shareholders. The charity owns 900 non-voting shares, and the individual owns 100 voting shares and 7,000 warrants.

<u>Second Slide</u>:

For the next 2 or 3 years while the charity is a shareholder in the S-Corporation, due to the non-distribution resolution, the corporation "allocates" but does not actually distribute 90% of its net income to the charity and 10% to the individual-shareholder. The difference between allocations and distributions is critical. Under federal tax law, an S-Corporation shareholder, unless tax-exempt, pays income tax on the net income "allocated" to it on the company books, not on the cash actually distributed. According to KPMG, that means that the 90% of company income allocated to the charity is tax-exempt, while the individual has to pay taxes on only the 10% allocated to him. That's true even though the charity often never sees a nickel of the money supposedly "allocated" to it and agrees to forgo that income.

<u>Third Slide</u>:

Now we are two or three years down the road after significant net income has been accumulating inside the company, when the charity's redemption right kicks in. The charity sells back the 900 non-voting shares to the S-Corporation for cash. While this cash payment pales in comparison to the amount of sheltered corporate income, because of the way the shares are valued, it is nonetheless a significant amount for the charity.

Fourth Slide:

Now for the payout for the individual-shareholder. The charity has sold back its shares and is no longer a shareholder in the S-Corporation. All of the income that has built up in the corporation for the last 2 or 3 years is distributed to the individual-shareholder. KPMG advises him that, on the 90% of the income "allocated" to the charity, which is now his, he can claim the income is capital gains, taxable at the lower capital gains rate, rather than the higher ordinary income rate.

KPMG approved SC2 for sale in March 2000, and, over the next 2 years, sold it to about 58 corporations. This tax product became one of KPMG's top tax products in 2000 and 2001, generating more than $28 million in fees for the firm. KPMG discontinued the sales in late 2001. In early 2002, the IRS asked KPMG to produce documents related to SC2 and is now reviewing the product.

End of Slides.

We may hear this morning that KPMG has seen the light and that it and the other large accounting firms no longer develop and sell these types of aggressive shelters. Let's hope that is the case. However, the report we are releasing today depicts a powerful engine going at full speed, developing and selling 500 "active tax products" as of February 2003, the response date for the Subcommittee subpoena. Having claimed all year to my staff that these tax products are legitimate, KPMG's prepared testimony today is that the firm has not only turned off, but dismantled that 500-cylinder engine. List me as skeptical.

I'm afraid we cannot trust this industry to police itself. We need to take strong and forceful action to stop the pilfering of our Treasury and the damage to the credibility of our tax system. We need stronger penalties on tax shelter promoters, an end to auditor conflicts of interest, a better economic substance test, and more enforcement dollars for the IRS to go after tax shelter promoters and their abusive schemes. These and other actions are outlined in the Report my staff has released today. These reforms are, of course, only part of the answer. The firms involved in designing, hawking and implementing these dubious tax products need to restore professional pride.

KPMG now says it has stopped selling aggressive tax products. PriceWaterhouseCoopers has withdrawn from a number of transactions and refunded some client fees. Ernst & Young says it will no longer market certain transactions to its public company audit clients and will require those clients to obtain audit committee approval before Ernst & Young will sell tax shelter services to their executives. That's a start. The engine of deception and greed needs to be turned off, dismantled, and consigned to the junkyard where it belongs.

That's what happened after the Enron collapse – exposure helped put an end to some deceptive financial scams. If that is the result of this investigation, it will move the production and promotion of abusive tax shelters out of big business, although it may well be picked up by the fly-by-night hucksters from whom such behavior is less surprising.