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*Norm Coleman, Chairman*

*Carl Levin, Ranking Minority Member*

**U.S. TAX SHELTER INDUSTRY:  
THE ROLE OF ACCOUNTANTS,  
LAWYERS, AND FINANCIAL PROFESSIONALS**

**FOUR KPMG CASE STUDIES:  
FLIP, OPIS, BLIPS, AND SC2**

**REPORT**

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**OF THE**

**PERMANENT SUBCOMMITTEE ON  
INVESTIGATIONS**



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# TABLE OF CONTENTS

|   |     |
|---|-----|
| <b>I. INTRODUCTION</b> .....  | 1   |
| <b>II. FINDINGS</b> .....   | 4   |
| <b>III. EXECUTIVE SUMMARY</b> .....   | 5   |
| A. Developing New Tax Products .....  | 7   |
| B. Mass Marketing Tax Products .....  | 8   |
| C. Implementing Tax Products .....  | 9   |
| D. Avoiding Detection .....   | 13  |
| E. Disregarding Professional Ethics .....   | 15  |
| <b>IV. RECOMMENDATIONS</b> .....  | 16  |
| <b>V. OVERVIEW OF U.S. TAX SHELTER INDUSTRY</b> .....   | 18  |
| A. Summary of Current Law on Tax Shelters .....   | 18  |
| B. U.S. Tax Shelter Industry and Professional Organizations .....   | 20  |
| <b>VI. FOUR KPMG CASE HISTORIES</b> .....   | 23  |
| A. KPMG In General .....  | 23  |
| B. KPMG's Tax Shelter Activities .....  | 25  |
| (1) Developing New Tax Products .....   | 30  |
| (2) Mass Marketing Tax Products .....   | 47  |
| (3) Implementing Tax Products .....   | 67  |
| a. KPMG's Implementation Role .....   | 67  |
| b. Role of Third Parties in Implementing KPMG Tax Products .....  | 77  |
| (4) Avoiding Detection .....  | 99  |
| (5) Disregarding Professional Ethics .....  | 109 |
| <b>APPENDIX A. CASE STUDY OF BOND LINKED ISSUE PREMIUM STRUCTURE<br/>            (BLIPS)</b> .....          | 120 |
| <b>APPENDIX B. CASE STUDY OF S-CORPORATION CHARITABLE CONTRIBUTION<br/>            STRATEGY (SC2)</b> ..... | 123 |
| <b>APPENDIX C. OTHER KPMG INVESTIGATIONS OR ENFORCEMENT ACTIONS</b> ..                                      | 125 |

# **U.S. TAX SHELTER INDUSTRY: THE ROLE OF ACCOUNTANTS, LAWYERS, AND FINANCIAL PROFESSIONALS**

## **FOUR KPMG CASE STUDIES: FLIP, OPIS, BLIPS, AND SC2**

### **I. Introduction**

In 2002, the U.S. Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, at the direction of Senator Carl Levin, then its Chairman, initiated an in-depth investigation into the development, marketing, and implementation of abusive tax shelters by professional organizations such as accounting firms, banks, investment advisors, and law firms. The information in this Report is based upon the ensuing bipartisan investigation conducted jointly by the Subcommittee's Democratic and Republican staffs, with the support of Subcommittee Chairman Norm Coleman.

During the course of its investigation, the Subcommittee issued numerous subpoenas and document requests, and the Subcommittee staff reviewed over 235 boxes, and several electronic compact disks, containing hundreds of thousands of pages of documents, including tax product descriptions, marketing material, transactional documents, manuals, memoranda, correspondence, and electronic mail. The Subcommittee staff also conducted numerous, lengthy interviews with representatives of accounting firms, banks, investment advisory firms, and law firms. In addition, the Subcommittee staff reviewed numerous statutes, regulations, legal pleadings, reports, and legislation, dealing with federal tax shelter law. The staff consulted with federal and state agencies and various accounting, tax and financial experts, including the U.S. Department of the Treasury, U.S. Internal Revenue Service (IRS), Public Company Accounting Oversight Board (PCAOB), California Franchise Tax Board, tax experts on the staffs of the Joint Commission on Taxation, Senate Committee on Finance, and House Committee on Ways & Means, various tax professionals, and academic experts, and other persons with relevant information.

