United States Government Accountability Office

GAO

Report to the Ranking Minority Member, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate

February 2005

TAX SHELTERS

Services Provided by External Auditors

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GAO-05-171

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Highlights

Highlights of GAO-05-171, a report to the Ranking Minority Member, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate

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Services Provided by External Auditors

Why GAO Did This Study

Recent legislative and regulatory changes have addressed the relationship between auditor-provided tax services and auditor independence. At this time, the federal regulatory community is exploring further changes.

To contribute to the discussion surrounding these changes, GAO's objectives were to determine (1) according to Internal Revenue Service (IRS) data, how many Fortune 500 companies obtained tax shelter services from their auditor; (2) according to IRS data, in how many Fortune 500 companies did the auditor provide the services to individual company officers or directors; and (3) whether selected Fortune 500 case study companies changed how they obtain tax services from their auditor in recent years.

For the first two objectives, GAO used IRS and Standard and Poor's data after finding they were sufficiently reliable for our work. GAO counted a company, officer, or director as obtaining a tax shelter service from the company's external auditor when an auditor that IRS identified as promoting a tax shelter also audited the company in at least one year that the shelter was in effect. For the third objective, independent of any IRS information, GAO selected case studies on the basis of geographic location and previous GAO contact. The companies are illustrative in nature and not intended to be representative of other companies.

www.gao.gov/cgi-bin/getrpt?GAO-05-171.

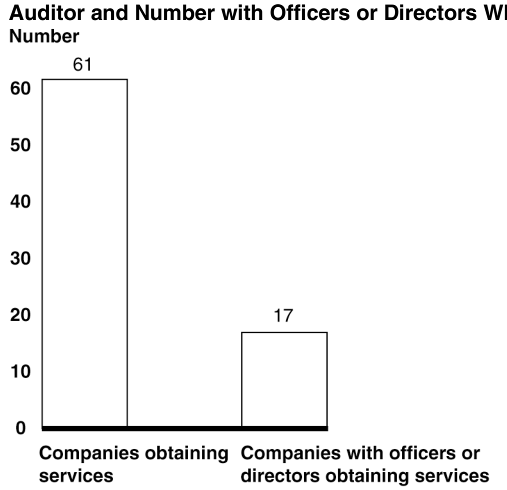
To view the full product, including the scope and methodology, click on the link above. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

What GAO Found

IRS data available on tax shelter services sometimes predate legislative and regulatory changes reflecting a heightened focus on auditor independence. However, both during this earlier period covered by some of the data and also following the recent changes, auditors were allowed to provide tax services, including tax shelter services, to firms they audited. According to IRS data, 61 Fortune 500 companies obtained tax shelter services from their external auditor during 1998 through 2003 for transactions generally reportable on tax returns sent to IRS. IRS considered some reportable transactions abusive, with tax benefits subject to disallowance under existing law, and other transactions to possibly have some traits of abuse. Estimated multi-year potential tax revenue lost to the federal government from the 61 companies' auditor-related transactions was about $3.4 billion (about $1.8 billion in categories IRS considered abusive). In 17 companies, at least one officer or director used the company's auditor to obtain individual tax shelter services. These numbers are imprecise because they have important limitations. These limitations, such as some transactions in IRS's database without tax shelter providers listed, are fully discussed in this report. Commenting on a draft of this report, IRS said that ongoing changes and recent legislation will enable it to address the data limitations noted.

According to their representatives, all eight case study companies adopted or refined policies or practices in 2002 or 2003 for pre-approving tax services or governing the tax services provided, such as who would provide them. All eight reported using their auditor for tax services during 2000 through 2003. Two told us of obtaining tax shelter services from their auditor, but one of them obtained the services before this period. Six of the eight reported officers or directors obtaining individual tax services from the auditor at some time since 2000, with four disallowing the practice later. None reported officers or directors using the auditor for individual tax shelter services.

Number of Fortune 500 Companies That Obtained Tax Shelter Services from Their External Auditor and Number with Officers or Directors Who Did So, 1998 through 2003



Source: GAO analysis of IRS and Standard and Poor's data.

Contents

United States Government Accountability Office
Washington, D.C. 20548

February 1, 2005

The Honorable Carl Levin
Ranking Minority Member
Permanent Subcommittee on Investigations
Committee on Homeland Security and Governmental Affairs
United States Senate

Dear Senator Levin:

Independent public accountants play a critical role in capital and credit markets by auditing companies' financial statements that millions of people rely on when investing in the nation's securities markets. Previous and current auditor independence rules have allowed accounting firms to provide tax services, including tax shelter services, to audit clients. However, in May 2003, federal rules began requiring that clients' audit committees pre-approve the services. Pre-approval requirements were adopted pursuant to legislation that was precipitated by various corporate accountability breakdowns.

The Internal Revenue Code has defined tax shelters in various detailed and complicated ways for purposes of having them registered, for applying certain penalties, or for certain tax accounting rules.[1] Although IRS has no single, authoritative definition of abusive shelters, it has generally characterized them as complex techniques promoted by sophisticated tax professionals that companies and wealthy individuals use to exploit tax loopholes and reap unintended tax benefits. Tax services include services involving tax compliance, tax planning, and tax advice as described by the Securities and Exchange Commission (SEC).[2]

[1] 26 U.S.C. sections 6111, 6662, and 461.

