WRITTEN TESTIMONY OF MICHAEL HAMERSLEY
THE UNITED STATES SENATE FINANCE COMMITTEE
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I. INTRODUCTION

Good morning Senators. My name is Mike Hamersley. I earned my J.D. degree from Georgetown University Law Center in 1995. I also received M.B.A. and B.B.A. degrees prior to attending law school. My career at KPMG began in 1998 when I joined the Mergers and Acquisitions Group of KPMG's Washington National Tax office ("WNT"). I relocated to KPMG's downtown Los Angeles office in March 2000.

I noticed that I am listed in the program as a former employee of KPMG, LLP ("KPMG"). It seems that there are quite a few folks who are confused about my employment status. Well, let me see if I can be of some assistance. KPMG insists that I am not a former employee and that I remain employed as a Senior Manager in their Los Angeles Mergers and Acquisitions Tax Practice.[1] The confusion regarding my employment status is understandable. I do still receive a paycheck; however, I am not permitted to use the office, voicemail, email, computer network, or any other KPMG resources.

My performance ratings were "exceptional" throughout my tenure in Los Angeles and I was nominated for promotion to partner in 2002. However, in October 2002, after refusing to endorse or participate in what I believed to be illegal conduct and very soon after acknowledging that I had communicated with federal investigators, I was placed on

[1]KPMG is a "Big 4" public accounting firm. It's principal practices are Audit and Tax. The Audit practice offers advisory and assurance services to large and midsized businesses. The Tax practice offers a variety of federal, state, and other tax services to businesses (including Audit clients) and certain high wealth individuals.

administrative leave of absence. As a result of these events and upon learning that certain KPMG partners had maliciously disseminated false statements about me in an effort to discredit me, I filed a lawsuit against KPMG and certain of its partners. [2]

Perhaps, most confusing of all, is the fact that after more than one year from the time I was placed on leave, KPMG still has not provided me with a clearly articulated reason as to exactly why it is that I was placed on such leave. KPMG has made vague reference to at least three possible explanations, however, each one has been less credible than the last.

In my lawsuit, I described the coercive tax shelter environment that I observed at KPMG. I also briefly described some of the most significant problems that resulted from this environment. The circumstances that gave rise to my whistleblowing and which prompted KPMG to place me on administrative leave involved my participation in the tax provision review of a KPMG audit. The events described in my lawsuit illustrate one of the most significant and harmful "collateral problems" that arise in connection with the promotion of abusive corporate tax shelters by public accounting firm, which is violations of SEC auditor independence rules.

I. SCOPE OF TESTIMONY

The topic of corporate tax shelters involves myriad and complex issues. In my testimony here today, I will first provide a brief overview of what I believe to be the most significant and serious problems associated with the promotion of abusive tax shelters[3] I will then discuss a few of the more significant "collateral problems" that can arise in

[2] The complaint was filed in Los Angeles Superior Court (Case No. BC 297209) on June 23, 2003. The complaint was republished in its entirety by Tax Analysts in Tax Notes Today (Doc. 2003-14368).
[3] Although my testimony addresses only federal income tax strategies, similar issues exist with respect to the promotion of state tax shelters.

connection with the promotion of abusive corporate tax shelters by public accounting firms.

II. DISCUSSION

A. Identification of Some Concerns Associated With Abusive Tax Shelters

As a Senior Manager in KPMG's Los Angeles Mergers and Acquisitions Tax Practice, I provided transactional planning advice and review with respect to the federal income tax consequences of mergers, acquisitions, dispositions, and corporate restructurings. Although I did not promote abusive tax shelters, I was often contacted by KPMG Tax partners seeking advice on corporate tax shelters that were being promoted to their clients. I also worked in close geographic proximity to many of KPMG's most prolific tax shelter promoters. As a result, I witnessed a host of abusive tax shelter practices during my tenure in Los Angeles.

1. Abusive Tax Shelters in General

Most tax shelters involve some contortion of the law. Tax shelter promoters often misrepresent even gross contortions of the law as a "loopholes" when, in fact, a reasonably thorough and intellectually honest evaluation of most such "plays" generally yields a conclusion that Congress clearly never intended the tax benefits purported to be derived from the tax shelter.

