The New York Times
nytimes.com

October 22, 2003

Wide Range of Tax Shelters Draws Senate Inquiry

By DAVID CAY JOHNSTON

WASHINGTON, Oct. 21 — Major companies have leased parts of the subway systems in Washington, Boston and Chicago, to be joined soon by water mains in New York City, in deals intended to cut the companies' tax bills and to get around rules prohibiting abusive tax shelters, said a witness at a Senate Finance Committee hearing on Tuesday.

Big American corporations are also receiving tax breaks for leasing public assets in Canada and much of Europe in similarly circumspect deals, said the witness, a leasing industry executive who testified behind a screen to conceal his identity.

Using the pseudonym Mr. Janet, the witness said the deals were a sham and bad for the economy because they reduced federal and state corporate tax revenues by far more than the money they generated for local governments.

Although the new deals were described as improper, no current law or Treasury rule specifically prohibits them. In return for a sizable payment to what is often a cash-pinched local government, the company usually can depreciate the asset sharply, generating a big tax break. By including a service component in the contract, for maintaining the subway lines or the water system, the deal falls outside rules adopted several years ago by the Treasury Department to prevent abusive tax shelters.

The leasing executive was especially critical of recent deals across borders, in which an American company is supposed to operate a subway, water or other municipal service paid for by taxpayers in another country.

"I fail to see how the U.S. economy is stimulated by giving U.S. tax deductions for assets built by the French, funded by the French and used by the French," Mr. Janet said, his voice electronically altered to reduce the risk he would be identified and then sued by former co-workers.

He cited a deal in which Bank of America paid $25 million to be able to deduct much of the value of Canada's air traffic control system on its tax return. A spokeswoman for the bank, Eloise Hale, confirmed that such a deal existed, though she declined to discuss its terms. "We believe this transaction was appropriate under the Internal Revenue Code," she said.

The wide-ranging hearing was called to consider new curbs on tax shelters, an effort that has been stalled in Congress for two years. For three hours, witnesses described tax avoidance plans sold by the major accounting firms and bought by the biggest

companies with no fear that the I.R.S. would uncover the deals or impose a meaningful penalty.

The former tax officials of Levi Strauss, the jeans company, and the accounting firm KPMG said they were fired or disciplined for objecting to what they considered illegal conduct. The former employee of KPMG, Michael Hamersley, said his superiors openly expressed disregard for the law.

After the testimony, a spokesman for KPMG, George Ledwith, said that Mr. Hamersley was in no position to make the observations.

In a statement, he said that Mr. Hamersley, who worked in mergers and acquisitions, was "simply not qualified to reach the purely personal opinions he espouses about alleged improper or so-called 'abusive' activity. His conclusions are simply wrong."

Another person cited problems at Ernst & Young. Henry Camferdam, an Indianapolis executive whose company was a client of Ernst & Young, said he paid $7 million in fees for what turned out to be a fraudulent tax shelter. He said he bought it only because Ernst & Young described it as not just legal, but conservative. "Ernst & Young had always been to us the people who said no, so we had complete trust and faith in them," he said.

Senator Charles Grassley, the Iowa Republican who is chairman of the committee, characterized tax abuses as widespread. A report by the General Accounting Office, released at the hearing, said that as of Sept. 30 abusive tax shelters had cost the government $85 billion, roughly $2 billion less than the amount that President Bush persuaded Congress to appropriate for the occupation and reconstruction of Iraq.

The G.A.O. report criticized the I.R.S. for lacking goals and a plan to measure its success in combating abusive tax shelters.

The major accounting firms have suffered a complete ethical collapse, said William J. McDonough, chairman of the new Public Company Accounting Oversight Board, created by Congress after corporate scandals at Enron and other companies. He said he found the willingness to sell faulty tax shelters and hide them from I.R.S. auditors "immensely and immorally repugnant" and warned that his board has told the firms they must change or face dire consequences.

"If they do not save themselves," Mr. McDonough said, "we will save them and it will not be pleasant."

The testimony by the unidentified leasing executive called Mr. Janet drew criticism from leasing industry experts who attended the hearing. They said that his testimony referred to garden-variety deals.

Local officials in New York, Washington and Chicago all said in interviews on Tuesday that their lease deals were routine. The transit deals were done with the express approval of the federal Department of Transportation, they said.

William A. Macan IV, a leasing specialist with Allen & Overy in New York, who attended the hearing, said that “these deals use tried-and-true principles of tax law going back at least for the 34 years I have been in this.”

“I was highly offended at the treatment by witnesses and senators of those who do these transactions as liars and cheats,” Mr. Macan added.

Michael J. Fleming, president of the Equipment Leasing Association in Arlington, Va., a trade group for leasing companies, also said the leasing deals were well established in law.

Lee Sheppard, a tax critic, countered that there is a big difference between traditional leasing deals and the latest ones.

“In a traditional lease a city needs something like a rail car and it needs financing to buy it,” said Ms. Sheppard, a lawyer who writes for the magazine *Tax Notes*. “That’s a normal deal.

“But these are deals where the public agency already owns something and they’re using it fine. The city just wants to collect a fee,” she said. “So they make a lease deal with a service contract” that is intended to get around the Treasury rules banning leasing deals that are made purely for tax benefits. She characterized these new deals, sometimes called service leases, as shams in which “nothing happens” except divvying up bogus tax deductions.

The service provision obligates the company to operate the leased property eventually, something Ms. Sheppard said did not happen. That requirement is used by the company to justify accelerated depreciation of the asset, which means a big immediate tax break.

She and others said they had been unable to find out just how the tax breaks were split between the corporation and the municipality collecting the fee, but several people interviewed said they suspected the corporations received more than 90 percent of the benefits.

The hearing also exposed a split between Republicans and Democrats on how to enforce the law. Senator Grassley focused entirely on giving the I.R.S. better tools and said nothing about its work force of auditors and other experts. He has said previously that he was concerned with how the I.R.S. uses its enforcement resources.

Some witnesses, and Democratic senators, said the new tools were not enough. Several witnesses said the I.R.S. was so short of auditors that neither accounting firms nor big businesses feared it.

The I.R.S. also hunts for small-scale tax cheating while ignoring others because many auditors lack sophisticated financial skills, said Robert V. Lally of Federman, Lally and Remis, an accounting firm in Farmington, Conn.

In 27 years of representing taxpayers, Mr. Lally said, he had never been asked by an I.R.S. auditor about such issues as abusive leases. Auditors, he said, focus most of their questions on two kinds of business deductions: lunches and cars.

Copyright 2003 *The New York Times Company*