[2] Tax compliance generally involves tax return preparation, claims for refund, and tax payment-planning services. Tax planning and tax advice include such things as helping with tax audits and appeals and dealing with mergers and acquisitions and rulings or technical advice from taxing authorities. See SEC, *Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence*, Release No. 33-8183 (Washington, D.C.: Jan. 28, 2003).

In November 2003, the minority staff of the Permanent Subcommittee on Investigations reported that selling potentially abusive and illegal tax shelters was a lucrative business, with some professional firms, including accounting firms, mass marketing generic tax products to multiple clients.[3] Such generic tax products are potentially illegal depending on how buyers use them and calculate their tax liabilities. In October 2003, we testified that Internal Revenue Service (IRS) data sources, with their various limitations, suggested that abusive tax shelters totaled tens of billions of dollars of potential tax losses over about a decade.[4] More recently, the federal regulatory community has proposed more changes relating to the effect of auditor-provided tax services on auditor independence. In that context, we are providing information on auditor-provided tax services, including tax shelter services.

As discussed with your office, our objectives were to obtain information on both tax shelter services and other tax services provided by auditors of Fortune 500 companies. Specifically, our objectives were to determine (1) according to IRS data, how many Fortune 500 companies obtained tax shelter services from their auditor; (2) according to IRS data, in how many Fortune 500 companies did the auditor provide the services to individual company officers or directors; (3) whether selected Fortune 500 case study companies changed how they obtain tax services from their auditor in recent years; and (4) how many of our case study companies provided company funds to their auditor for tax shelter or other tax services for company officers or directors, and what the minimum and maximum amounts of the funds provided were.

To accomplish our first two objectives, we matched data disclosed to or discovered by IRS on tax shelter acquisitions and promoters of the tax shelters to information we acquired from Standard and Poor's (S&P) on the auditors, top officers, and directors of the April 2003 Fortune 500.[5] We

[3]Minority staff of the Permanent Subcommittee on Investigations, U.S. Senate Committee on Governmental Affairs, *U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals* (Washington, D.C.: November 2003).

[4]GAO, *Internal Revenue Service: Challenges Remain in Combating Abusive Tax Shelters*, GAO-04-104T (Washington, D.C.: Oct. 21, 2003).

[5]The Fortune 500, published annually by *Fortune* magazine, consists of the 500 largest U.S. corporations, in terms of revenue, that publish financial data and must report part or all of their figures to a government agency. The April 2003 list that we used ranked companies according to their 2002 revenues.

considered a company, officer, or director as obtaining tax shelter services from the company's auditor when, for at least one of the tax years for which the company, officer, or director received a tax shelter benefit, the company's auditor was identified as a promoter of the tax shelter by IRS. We used the company's fiscal year 1998 through 2003 auditors for performing our analysis and analyzed information from other years to provide context.

Although we found the data elements we used from the IRS and S&P information were sufficiently reliable for the purposes of our work, as will be described later, the IRS data had important limitations and should be used with caution. Despite these limitations, the information in this report provides a general indication of the extent to which Fortune 500 companies and their officers or directors used their external auditor for tax shelter services. Our results are imprecise in reflecting the universe of companies, officers, and directors that might have obtained tax shelter services from the companies' auditors. For example, IRS's data may not include all tax shelters because some taxpayers may not have disclosed all abusive or other reportable transactions to IRS, and IRS likely has not identified all such transactions on its own. On the other hand, the data also might include some tax shelters that could later be determined nonabusive and did include some items that needed to be reported to IRS but unexpectedly turned out to be nonabusive. Although not all transactions turned out to be abusive, we have included in our analysis those transactions that IRS or taxpayers believed needed to be reported to the federal government.

To accomplish our last two objectives, independent of any IRS information, we studied eight Fortune 500 companies that were not intended to be representative of other companies, and we collected information from their management and audit committee chairs on tax services, including tax shelter services, the eight companies obtained. We chose companies that were geographically diverse and whose audit committee chair had not been recently contacted for other GAO studies.

We did our work between December 2003 and January 2005 in accordance with generally accepted government auditing standards. A later section of this report contains a complete discussion of our scope and methodology.

Background

Both SEC and IRS have had an interest in the tax services, particularly tax shelter services, that accounting firms provide taxpayers. In terms of SEC, according to the Sarbanes-Oxley Act of 2002,[6] before an SEC registrant company's auditor can provide non-audit services such as tax services to the company, the company's audit committee must approve them. Effective May 6, 2003, SEC adopted rules required by the act to strengthen conflict of interest standards and clarify the relationship between the independent auditor and the audit committee.

In adopting these rules, SEC said it was enhancing the independence of accountants that audited financial statements and prepared related reports to be filed with SEC. It also said that accounting firms could provide tax services to their audit clients, subject to each client's audit committee pre-approval, without impairing their independence. However, accountants would impair their independence if they represented audit clients before a tax or district court or a federal court of claims. Further, according to the rules, audit committees should carefully scrutinize an accountant's involvement in a transaction if the accountant initially recommended the transaction, the transaction's sole business purpose might be tax avoidance, and its tax treatment might not be supported in the Internal Revenue Code and related regulations.