The problem of clever tax professionals twisting the law beyond its intended bounds has long existed. Congress, the courts, and the Internal Revenue Service ("IRS") are well equipped to challenge tax shelters that lack technical merit so long as the IRS can timely

identify these shelters and alert prospective tax shelter purchasers to their technical deficiencies and associated risk.

Under the circumstances, it is my opinion that the IRS has done a good job of identifying specific tax shelters and alerting the public regarding their lack of technical merit and risk. This is a good start. However, the most abusive tax shelters of recent years require more than a distortion of the law to be viable. These abusive tax shelters also require a distortion or concealment of facts. They require not only intellectual dishonesty, but also deception, secrecy, and even conspiracy. The reason for such fact distortion or concealment is simple—the promoters know that these transactions could never survive the light of day in court. Such distortion and concealment of facts often occurs both in the design and implementation of the abusive tax shelter (e.g., passthrough entities to mask transaction or facts, side agreements to report different facts for different purposes, abuse of privilege by using attorneys as conduits to facilitate fact concealment, providing false representations about business purpose, step transaction facts, etc.) and in any subsequent IRS administrative controversy actions.

Reasonable minds will differ regarding who, what, and how much should be taxed under existing tax law. However, modifications to existing substantive law made by Congress or Treasury aimed at preventing such contortions of the law will have no real or lasting impact on the incidence or severity of the current tax shelter abuses so long as unscrupulous tax shelter promoters and taxpayers are able to distort and conceal the facts of their transactions. The IRS can hardly be expected to hit what it cannot see.

Any approach to combating abusive tax shelters must strive to prevent "throwing the baby out with the bath water" by unduly punishing legitimate business transactions. The

abusive tax shelters described herein are not merely clever tax planning, nor are they creative solutions for maximizing the tax efficiency of alternative business transactions. These are transactions designed and consummated solely to obtain a tax result. The abusive tax shelters referred to herein are merely "window dressed" with a contrived façade of economic substance that is engineered into the tax shelter by the tax shelter promoters. In such cases, the tax shelter promoters are well aware that many of the facts and representations contained in the associated tax opinion letter (e.g., business purpose and step-transaction facts) are false.

A deliberate distortion of the tax law by a tax practitioner is surely unethical and unprofessional, but it rarely rises to the level of criminal behavior, and such intent is not easily proven. In contrast, a deliberate distortion of fact by a tax practitioner or taxpayer can often constitute criminal conduct. The promoters who engage in such behavior demonstrate an utter disrespect for the law, and those who make and enforce it.

Congress and the IRS must work to shift the risk/reward ratio to create a deterrent for this fact contortion and concealment behavior. Increased enforcement efforts must be focused at preventing this conduct in order to regain respect for the tax system by increasing the probability of a meaningful and proportionate punishment for those who so brazenly flout the law. This needs to happen soon, otherwise, there is a risk that this blatant noncompliance could become epidemic in scope and long-term in duration.

2. Specific Practices Associated With Abusive Tax Shelters

During my tenure at KPMG, I have observed several disturbing practices and workplace conditions with respect to the promotion of abusive tax shelters, including but not limited to:

- Tax professionals ignoring unfavorable facts and law, inventing facts, and subtly shifting the responsibility for these false facts to tax shelter clients via the facts and representations included in the tax opinion letters associated with tax shelters (i.e., opinion letters based on hypothetical facts).

- Tax professionals attempting to conceal form the IRS the existence of a transaction or discovery of unfavorable facts and circumstances associated with tax shelters. This conduct occurred both in the design and implementation of the tax shelters (e.g., side agreements, multi-tier "netting" structures, abuse of attorney/client privilege) and in subsequent IRS controversy matters (e.g., entering into IRS closing agreements without disclosing the existence of a listed transaction in the closed year). Tax shelters having a design or implementation intended to conceal unfavorable facts were often referred to and promoted by certain KPMG tax shelter partners as having "good optics."

- Tax shelter promoters engaging in conduct that demonstrates a blatant disregard for tax laws and those who write and enforce these laws. Many of these tax shelter promoters openly proclaimed their disregard for the law by making statements to clients and colleagues such "It's like stealing candy from a baby . . ."You'll never pay tax again . . . Our clients do not pay federal income tax, paying tax is optional." In recent years, some tax shelter promoters have trivialized the risks associated with tax promotion of abusive tax shelters making statements to the effect of (i) the IRS will never discover the tax shelter because it does not have the resources or ability to so, (ii) even if the IRS does discover the tax shelter, the law will likely only be changed and enforced prospectively thus the penalties will be minimal, and (iii) all public

accounting firms are selling these tax shelters and the government cannot shut down all of these firm.