The evidence reviewed by the Subcommittee establishes that the development and sale of potentially abusive and illegal tax shelters have become a lucrative business in the United States, and professional organizations like major accounting firms, banks, investment advisory firms, and law firms have become major developers and promoters. The evidence also shows that respected professional firms are spending substantial resources, forming alliances, and developing the internal and external infrastructure necessary to design, market, and implement hundreds of complex tax shelters, some of which are illegal and improperly deny the U.S. Treasury of billions of dollars in tax revenues.

The term “tax shelter” has come to be used in a variety of ways depending upon the context. In the broadest sense, a tax shelter is a device used to reduce or eliminate the tax liability of the tax shelter user. Some tax shelters are specific tax benefits explicitly enacted by Congress to advance a legitimate endeavor, such as the low income housing tax credit. Those types of legitimate tax shelters are not the focus of this Report. The tax shelters under investigation by the Subcommittee are complex transactions used by corporations or individuals to obtain significant tax benefits in a manner never intended by the tax code. These transactions have no economic substance or business purpose other than to reduce or eliminate a person’s tax liability. These abusive tax shelters can be custom-designed for a single user or prepared as a generic “tax product” available for sale to multiple clients. The Subcommittee investigation focuses on the abusive tax shelters sold as generic tax products available to multiple clients.

Under current law, generic tax shelters are not illegal per se; they are potentially illegal depending upon how purchasers actually use them and calculate their tax liability on their tax returns. Over the last five years, the IRS has begun publishing notices identifying certain generic tax shelters as “potentially abusive” and warning taxpayers that use of such “listed transactions” may lead to an audit and assessment of back taxes, interest, and penalties for using an illegal tax shelter. As used in this Report, “potentially abusive” tax shelters are those that come within the scope of an IRS “listed transaction,” while “illegal” tax shelters are those with respect to which the IRS has taken actual enforcement action against taxpayers for violating federal tax law.

The Subcommittee investigation perceives an important difference between selling a potentially abusive or illegal tax shelter and providing routine tax planning services. None of the transactions examined by the Subcommittee derived from a request by a specific corporation or individual for tax planning advice on how to structure a specific business transaction in a tax-efficient way; rather all of the transactions examined by the Subcommittee involved generic tax products that had been affirmatively developed by a firm and then vigorously marketed to numerous, in some cases thousands, of potential buyers. There is a bright line difference between responding to a single client’s tax inquiry and aggressively developing and marketing a generic tax shelter product. While the tax shelter industry of today may have sprung from the former, it is now clearly driven by the latter.

In order to gain a deeper understanding of the issues, the Subcommittee conducted four in-depth case studies examining tax products sold by a leading accounting firm, KPMG, to individuals or corporations to help them reduce or eliminate their U.S. taxes. KPMG is one of the largest accounting firms in the world, and it had built a reputation as a respected auditor and expert tax advisor. KPMG vigorously denies being a tax shelter promoter, but the evidence obtained as a result of the Subcommittee investigation is overwhelming in demonstrating KPMG’s active and, at times, aggressive role in promoting and profiting from generic tax products sold to individuals and corporations, including tax products later determined by the IRS to be potentially abusive or illegal tax shelters.

Earlier this year, KPMG informed the Subcommittee that it maintained an inventory of over 500 “active tax products” designed to be offered to multiple clients for a fee. The four KPMG case studies featured in this Report are the Bond Linked Issue Premium Structure (BLIPS), Foreign

Leveraged Investment Program (FLIP), Offshore Portfolio Investment Strategy (OPIS), and the S-Corporation Charitable Contribution Strategy (SC2). KPMG sold these four tax products to more than 350 individuals from 1997 to 2001. All four generated significant fees for the firm, producing total revenues in excess of \$124 million.<sup>1</sup> The IRS later determined that three of the products, BLIPS, FLIP, and OPIS, were potentially abusive or illegal tax shelters, while the fourth, SC2, is still under review. As of June 2002, an IRS analysis of just some of the tax returns associated with BLIPS, FLIP, and OPIS had identified 186 people who had used BLIPS to claim losses on their tax returns totaling \$4.4 billion, and 57 people who had used FLIP or OPIS to claim tax losses of \$1.4 billion, for a grand total of \$5.8 billion.<sup>2</sup> Evidence made available to the Subcommittee suggests that lost tax revenues are also significant, including documents which show that, for 169 out of 186 BLIPS participants for which information was recorded, federal tax revenues were reduced by \$1.4 billion.