The Sarbanes-Oxley Act established the Public Company Accounting Oversight Board (PCAOB) and authorized it to establish standards and rules for auditor independence. In exercising its responsibilities under the act, PCAOB determined it was appropriate to consider the impact on auditor independence of providing tax services to audit clients. In July 2004, it convened a roundtable discussion on the effect of tax services provided by auditors on auditor independence. Participants at the roundtable, including representatives of accounting firms, public companies, investors, and regulators, discussed many different topics, with suggestions including more PCAOB guidance to audit committees and a rule barring auditors from providing at least some tax services to audit clients.

[6]Pub. L. No. 107-204, July 30, 2002.

On December 14, 2004, PCAOB proposed new ethics and independence rules, with comments due by February 14, 2005, and an effective date of no earlier than October 20, 2005. The proposed rules would treat an accounting firm registered with PCAOB as not independent in certain instances for purposes of doing a financial statement audit and for other purposes. For example, the firm would be considered not independent if it provided services related to planning or giving an opinion on the tax treatment of a listed (described later) or confidential transaction under Department of the Treasury regulations. Similarly, the firm would be considered not independent if it provided these services for a transaction that was based on an aggressive interpretation of the applicable tax laws and regulations. Such a transaction is one that satisfies three criteria: it was initially recommended by a tax advisor; it has tax avoidance as a significant purpose; and it "is not at least more likely than not to be allowed under; applicable tax laws."[7] The proposal would also treat the firm as not independent if the firm provided tax services to officers who oversee an audit client's financial reporting. It would not prohibit the audit firm from providing the audit client with routine tax return preparation and tax compliance, general tax planning and advice, international assignment tax services, and employee personal tax services. In addition, the proposal would expand on current SEC pre-approval requirements to require an auditor seeking audit committee pre-approval of tax services to give the committee certain information, discuss with the committee the services' potential effects on the firm's independence, and document the discussion's substance.

Treasury regulations address IRS's oversight of tax shelters. Under the regulations,[8] there are six categories of transactions for which investors must report, or disclose, the transactions into which they have entered, and promoters must maintain lists of investors who have entered into the transactions.

[7]Public Company Accounting Oversight Board, PCAOB Release No. 2004-015 (Washington, D.C.: Dec. 14, 2004.)

[8]Treas. Reg. Sec. 301.6112-1 and Treas. Reg. Sec. 1.6011-4.

At IRS, the Office of Tax Shelter Analysis (OTSA) maintains a database containing information on tax shelter investors and promoters, including accounting firms.[9] Created in February 2000 to centralize and coordinate IRS's response to abusive tax shelter activity nationwide, OTSA includes in its database the amount of potential federal tax loss estimated by the taxpayer or IRS to result from both listed and nonlisted transactions. These losses, which also represent benefits to the taxpayer, may or may not be disallowed by IRS upon further review of each transaction. IRS considers listed transactions, which must be reported on tax returns sent to IRS, to be abusive. The Joint Committee on Taxation has described listed transactions as having a tax avoidance purpose, with the tax benefits subject to disallowance under existing law.[10] For a transaction to be listed, IRS must issue a notice, regulation, or other form of published guidance informing taxpayers of the details of the transaction. In October 2004, IRS had 30 types of listed transactions, a number that had grown more quickly in recent years than earlier. Nonlisted transactions generally are transactions reportable to IRS that may have some characteristics of abusive shelters but are not, and may never be, listed. At times, IRS questions whether some nonlisted transactions should be moved into the category of listed transactions.

Results in Brief

According to available IRS data, for the period from 1998 through 2003, 61 Fortune 500 companies obtained tax shelter services from an accounting firm that was the company's external auditor for at least one year that the company received federal tax benefits from the shelter. These tax shelter transactions were generally reportable on tax returns sent to IRS. The estimated potential tax revenue loss to the federal government over many years for these auditor-promoted transactions used by the 61 companies was about $3.4 billion, with about $1.8 billion in categories IRS considered to be abusive. More companies—114–obtained tax shelter services from any accounting firm and received tax shelter benefits for any year in IRS's database, including the 61 companies that obtained auditor-related services. By comparison, a total of 207 Fortune 500 companies obtained

[9]According to an IRS official and IRS Form 8886, the database includes as a promoter a person, including an entity such as an accounting firm, that received a fee with regard to a transaction if that person promoted, solicited, or recommended a taxpayer's participation in the transaction, or provided tax advice related to the transaction.

[10]Joint Committee on Taxation, *Background and Present Law Relating to Tax Shelters*, JCX-19-02 (Washington, D.C.: Mar. 19, 2002).

tax shelter services from any type of firm that provided these services—including the 114 companies that obtained services from accounting firms. The estimated potential tax revenue loss to the federal government over many years for these 207 companies was about $56 billion, about 44 percent of it related to tax years 1998 through 2003. The revenue loss estimates are sometimes from the individual companies and sometimes from IRS. These numbers are imprecise because they have important limitations. These limitations, such as some transactions in IRS's database without tax shelter providers listed, are fully discussed in this report.

In 17 of the Fortune 500 companies for which we had data on company officers and directors, at least one officer or director used the company's auditor to obtain individual tax shelter services for at least 1 year from 1998 through 2003. By comparison, officers and directors in more companies—33–used any accounting firm for tax shelter services. In a total of 57 companies, at least one officer or director obtained tax shelter services from any type of firm, including accounting firms and others, providing such services.