- Tax shelter promoters misleading or otherwise inadequately informing tax shelter clients regarding the legal merits and true risks associated with these tax shelters, including the nature of the taxpayer representations provided and the limited scope of protection provided by KPMG's tax opinion letters.
- Tax professionals failing to inform tax shelter clients upon discovery of fatal flaws in tax shelters, particularly where such clients were KPMG audit clients and had already included the benefit of such tax shelters on their financial statements.
- Tax professionals promoting or enabling tax shelter clients to obtain insurance policies to cover tax liabilities associated with abusive tax shelters statements.
- Tax professionals engaging in highly questionable billing practices.

3. Abusive Tax Shelter Environment at KPMG

A culture existed in which intimidation and coercion were often used to foster the abusive tax shelter environment. Tax professionals who "played the game" and fully embraced the promotion of abusive tax shelters were rewarded handsomely. However, those who were vocal in raising concerns about abusive tax shelters were stifled and reprimanded and their opportunities for advancement were limited. Many of the tax professionals who expressed concerns regarding abusive tax shelters were instructed by Tax partners not to worry because they were merely following orders and had not signed-off on or approved the abusive tax shelters. These individuals were assured that they could not be held accountable under such circumstances.

My decision to "blow the whistle" was an easy one. I was placed in a position of having no other choice but to participate in the unlawful conduct and bear the associated risk. For most of my career at KPMG, I, like many other tax professionals who occasionally vocalized concerns about KPMG's tax shelter activity, chose to avoid direct involvement in unlawful activity and refrained from blowing the whistle in fear that it would bring my career to a screeching halt.

Despite the recent adoption of a whistleblower hotline and the new whistleblower protections provided under Sarbanes-Oxley, KPMG employees who might otherwise contemplate blowing the whistle will continue to remain silent because they know such action will require them to sacrifice their career without having any adequate legal recourse. They also fear that KPMG might attempt to sue them if they disclose information about KPMG's unlawful acts. KPMG has in place a number of measures that have been effective in preventing employees and others from disclosing unlawful conduct on the part of KPMG. Such measures include the use of confidentiality agreements, mandatory arbitration agreements, blackballing of whistleblowers, intimidation and legal maneuvers to stifle meritorious claims, sealing of court documents, and the like.

Indeed, it appears that KPMG has taken the position that the filing of my lawsuit is a breach of their confidentiality agreements. Given this view, KPMG may very well argue that my appearance before this Committee today is prohibited by KPMG's confidentiality agreements which purport to prevent me from talking to anyone--including Congress and regulators--about anything I learned on the job, including unlawful conduct.

B. Collateral Problems and Concerns Associated with the Promotion of Corporate Tax Shelters by Public Accounting Firms

1. Identification of Some Collateral Problems

The promotion of abusive corporate tax shelters by public accounting firms can have highly detrimental ramifications beyond the obvious drain on federal tax revenues. Some of the collateral problems raised by the promotion or other involvement in corporate tax shelters by public accounting companies include:

- SEC auditor independence issues that can result from a lack of objectivity on the part of the audit firm or the Tax partners performing the tax provision review of an audit.

  Generally speaking, in order for a publicly traded corporation to include in its financial statements the benefit derived from a tax shelter, it must be "probable" that the tax shelter will succeed on its merits.[4] There is great potential for auditor independence violations if the audit client has implemented one or more corporate tax shelters[5]and (1) any such corporate tax shelters were developed, promoted, or participated in by the audit firm or any of its partners, or (2) the audit firm or any of its partners promoted or otherwise participated in the same or substantially similar tax shelter.

[4] This "probable" standard generally requires that the tax benefits have a greater than 50 percent chance of success on the merits (i.e., more likely than not). See FAS 109. With respect to "tax exposure items" including tax shelter transactions, a 70 percent or greater chance of success on the merits (i.e., "should" level of certainty) is required to fully benefit such item.