Some members of the U.S. tax profession are apparently claiming that the worst tax shelter abuses are already over, so there is no need for investigations, reforms, or stronger laws. The Subcommittee investigation, however, indicates just the opposite: while a few tax shelter promoters have ended their activities, the tax shelter industry as a whole remains active, developing new products, marketing dubious tax shelters to numerous individuals and corporations, and continuing to wrongfully deny the U.S. Treasury billions of dollars in revenues, leaving average U.S. taxpayers to make up the difference.

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<sup>1</sup>Letter dated 9/12/03, from KPMG's legal counsel, Wilkie Farr & Gallagher, to the Subcommittee, at 2. According to KPMG information provided to the Subcommittee in this letter and a letter dated 8/8/03, FLIP was sold to 80 persons, in 63 transactions, and produced total gross revenues for the firm of about \$17 million over a four-year period, 1996-1999. OPIS was sold to 111 persons in 79 transactions, and produced about \$28 million over a two-year period, 1998-1999. BLIPS, the largest revenue generator, was sold to 186 persons in 186 transactions, and produced about \$53 million over a one-year period from about October 1999 to about October 2000. SC2 was sold to 58 S corporations in 58 transactions, and produced about \$26 million over an 18-month period from about March 2000 to about September 2001. Other information presented to the Subcommittee suggests these revenue figures may be understated and that, for example, BLIPS generated closer to \$80 million in fees for the firm, OPIS generated over \$50 million, and SC2 over \$30 million.

<sup>2</sup>United States v. KPMG, Case No. 1: 02MS00295 (D.D.C. 7/9/02), "Declaration of Michael A. Halpert," Internal Revenue Agent, at ¶37.

## II. Findings

Based upon its investigation to date, the Subcommittee Minority staff recommends that the Subcommittee make the following findings of fact.

- (1) The sale of potentially abusive and illegal tax shelters has become a lucrative business in the United States, and some professional firms such as accounting firms, banks, investment advisory firms, and law firms are major participants in the mass marketing of generic “tax products” to multiple clients.
- (2) Although KPMG denies being a tax shelter promoter, the evidence establishes that KPMG has devoted substantial resources to, and obtained significant fees from, developing, marketing, and implementing potentially abusive and illegal tax shelters that U.S. taxpayers might otherwise have been unable, unlikely or unwilling to employ, costing the Treasury billions of dollars in lost tax revenues.
- (3) KPMG devotes substantial resources and maintains an extensive infrastructure to produce a continuing supply of generic tax products to sell to multiple clients, using a process which pressures its tax professionals to generate new ideas, move them quickly through the development process, and approve, at times, potentially abusive or illegal tax shelters.
- (4) KPMG uses aggressive marketing tactics to sell its generic tax products, including by turning tax professionals into tax product salespersons, pressuring its tax professionals to meet revenue targets, using telemarketing to find clients, using confidential client tax data to identify potential buyers, targeting its own audit clients for sales pitches, and using tax opinion letters and insurance policies as marketing tools.
- (5) KPMG is actively involved in implementing the tax shelters which it sells to its clients, including by enlisting participation from banks, investment advisory firms, and tax exempt organizations; preparing transactional documents; arranging purported loans; issuing and arranging opinion letters, providing administrative services, and preparing tax returns.
- (6) Some major banks and investment advisory firms have provided critical lending or investment services or participated as essential counter parties in potentially abusive or illegal tax shelters sold by KPMG in return for substantial fees or profits.
- (7) Some law firms have provided legal services that facilitated KPMG’s development and sale of potentially abusive or illegal tax shelters, including by providing design assistance or collaborating on allegedly “independent” opinion letters representing to clients that a tax product would withstand an IRS challenge, in return for substantial fees.
- (8) Some charitable organizations have participated as essential counter parties in a highly questionable tax shelter developed and sold by KPMG, in return for donations or the promise of future donations.

- (9) KPMG has taken a number of measures to conceal its tax shelter activities from tax authorities and the public, including by refusing to register potentially abusive tax shelters with the IRS, restricting file documentation, and using improper tax return reporting techniques.

### **III. Executive Summary**

The Subcommittee's investigation into the role of professional organizations in the tax shelter industry has identified two fundamental, relatively recent changes in how the industry operates.

First, the investigation has found that the tax shelter industry is no longer focused primarily on providing individualized tax advice to persons who initiate contact with a tax advisor. Instead, the industry focus has expanded to developing a steady supply of generic "tax products" that can be aggressively marketed to multiple clients. In short, the tax shelter industry has moved from providing one-on-one tax advice in response to tax inquiries to also initiating, designing, and mass marketing tax shelter products.