Representatives of all eight companies we studied in more depth said they adopted or refined policies or practices in 2002 or 2003 for pre-approving tax services or governing the tax services that could be provided, such as who would provide them. Examples of changes made include requiring that all engagements with the outside auditor be subject to approval by the company's audit committee and directing more work to other tax service providers. All eight companies reported using their auditor for some tax services during the period from 2000 through 2003. The services ranged from preparing or reviewing company tax returns to consulting on foreign tax transactions, and the companies told us that the specific services changed over time. Two of the eight companies we studied told us of obtaining tax shelter services from their auditor, but one of them obtained the services before 2000. The two companies were among three companies that said they did not have a current policy prohibiting obtaining tax shelter services. None of our eight case study participants reported officers or directors obtaining tax shelter services from the auditors, but six of the companies reported that at some time since 2000 their officers or directors obtained other tax services from the auditors. In four of these cases, officials said obtaining such services was later disallowed by the company.

Officials from four of the eight companies we studied said their companies paid auditors varying amounts for tax services for company officers and directors for 2001, and the other four paid nothing. Two companies indicated one paid about $8,000 and the other about $13,000 for these services. Two other companies did not provide specific amounts but reported paying more than $0 but less than or equal to $1 million, a category we used in collecting these data.

We are not making any recommendations in this report.

In written comments on a draft of this report, the Commissioner of Internal Revenue said it was comprehensive and provided an accurate picture of the factors affecting IRS's ability to have an accurate tax shelter database. He added that changes IRS was making and recent legislation will enable IRS to address the data limitations we note in our report.

Scope and Methodology

To address our first two objectives—relating to Fortune 500 companies, officers, and directors obtaining tax shelter services from their company auditors--we matched data from two sources—S&P and IRS. We acquired specific S&P data elements for the 497 companies on the April 2003 Fortune 500 list that, according to S&P, either were publicly owned or had to file with SEC for another reason, such as having publicly-traded debt. The data elements included the company's employer identification number, the names of company officers and directors, and the name of the company's auditor for each year from 1998 through 2003. The number of Fortune 500 companies for which we actually received S&P data varied; for instance, we received names of directors and officers for 471 companies and employer identification numbers for 492.

As shown in table 1, the officers for 441 of the 471 companies were those listed in the company's proxy statement section on most highly compensated officers, as filed with SEC for either 2000 or 2002. We used the years 2000 and 2002 because those were years when the federal government was significantly enhancing its presence to counter tax shelter activity that might have been going on for years. Because S&P did not have similar top officer information for the other companies in the Fortune 500, or 2000 or 2002 director information for any of them, it gave us the names reflecting current officers and directors as of March 2004—the date we obtained the data. Obviously, some of the March 2004 officers for 30 companies and the March 2004 directors for all 471 might have been different from those working in 2000 or 2002, which was closer to the time when most of the tax benefits related to the shelters were taken. Consequently, our analysis of the March 2004 information omits any officers and directors who left the relevant companies after 2002.

Table 1: Breakdown of the Dates Associated with Officers and Directors Who Were Listed in S&P Data for 471 Companies

Number of companies	Dates for officers	Dates for directors
441	2000 or 2002	March 2004
30	March 2004	March 2004

Source: Information GAO received from S&P.

We matched the S&P data to tax shelter information in IRS's OTSA database as of May 28, 2004. IRS's database included information disclosed to or discovered by IRS on companies, individuals, and other taxpayers who used tax shelters. It also included information on as many as three entities, including accounting firms, which IRS said promoted the shelter to the investor. We considered both listed and nonlisted transactions in the database because from an auditor independence standpoint, in both cases the promoters were involved with transactions that IRS or taxpayers believed needed to be reported to the federal government.

To determine to what extent the 497 companies obtained tax shelter services, we matched the employer identification numbers in the S&P and IRS databases. When we found a match, we checked the promoter information in the IRS database against the audit firm information in the S&P database to see if the same accounting firm was listed as a promoter for a particular transaction and as the company's auditor for one or more years that the shelter benefited the company. Although we do not know for sure that a company obtained tax shelter and auditing services from an accounting firm at exactly the same time, we considered it a match when at least one of the tax years for which the company received a tax benefit matched a fiscal year from 1998 through 2003 for which the accounting firm was the company's auditor. We did this because IRS did not have information on exactly when taxpayers obtained tax shelter services, and 1998 was the year before the Department of the Treasury reported that the proliferation of corporate tax shelters was unacceptable.[11] We analyzed information from other years to provide context.

We also matched the names of company officers and directors in the S&P data to the names of the tax shelter investors in the IRS database.

[11]Department of the Treasury, *The Problem of Corporate Tax Shelters* (Washington, D.C.: July 1999).

Whenever we found a match, we tried to verify if the same person was actually involved, as opposed to two people with the same first and last names. If the person appeared to be the same (for example, had the same middle initial), we matched the promoter name for that individual and, similar to what was just described, the tax benefit dates in the IRS database to the auditing firm of the individual's company for 1998 through 2003 in the S&P data. Our matching methodology did not allow us to detect instances in which a spouse or other relative of the officer or director was the tax shelter investor or instances in which the investing entity was a partnership or other unit formed by the officer or director.