[5] This conflict is not limited to tax shelters. Similar auditor independence concerns exist for other financial statement improvement strategy or other consulting services that result in financial statement benefit for the audit client if the audit firm or any of its partners participated in the promotion of that strategy or similar strategies implemented by other corporations.

The potential for such conflicts is heightened if any of the Tax partners working on the tax provision review portion of the audit engaged in such corporate tax shelter activity

- Breach of fiduciary duty to audit clients in circumstances where there is a failure to fully disclose and take proper corrective measures when defects or implementation problems are discovered with KPMG abusive corporate tax shelters after consummation of the transaction and after the KPMG audit client has been advised by KPMG that the benefit associated with the tax shelter could be included on its financial statement benefit.[6]

- Conflicts of interest issues arising when a public accounting firm conducts acquisition due diligence of a target corporation that has implemented one or more tax shelters or other financial statement improvement strategies promoted by the firm conducting the due diligence.

- Unanticipated liabilities or other negative consequences resulting from implementation of tax shelter transactions without adequate diligence to determine the impact of the transaction in other jurisdictions, for other regulatory purposes, or under applicable non-tax law.

- Disparate reporting of facts for purposes other than federal income taxes or in other jurisdictions (e.g., financial statements, non-tax regulators, state and foreign

[6] This can obviously lead to auditor independence and other securities law violations. Discovery and full disclosure of a "fatal flaw" in a tax shelter would almost certainly result in the client incurring a significant tax liability. If the audit client fully benefited the item on its financial statements, correction of this problem would often require a restatement. Disclosure of the true circumstances of such matters would likely result in KPMG being sued for malpractice and losing the client. Compare FAS 109 and FAS 5 standards for addressing tax benefits after already included in financial statements.

tax regulators.). This practice is often facilitated through the use of side agreements and some less sophisticated means. Such disparate reporting of facts is often mischaracterized by tax shelter promoters as being solely attributable to a difference in focus by the relevant jurisdictions or regulators with respect to the substance versus the form of the transaction.

C. Auditor independence issues described in my lawsuit

Generally Accepted Audit Standards (GAAS) and SEC auditor independence rules under Regulation S-X, Rule 2-01 require public company auditors to maintain independence and exercise professional due care and skepticism. SEC rules require that auditors of public companies maintain independence *in fact* and *in appearance*. These rules specifically state that the placing of an auditor in a position of auditing his own work or situations which place the auditor in a position of advocating for the client are both indicia of an inappropriate conflict of interest and lack of auditor independence.

The auditor independence matters described in my lawsuit illustrate the conflicts of interest that can arise when the audit client has implemented corporate tax shelters and there are tax professionals involved on the audit team who have been regularly involved in corporate tax shelter activities. As described in the lawsuit in further detail, some of the facts giving rise to such conflicts of interest included:

- KPMG audit approach was focused on looking for opportunities (to sell tax consulting services), not on finding problems. During the course of the audit, many of the KPMG Tax partners charged with auditing the tax provision regularly discussed, and were often primarily focused on, selling KPMG tax shelters and other tax services. These individuals were often wearing their tax consulting uniforms

while playing on the audit team. They were seeking to develop a relationship with management so as to enable the sale of tax shelters and other value-added tax services.

- Several of the KPMG Tax partners involved in the audit had developed, promoted, or implemented the same or substantially identical corporate tax shelters or other financial statement improvement strategies for other KPMG clients, many of which had also included financial statement benefit approved by KPMG.

- As a result of their desire to win over the audit client management, certain KPMG Tax partners involved on the audit exercised excessive advocacy, lack of objectivity, and professional due care and skepticism, and other improper conduct. These partners often relied on management representations and demonstrated an absolute unwillingness to objectively probe highly questionable transactions refusing to inquire further when client answers on significant matters did not make sense or were clearly inadequate or incomplete.

- Fearing that KPMG might be fired by the client, KPMG Tax partners rapidly reversed their position and permitted the audit client management to include a several hundred million dollar tax benefit while these partners intentionally ignored highly unfavorable facts and law directly on point and failed to conduct any significant research on the most problematic points. Certain KPMG Tax partners subsequently requested that I remove from my audit work papers any negative authority and that I draft a "persuasive brief" supporting KPMG's favorable conclusion.