Secondly, the investigation has found that numerous respected members of the American business community are now heavily involved in the development, marketing, and implementation of generic tax products whose objective is not to achieve a business or economic purpose, but to reduce or eliminate a client's U.S. tax liability. Dubious tax shelter sales are no longer the province of shady, fly-by-night companies with limited resources. They are now big business, assigned to talented professionals at the top of their fields and able to draw upon the vast resources and reputations of the country's largest accounting firms, law firms, investment advisory firms, and banks.

The four case studies featured in this Report examine tax products developed by KPMG, a respected auditor and tax expert and one of the top four accounting firms in the United States. In the latter half of the 1990s, according to KPMG employees interviewed by Subcommittee staff, KPMG's Tax Services Practice underwent a fundamental change in direction by embracing the development of generic tax products and pressing its tax professionals to sell them. KPMG now maintains an inventory of more than 500 active tax products and routinely presses its tax professionals to participate in tax product marketing campaigns.

Three of the tax products examined by the Subcommittee, FLIP, OPIS, and BLIPS, are similar in nature. In fact, BLIPS was developed as a replacement for OPIS which was developed as a replacement for FLIP.<sup>3</sup> All three tax products function as "loss generators," meaning they generate large paper losses that the purchaser of the product then uses to offset other income, and shelter it

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<sup>3</sup>See, e.g., document dated 5/18/01, "PFP Practice Reorganization Innovative Strategies Business Plan – DRAFT," authored by Jeffrey Eischeid, Bates KPMG 0050620-23, at 1.

from taxation.<sup>4</sup> All three products have generated hundreds of millions of dollars in phony paper losses for taxpayers, using a series of complex, orchestrated transactions involving shell corporations, structured finance, purported multi-million dollar loans, and deliberately obscure investments.<sup>5</sup> All three also generated substantial fees for KPMG, with BLIPS and OPIS winning slots among KPMG's top ten revenue producers in 1999 and 2000, before sales were discontinued. All three tax products are also covered by the "listed transactions" that the IRS has published and declared to be potentially abusive tax shelters.<sup>6</sup> In all three cases, the IRS has already begun requiring taxpayers who used these products to pay back taxes, interest, and penalties. Over a dozen taxpayers penalized by the IRS for using these tax products have subsequently filed suit against KPMG for selling them an illegal tax shelter.<sup>7</sup>

The fourth tax product, SC2, is described by KPMG as a "charitable contribution strategy."<sup>8</sup> It is directed at individuals who own profitable corporations organized under Chapter S of the tax code (hereinafter "S corporations"), which means that the corporation's income is attributed directly to the corporate owners and taxable as personal income. SC2 is intended to generate a tax deductible charitable donation for the corporate owner and, more importantly, to defer and reduce taxation of a substantial portion of the income produced by the S corporation, essentially by "allocating" but not actually distributing that income to a tax exempt charity holding the corporation's stock. Like BLIPS, FLIP, and OPIS, SC2 requires a series of complex, orchestrated transactions to obtain the promised tax benefits. Among other measures, these transactions involve the issuance of non-voting stock and warrants, a corporate non-distribution resolution, and a stock redemption agreement; a temporary donation of the non-voting stock to a charity; and various steps to "allocate" but not distribute corporate income to the tax exempt charity.<sup>9</sup> Early in its development, KPMG tax professionals referred to SC2 as "S-CAEPS," pronounced "escapes." The name was changed after a senior tax official pointed out: "I think the last thing we or a client would want is a letter in the files regarding a tax planning strategy for which the acronym when pronounced sounds like we are saying 'escapes.'"<sup>10</sup>

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<sup>4</sup>Id. See also document dated 7/21/99, entitled "Action Required," authored by Jeff Eischeid, Bates KPMG 0040502 (In the case of BLIPS, "a key objective is for the tax loss associated with the investment structure to offset/shelter the taxpayer's other, unrelated, economic profits.").

<sup>5</sup>See Appendix A for a more detailed explanation of BLIPS.

<sup>6</sup>FLIP and OPIS are covered by IRS Notice 2001-45 (2001-33 IRB 129)(8/13/01); while BLIPS is covered by IRS Notice 2000-44 (2000-36 IRB 255)(9/5/00). See also United States v. KPMG, Case No. 1: 02MS00295 (D.D.C. 9/6/02).