As part of our work, we tested the reliability of IRS's database and the data we received from S&P. For the IRS database, we reviewed related documentation, interviewed knowledgeable officials, and did electronic testing. For the information received from S&P, we reviewed S&P information on its controls over the data and verified sample data to publicly available documents obtained from SEC's Web site or elsewhere. For both types of data, we found that the required data elements were sufficiently reliable for the purposes of our work. However, as we will describe later, the IRS database had important limitations and therefore our results are imprecise in reflecting the universe of companies, officers, and directors that might have obtained tax shelter services from the companies' auditors.

To deal with our last two objectives--those on case study companies obtaining tax shelter and other tax services from their auditor and funding these services for officers and directors--we selected publicly traded companies among the Fortune 500 to study in depth. Independent of any IRS information, we reviewed the April 2003 Fortune 500 list and chose companies that were headquartered in three geographically diverse parts of the country and whose audit committee chair worked or lived in one of those areas. We excluded companies whose audit committee chairs had been contacted in other recent GAO studies.[12] Of the 23 companies that met our criteria, 8 agreed to provide information in response to a structured interview guide we used. For 5 of these 8 companies, we interviewed the audit committee chair. For the other 3, we relied only on written answers

[12]GAO, *Public Accounting Firms: Mandated Study on Consolidation and Competition*, GAO-03-864 (Washington, D.C.: July 30, 2003) and GAO, *Public Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation*, GAO-04-216 (Washington, D.C.: Nov. 21, 2003).

we received from the companies. Because we studied so few companies and because of the method of selection, we cannot say that the responses we received represent any larger group of companies. Further, the companies that we did study might have agreed to participate because they had special reasons for wanting to share their tax services experiences with us. Although they were not representative of change overall, we believe that the 8 companies illustrate some of the changes that have occurred in recent years related to auditors providing tax services.

We did our work between December 2003 and January 2005 in accordance with generally accepted government auditing standards.

According to Available but Limited Data, 61 Fortune 500 Companies Used Tax Shelters That Had Been Promoted by Their Auditor

As shown in table 2, 61 Fortune 500 companies used a tax shelter that was promoted by an accounting firm that was their external auditor for one or more years from 1998 through 2003 in which the company received benefits from the tax shelter. The 61 companies had 82 transactions worth about $3.4 billion in estimated potential tax losses over many years for transactions that were generally reportable on tax returns sent to IRS. They are out of 492 Fortune 500 companies for which S&P supplied employer identification numbers and for which we searched for a match in the May 28, 2004 version of IRS's tax shelter database.

Table 2: Types of Tax Shelters and Estimated Losses for 61 Fortune 500 Companies That Obtained Tax Shelter Services from Their Auditor for Tax Years 1998 through 2003[a]

	Number of tax shelter transactions by IRS category			Taxpayer or IRS estimates of potential tax loss (billions)[b]		
	Listed	Nonlisted	Total	Listed	Nonlisted	Total
Tax shelter transactions involving the company's auditor for 61 Fortune 500 companies	42	40	**82**	$1.8	$1.6	**$3.4**

Source: GAO analysis of IRS's May 28, 2004 OTSA database and S&P data.

[a]See text in the next subsection for a discussion of data limitations that may result in a misstatement of the number of companies obtaining tax shelter services from their auditors.

[b]The estimated potential tax loss covers a multiyear period and has important limitations, such as not considering reductions in IRS estimates that may result from examination, appeal, litigation, or other sources, and not including potential tax loss estimates for many transactions.

Table 3 puts this information into various contexts. For instance, including the 61 companies just described, 67 companies with about $4.1 billion in tax shelter benefits obtained tax shelter services from a firm that was their auditor sometime, but not necessarily in the same year the company received some or all the related tax shelter benefits. We include the 6 additional companies because some analysts have questioned the propriety of accounting firms promoting tax shelters even to companies they are not currently auditing. For example, recent press reports described a company that employed an accounting firm as its auditor sometime after the year for which the company claimed a tax shelter benefit from the shelter provided by the accounting firm. According to the reports, the auditor began auditing financial statement items resulting from the tax shelter that it had previously provided, a task the auditor said was within SEC rules.

Table 3: Types of Tax Shelters and Estimated Losses for Various Categories of Fortune 500 Companies Obtaining Tax Shelter Services[a]

	Number of tax shelter transactions by IRS category			Taxpayer or IRS estimates of potential tax loss (billions)[b]		
	Listed	Nonlisted	Total	Listed	Nonlisted	Total
Tax shelter transactions involving a firm that was the company's auditor at any time—67 Fortune 500 companies	55	45	**100**	$2.4	$1.7	**$4.1**
Tax shelter transactions with any accounting firm involvement—114 Fortune 500 companies	97	99	**196**	4.0	4.6	**8.6**
Tax shelter transactions with any accounting firm involvement—4,383 taxpayers, including individuals	4,311	761	**5,072**	12.3	11.4	**23.6**[c]
Tax shelter transactions of 207 Fortune 500 companies in the database	396	636	**1,032**	16.1	39.5	**55.6**
Tax shelter transactions of all 10,371 taxpayers, including individuals, in the database	12,261	2,779	**15,040**	43.0	85.9	**128.9**

Source: GAO analysis of IRS's May 28, 2004 OTSA database and S&P data.

