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Skeptical Hearing for Audit Firm

By DAVID CAY JOHNSTON

WASHINGTON, Nov. 18 - Senior partners of the KPMG accounting firm told a Senate panel on Tuesday that the firm no longer sells aggressive tax shelters, but their answers to questions failed to persuade Senator Carl Levin, who during three hours of questioning wondered aloud whether he would "ever get an honest answer" from the firm.

KPMG and others often charged multimillion-dollar fees for shelters but risked penalties of no more than $10,000 if the Internal Revenue Service uncovered them and determined they were illegal. Senator Norm Coleman, the Minnesota Republican who is chairman of the panel, the Senate Permanent Subcommittee on Investigations, said that "ethical standards of the legal and accounting profession have been pushed, prodded, bent and, in some cases, broken, for enormous monetary gain."

KPMG collected $124 million in fees from 1997 through 2001 for shelters that cost the government at least $1.4 billion in lost revenue, a report by the subcommittee's minority staff members estimated.

Mr. Coleman and Mr. Levin appeared to accept at face value testimony by two large accounting firms, PricewaterhouseCoopers and Ernst & Young, that they had gotten out of the tax shelter business and regretted their involvement.

But KPMG's assertions that it has changed its culture and stopped selling aggressive tax shelters were met with skepticism by both senators.

Mark Watson, a former KPMG technical tax advice partner, repeatedly wrote e-mail messages denouncing several tax shelters as improper, only to be rebuffed by those above him. One e-mail message in 1999 said KPMG used "stealth reporting" on tax returns to deceive the I.R.S. while another warned that "we are filing misleading, and perhaps false" tax returns for clients.

Jeffrey Eischied, a supervising partner in the tax shelter unit who received the e-mail messages, was asked why KPMG sold products whose sole purpose was to avoid taxes, which makes them invalid.

"I certainly viewed them as investment strategies that" also had tax avoidance properties, Mr. Eischied said, describing the legal standard for a lawful tax shelter.

Mr. Levin, Democrat of Michigan, read from a series of documents that mentioned only tax avoidance, including a memorandum from the Swiss bank UBS that said "the principal design of this scheme is to generate significant capital losses for U.S. taxpayers" so they can earn capital gains tax free. Other documents called any chance of profit "remote" and contingent on earning a 240 percent return in a few months.

Mr. Eischied said he was not responsible for various documents, including a long written presentation by a "champion" seller of KPMG tax shelters titled "generating capital losses."

Mr. Levin then showed Mr. Eischied e-mail messages he had written. One said a KPMG tax shelter was "designed to mitigate an individual's income" and gift and estate taxes. Mr. Eischied also tried to disavow that document.

"Did you write 'designed,' yes or no?" Mr. Levin asked after trying other versions of the question.

"As I previously testified, that is one of the attributes" of the tax shelter products, Mr. Eischied replied, the stress in his voice growing with each answer along with the time he took before answering.

"Do you see anything about investment attributes in your memo?" Mr. Levin asked, adding that "you can't blame this" e-mail message on anyone else. Mr. Eischied then suggested that the senator was reading his memo "somewhat out of context."

Mr. Levin rephrased his question, pressing for an admission that KPMG based its fees on taxes avoided and not investment returns.

The large Senate hearing room fell silent. Finally, Mr. Eischied volunteered that he had not answered immediately because "I don't know how to change my answer."

Mr. Levin suggested that the partner "try an honest answer."

The senator continued to press for admissions and Mr. Eischied testified in various ways that "I don't believe we looked at our fee" as a share of taxes saved.

Another witness, Prof. Calvin Johnson of the University of Texas law school, said that "tax shelters have done real damage to the tax system" and allowed many taxpayers who should pay income taxes of 35 percent to pay 10 percent.

"There is an awful lot of money to be made beating the I.R.S., which is increasingly perceived as a paper tiger," Professor Johnson said. He said the accounting firms "realize the degree of righteous anger of investors" over both tax shelters and manipulated financial statements at some publicly traded companies.

He warned that failure to protect the tax base from predators in the accounting, legal and banking industries could mean the end of the United States. "The tax base is sacred," he said. "Countries decline and disappear when they lose their tax base."

Professor Johnson called for Congress to break up the accounting firms into separate businesses, one to audit companies and another to sell other services and products. "This selling of sleazy tax shelters is utterly irreconcilable with their cop function" as auditors, he said.

The day's final witness, KPMG's vice chairman for tax services, Richard H. Smith Jr., testified that when he took his post in April 2002, he shut down KPMG's two major tax shelter units. Mr. Levin then produced documents that cast doubt on this, including KPMG's own organization chart issued months later. After parrying with Mr. Levin, Mr. Smith said KPMG had not given the committee the most recent documents.

Mr. Levin did extract one acknowledgment from Mr. Smith. It appeared to contradict the company's position in civil suits brought by clients whose tax shelters were demolished by the I.R.S., to whom KPMG has insisted that it never sold anything but advice.

After Mr. Levin asked the question at least six different ways, Mr. Smith admitted that KPMG had sold tax products, as shelters are known in the industry.

The admission came after Mr. Smith was given a stack of paper that was withheld from the public record because KPMG said its contents were proprietary.

Mr. Smith later described them as "a list of ideas" for clients. Mr. Levin's aides said those ideas were the 500 tax products that KPMG continued to sell.