<sup>7</sup>See, e.g., Jacoboni v. KPMG, Case No. 6:02-CV-510 (M.D. Fla. 4/29/02)(OPIS); Swartz v. KPMG, Case No. C03-1252 (W.D. Wash. 6/6/03)(BLIPS); Thorpe v. KPMG, Case No. 5-030CV-68 (E.D.N.C. 1/27/03)(FLIP/OPIS).

<sup>8</sup>The formal title of the tax product is the S-Corporation Charitable Contribution Strategy.

<sup>9</sup>See Appendix B for a more detailed explanation of SC2.

<sup>10</sup>Email dated 3/24/00, from Mark Springer to multiple KPMG tax professionals, "RE: S-corp Product," Bates KPMG 0016515. See also email dated 3/24/00, from Mark Springer to multiple KPMG tax professionals, "Re: S-corp Product," Bates 0016524 (suggesting replacing "all S-CAEPS references with something much more



In 2000 and 2001, SC2 was one of KPMG's top ten revenue producers. SC2 is not covered by one of the "listed transactions" issued by the IRS, but is currently undergoing IRS review.<sup>11</sup>

Together, these four case histories, BLIPS, FLIP, OPIS, and SC2, provide an in-depth portrait of how a professional organization like KPMG, and the professional organizations it allies itself with, end up developing, marketing, and implementing highly questionable or illegal tax products. The evidence also sheds light on the critical roles played by other professional organizations to make suspect tax products work.

## **A. Developing New Tax Products**

The Subcommittee investigation has found that the tax product development and approval process used at KPMG was deeply flawed and led, at times, to the approval of tax products that the firm knew were potentially abusive or illegal. Among other problems, the evidence shows that the KPMG approval process has been driven by market considerations, such as consideration of a product's revenue potential and "speed to market," as well as by intense pressure that KPMG supervisors have placed on subordinates to "sign-off" on the technical merits of a proposed product even in the face of serious questions about its compliance with the law.

The case of BLIPS illustrates the problems. Evidence obtained by the Subcommittee discloses an extended, unresolved debate among KPMG tax professionals over whether BLIPS met the technical requirements of federal tax law. In 1999, the key KPMG technical reviewer resisted approving BLIPS for months, despite repeated expressions of dismay from superiors. He finally agreed to withdraw his objections to the product in this email sent to his supervisor: "I don't like this product and would prefer not to be associated with it [but] I can reluctantly live with a more-likely-than-not opinion being issued for the product." This assessment is not exactly the solid endorsement that might be expected for a tax product sold by a major accounting firm.

The most senior officials in KPMG's Tax Services Practice exchanged emails which frankly acknowledged the problems and reputational risks associated with BLIPS, but nevertheless supported putting it on the market for sale to clients. One senior tax professional summed up the pending issues with two questions:

"(1) Have we drafted the opinion with the appropriate limiting bells and whistles ... and (2) Are we being paid enough to offset the risks of potential litigation resulting from the transaction? ... 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."

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benign").

<sup>11</sup>See email dated 4/10/02, from US-Tax Innovation Center to multiple KPMG tax professionals, "IRS Summons Information Request for SC2," Bates XX 001433 ("The IRS has requested certain information from the Firm related to SC2."); undated KPMG document entitled, "April 18 IRS Summons Response."

No one challenged the analysis that the risky nature of the product justified the firm's charging "a lot of money" for a tax opinion letter predicting it was more likely than not that BLIPS would withstand an IRS challenge. When the same KPMG official observed, "I do believe the time has come to shit and get off the pot," the second in command at the Tax Services Practice responded, "I believe the expression is shit OR get off the pot, and I vote for shit."

BLIPS, like its predecessors OPIS and FLIP, was sold by KPMG to numerous clients before the IRS issued notices declaring them potentially abusive tax shelters that did not meet the requirements of federal tax law. Other professional firms have also sold potentially abusive or illegal tax products such as the Currency Options Brings Reward Alternatives (COBRA) and Contingent Deferred Swap (CDS) sold by Ernst & Young, the Bond and Option Sales Strategy (BOSS and Son of BOSS) sold by PricewaterhouseCoopers, the Customized Adjustable Rate Debt Facility (CARDS) sold by Deutsche Bank, the FLIP tax product sold by Wachovia Bank, and the Slapshot tax product sold by J.P. Morgan Chase.<sup>12</sup> The sale of these abusive tax shelters by other firms clearly demonstrates that flawed approval procedures are not confined to a single firm or a single profession. Many other professional firms are also developing and selling dubious tax products.