[a]See text in the next subsection for a discussion of data limitations that may result in a misstatement of the number of companies obtaining tax shelter services.

[b]The estimated potential tax loss covers a multiyear period and has important limitations, such as not considering reductions in IRS estimates that may result from examination, appeal, litigation, or other sources, and not including potential tax loss estimates for many transactions.

[c]Total does not equal sum of components due to rounding.

For further context, table 3 shows that including the 67 companies, 114 Fortune 500 companies and almost 4,400 total taxpayers obtained tax shelter services from accounting firms, including firms they had not ever used as auditors but might one day. The estimated potential tax losses involved were about $9 billion for the 114 companies for any year in IRS's database and about $24 billion for all taxpayers.[13] Although we did not have enough information to know whether taxpayers obtained fewer tax shelter services from accounting firms as time went on, several accounting firms testified in November 2003 before the Permanent Subcommittee on Investigations of the Senate Committee on Governmental Affairs that they had scaled back their tax shelter activities in general.

Including the 114 companies, 207 Fortune 500 companies, regardless of who their promoters were, used tax shelters accounting for about $56 billion in estimated potential tax losses, about 44 percent of it related to tax years 1998 through 2003. To break out the $56 billion further, of the 492 Fortune 500 companies for whom S&P supplied employer identification numbers, 139 appeared in IRS's database to have engaged in listed transactions with estimated potential tax losses of about $16 billion. The number of companies engaged in nonlisted transactions estimated to be potentially worth about $40 billion was 129, and because some companies were involved in both kinds of transactions, the number engaged in either listed or nonlisted transactions was 207.

The 207 Fortune 500 companies' transactions are part of IRS's total tax shelter database. As of May 28, 2004, for all taxpayers, the database contained listed and nonlisted transactions with estimated potential tax losses of about $129 billion, about half of it related to tax years 1998 through 2003. Most of the dollar amounts related to nonlisted, as opposed to listed, transactions, and some of the amounts shown as listed might represent transactions that taxpayers entered into before IRS had designated them as listed. About a third of the approximately 15,000

[13]The tax losses estimated by taxpayers and IRS and contained in IRS's 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.

transactions in the database had an accounting firm listed as a promoter, and these transactions accounted for about 18 percent of the $129 billion estimated potential tax loss.

IRS Database Limitations

We and IRS know the numbers in this section are not precise. Some of the imprecision could make the count of transactions and associated estimated potential losses too high, and some could make them too low. Accordingly, the numbers should be used with caution and should be understood and used as general estimates of the degree to which companies might have obtained tax shelter services from external auditors and of the possible dollar magnitude of the associated tax benefits, and thus possible decreased federal revenues.

The numbers could be overestimates for the following reasons:

- The number of abusive transactions and their dollar amounts might have been or might still be reduced upon further examination, appeal, litigation, or other action.
- The database included some reported transactions that turned out to be nonabusive. Additional transactions might later be found to be nonabusive.
- According to an IRS official, the database included some tax shelter transactions more than once—at the level of a flow-through entity, such as a partnership, and again at the level of the taxpayers, for example, the individual partners—with the relevant dollar amounts thus appearing twice. This limitation would not apply to information dealing only with Fortune 500 companies' use of tax shelters.

The numbers could be underestimates for the following reasons:

- The IRS database did not include promoters for about a quarter of the transactions of the 207 Fortune 500 companies that used tax shelters. In these cases, the tax shelter might have been obtained using a promoter that the taxpayer did not identify to IRS, or, according to an IRS official, a very few taxpayers not working for firms designing tax shelters might have developed their own tax shelter. In total, the database did not include promoters for 2,095, or about 14 percent, of its transactions as of May 28, 2004.

- The database did not reflect estimated potential tax losses for about a third of the transactions of the Fortune 500 companies using an accounting firm to obtain tax shelters, or for about a quarter of the transactions of the total number of Fortune 500 companies obtaining tax shelters. According to an IRS official, this was because taxpayers did not include estimated losses on documents submitted to IRS. The official added that a possible reason for taxpayers not disclosing such information was that nondisclosure penalties did not yet exist.[14] The database did not reflect estimated potential tax losses for about two-thirds of the 15,040 total transactions it contained. These potential losses could range from small to large amounts; however, their distribution is unknown.

- In addition, as of May 28, 2004, IRS had not yet entered into the database all of the tax shelter information that it possessed even though the information included data pertaining to transactions done years ago.

- The database only included information on abusive or possibly abusive transactions that had been disclosed to or discovered by IRS, and as alluded to earlier, the number of listed transactions had continually grown from even before OTSA was established.

Adding to the uncertainty, the tax loss estimates in the database vary from being IRS officials' recommended taxes, based on examining some transactions, to taxpayer judgments regarding potential losses in cases where examinations had not been done. According to an IRS official, taxpayer-provided information may represent estimates or incomplete information.

Despite these data limitations, the numbers we present in this report provide a general indication of the extent to which Fortune 500 companies did use their external auditor for tax shelter services. In addition, they include larger numbers showing that many Fortune 500 and other taxpayers obtained tax shelter services using their own and other accounting firms, and many obtained tax shelters without using accounting firms at all.

[14] The American Jobs Creation Act of 2004, Pub. L. No. 108-357, Oct. 22, 2004, created such penalties.

According to Available but Limited Data, Officers or Directors Associated with 17 Fortune 500 Companies Used Tax Shelters That Had Been Promoted by the Company's Auditor

As shown in table 4, one or more officers or directors of 17 Fortune 500 companies used tax shelters that were promoted by an accounting firm that was the Fortune 500 company's external auditor during at least one of the years that the officer or director benefited from the tax shelter. The years in question were 1998 through 2003, and the potential tax loss from these transactions was about $100 million. The officers or directors are from 471 Fortune 500 companies for which we had data on officers or directors from S&P that we matched against data in the May 28, 2004 version of IRS's tax shelter database.

Table 4: Numbers of Tax Shelter Transactions and Estimated Losses for Various Categories of Fortune 500 Companies Whose Officers or Directors Obtained Tax Shelters[a]

	Number of tax shelter transactions	Taxpayer or IRS estimates of potential tax loss (billions)[b]
Tax shelter transactions of officers and directors involving the company's auditor—17 Fortune 500 companies	33	$0.1
Tax shelter transactions of officers and directors involving any accounting firm—33 Fortune 500 companies	53	0.3
All tax shelter transactions of officers and directors—57 Fortune 500 companies	87	1.0

Source: GAO analysis of IRS's May 28, 2004 OTSA database and S&P data.

[a]See the accompanying text for a discussion of data limitations that may result in a misstatement of the number of companies whose officers or directors obtained tax shelter services.

[b]The estimated potential tax loss covers a multiyear period and has important limitations, such as not considering reductions in IRS estimates that may result from examination, appeal, litigation, or other sources, and not including potential tax loss estimates for many transactions.

To place the officers and directors of the 17 companies into context, in 33 companies, a transaction of at least one officer or director had an accounting firm listed as a promoter,[15] and in 57 of them, at least one officer or director obtained a tax shelter regardless of whom he or she used as a

[15]The fact that the IRS database shows about 4,400 taxpayers obtaining tax shelter services from an accounting firm shows that many of the taxpayers using accounting firms for tax shelter work were neither Fortune 500 companies nor their officers or directors.

promoter. The number of officers and directors involved in even the 57 companies translated to less than one percent of the officers and directors of Fortune 500 companies that we matched against IRS's database.

These numbers relating to officers and directors of Fortune 500 companies are subject to the limitations described previously for the numbers related to the companies themselves. For example, IRS's database did not list promoters or estimated potential tax losses for every transaction. In addition, according to an IRS official, disclosures from individuals, partnerships, and S corporations, which were first due to IRS for filing year 2003, arrived in great numbers beginning in April 2004, and many were not yet entered into the IRS database as of May 28, 2004.

According to Their Representatives, All Case Study Companies Recently Changed How They Acquire Tax Services from Their Auditors

According to their representatives, all eight of our case study companies adopted or refined policies or practices in 2002 or 2003 requiring their audit committees to pre-approve tax services to be obtained or governing the tax services provided. At least some of these changes were in response to the Sarbanes-Oxley Act. Examples of changes made include requiring that all engagements with the external auditor be subject to approval and directing more work to other providers. As stated earlier, these companies are not representative of other companies because of their small number, the way we selected them, and their unknown motivation for participating with us. However, they do illustrate that the provision of tax services has changed in recent years for at least some companies.

According to company representatives, all eight case study companies obtained tax services from their auditors during the period from 2000 through 2003.[16] Services provided ranged from company to company, sometimes involving, for instance, tax return preparation, tax return review, advice on foreign tax transactions, or consultations on

[16]In 2003, a GAO report included information from which we calculated that 82 percent, or 130 of 159, respondents to an unprojected GAO survey of Fortune 1000 companies received tax-related services, such as tax preparation, from their auditor. See GAO, *Accounting Firm Consolidation: Selected Large Public Company Views on Audit Fees, Quality, Independence, and Choice*, GAO-03-1158 (Washington, D.C.: Sept. 30, 2003). Similarly, in 2004, Glass, Lewis & Co. included information from which we calculated that about 95 percent of the approximately 460 Fortune 500 companies it reviewed paid tax fees to their auditors in 2003. See Glass, Lewis & Co., LLC, *Auditor Fees: The Price of an Independent, Quality Audit* (2004).

negotiations. Only two of the companies told us of obtaining tax shelter services, and one of them obtained the services before 2000.

Company representatives told us about how specific services the company acquired changed over time. In fiscal year 2004, one company's audit committee rejected auditor involvement in a particular tax strategy out of concern that the auditor could potentially be in the position of auditing its own work. Another company told us of discontinuing an arrangement for obtaining certain tax services from its auditor because of the arrangement's undesirable appearance. A third company told us of transferring some tax services from its auditor to other providers in 2003 and 2004 because the audit committee began requiring a compelling reason to use its auditor for the services. In spite of these changes, in stating general impressions, six case study companies said that having their audit firm provide tax services brought efficiency and effectiveness gains due to the firm's understanding of the company and its business.

The two case study companies that obtained tax shelter services in the past were among the three companies of the eight that said they did not have a current policy prohibiting obtaining tax shelter services. However, one of the two companies said that it did not plan to obtain tax shelters in the future. According to both companies, IRS challenged the tax shelter claimed, and the issue had not yet been resolved.

Six of Eight Case Study Companies Said They Allowed Officers and Directors to Obtain Tax Services from the External Auditor, but Four Said They Then Stopped

Although six of our case study companies reported that officers or directors at some time since 2000 used the auditor for some tax services, such as tax return preparation, officials told us that four of the companies in 2002 or 2003 adopted policies prohibiting officers from using the auditor for the services in the future. One company cited auditor independence reasons for removing as of 2003 its requirement that a particular executive use the company's auditor. In contrast to the situation with tax services in general, none of the companies reported officers or directors obtaining tax shelter services from the company auditor.

Three companies we contacted said they did not have a policy prohibiting officers from obtaining tax services from the company auditor. However, even among those, one company knew of no officers who had actually used the auditor from 2000 onward for tax services. Another company allowed using the auditor but annually surveyed its senior officers about perceived or actual conflicts of interest. The third said its executives could use the auditor but had done so only in limited instances.

Case Study Companies Said They Paid Auditors Varying Amounts for Tax Services for Company Officers and Directors

For the year we asked about in which officers or directors were still using the company auditor for tax services—2001—two case study companies that paid for these services indicated one paid the auditor about $8,000 and the other about $13,000. Although two other companies reported paying for these services, they did not provide us with specific amounts. Both fell into the lowest non-zero choice of range we provided—greater than $0 but less than or equal to $1 million.[17] The other four of the eight companies we studied reported paying their auditors nothing in 2001 for tax services for officers or directors.[18]

In general and not restricted to 2001, five case study companies reported setting aside funds for, or annually paying for, tax services that officers or directors obtain from their auditors or others. In those cases, company figures varied from a range of $30,000 to $50,000 in one case to $150,000 in another.

Agency Comments

In written comments on a draft of this report, the Commissioner of Internal Revenue said it was comprehensive and provided an accurate picture of the factors affecting IRS's ability to have an accurate tax shelter database. He particularly pointed to indications in the draft report that not all the information in the database might relate to abusive tax avoidance transactions.

The Commissioner also said that IRS changes and recent legislation will enable IRS to address the database limitations we note, several of which IRS had already identified and was working to overcome. He added that IRS was creating a new database and exploring considering whether various IRS forms should be revised to improve the quality of information IRS receives. In addition, he noted that IRS supported the December 2004 PCAOB action to revise auditor ethics and independence rules.

[17] We used this broad a range in light of press reports showing fees of $1 million and more.

[18] 2001 was the last year for which publicly held companies did not have to report to SEC the amounts of tax fees paid to the company auditor for all tax services, including any for officers or directors. For fiscal years ending after December 15, 2003, companies for the first time had to publicly disclose these tax fees, and they had to do it for the last 2 fiscal years. According to these reported amounts, for five of the eight case study companies, 2003 tax fees were lower than 2002 tax fees. Reasons given to us for the decline in individual company tax fees included a large number of tax-related transactions in 2002 and the need to spend more money in 2002 to deal with an IRS audit and to use auditor software.

The full text of the Commissioner's comments is reprinted in appendix I.

As discussed with your staff, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of the report. At that time, we will send copies to the Chairmen and Ranking Minority Members of the Senate Committee on Finance and the House Committee on Ways and Means, the Commissioner of Internal Revenue, and other interested parties. The report will also be available at no charge on GAO's Web site at http://www.gao.gov.

If you or your staff have any questions about this report, please contact me at (202) 512-9110 or at brostekm@gao.gov or Signora May at (404) 679-1920 or at maysj1@gao.gov. Jeffrey Arkin, Lawrence Korb, MacDonald Phillips, Tina Smith, James Ungvarsky, and Walter Vance were key contributors to this report.

Sincerely yours,

Michael Brostek
Director, Tax Issues

Comments from the Internal Revenue Service

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

January 19, 2005

Mr. Michael Brostek
Director, Tax Issues
United States Government Accountability Office
Washington, D.C. 20548

Dear Mr. Brostek:

Thank you for giving us the opportunity to review and comment on your draft audit report titled, "Tax Shelters: Services Provided by External Auditors" (GAO-05-171). The report is comprehensive and although it does not contain any audit recommendations, it provides an accurate picture of the factors that have impacted the Internal Revenue Service's ability to accurately populate the Tax Shelter Database. We appreciate your efforts to fully describe the tax shelter information in this database and the fact that not all the information reported might relate to abusive tax avoidance transactions.

The Commissioner, Large and Mid-Size Business Division had already identified several of the limitations you describe in the report, and is working to develop and implement a plan to overcome them. This includes the creation of a new database underway that would allow faster and more accurate population of the database. It also includes recommendations for a number of revisions to Form 8886, Reportable Transaction Disclosure Statement; Form 8264, Application for Registration of a Tax Shelter; and Form 8271, Investor Reporting of Tax Shelter Registration Number, to refine and enhance the quality of the information we currently receive. These changes together with the new tax shelter provisions of the American Jobs Creation Act of 2004 will enable us to address the limitations you noted in your report.

If you have any questions, please call me or Kathy Petronchak, Director of Pre-Filing and Technical Guidance within the LMSB Division at (202) 283-8463.

Sincerely,

Mark

Mark W. Everson

Mike - We support the December 2004 action of PCAOB on this problem! Mark

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