## **B. Mass Marketing Tax Products**

A second striking aspect of the Subcommittee investigation was the discovery of the substantial effort KPMG has expended to market its tax products to potential buyers. The investigation found that KPMG maintains an extensive marketing infrastructure to sell its tax products, including a market research department, a Sales Opportunity Center that works on tax product "marketing strategies," and even a full-fledged telemarketing center staffed with people trained to make cold calls to find buyers for specific tax products. When investigating SC2, the Subcommittee discovered that KPMG used its telemarketing center in Fort Wayne, Indiana, to contact literally thousands of S corporations across the country and help elevate SC2 to one of KPMG's top ten revenue-producing tax products.

The evidence also uncovered a corporate culture in KPMG's Tax Services Practice that condoned placing intense pressure on the firm's tax professionals – CPAs and lawyers included – to sell the firm's generic tax products. Numerous internal emails by senior KPMG tax professionals exhorted colleagues to increase their sales efforts. One email thanked KPMG tax professionals for a team effort in developing SC2 and then instructed these professionals to "SELL, SELL, SELL!!" Another email warned KPMG partners: "Look at the last partner scorecard. Unlike golf, a low number is not a good thing. ... A lot of us need to put more revenue on the board." A third email asked all partners in KPMG's premier technical tax group, Washington National Tax (WNT), to "temporarily defer non-revenue producing activities" and concentrate for the "next 5 months" on meeting WNT's revenue goals for the year. The email stated: "Listed below are the tax products identified by the functional teams as having significant revenue potential over the next few months. ... Thanks for help in this critically important matter. As [the Tax Services Practice second in

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<sup>12</sup>Slapshot is an abusive tax shelter that was examined in a Subcommittee hearing last year. See "Fishtail, Bacchus, Sundance, and Slapshot: Four Enron Transactions Funded and Facilitated by U.S. Financial Institutions," S.Prt. 107-82 (107<sup>th</sup> Congress 1/2/03).

command] said, ‘We are dealing with ruthless execution - hand to hand combat - blocking and tackling.’ Whatever the mixed metaphor, let’s just do it.”

The four case studies featured in this Report provide detailed evidence of how KPMG pushed its tax professionals to meet revenue targets, closely monitored their sales efforts, and even, at times, advised them to use questionable sales techniques. For example, in the case of SC2, KPMG tax professionals were directed to contact existing clients about the product, including KPMG’s own audit clients. In a written document offering sales advice on SC2, KPMG advised its employees, in some cases, to make misleading statements to potential buyers, such as claiming that SC2 was no longer available for sale, even though it was, apparently hoping that reverse psychology would then cause the client to want to buy the product. KPMG also utilized confidential and sensitive client data in an internal database containing information used by KPMG to prepare client tax returns in order to identify potential targets for its tax products.

KPMG also used opinion letters and insurance policies as selling points to try to convince uncertain buyers to purchase a tax product. For example, KPMG tax professionals were instructed to tell potential buyers that opinion letters provided by KPMG and Sidley Austin Brown & Wood would protect the buyer from certain IRS penalties, if the IRS were later to invalidate the tax product. In the case of SC2, KPMG tax professionals were instructed to tell buyers that, “for a small premium,” they could buy an insurance policy from AIG, Hartford Insurance, or another firm that would reimburse the buyer for any back taxes or penalties actually assessed by the IRS for using the tax product. These selling points suggest KPMG was trying to present its tax products as a risk free gambit for its clients. They also suggest that KPMG was pitching its tax products to persons with limited interest in the products and who likely would not have used them to avoid paying their taxes, absent urging by KPMG to do so.

### **C. Implementing Tax Products**

Developing and selling a tax product to a client did not, in many cases, end KPMG’s involvement with the product, since the product often required the purchaser to carry out complex financial and investment activities in order to realize the promised tax benefits. In the four cases examined by the Subcommittee, KPMG enlisted a bevy of other professionals, including lawyers, bankers, investment advisors and others, to carry out the required transactions. In the case of SC2, KPMG actively found and convinced various charitable organizations to participate. Charities told the Subcommittee staff that KPMG had contacted the organization “out of the blue,” convinced them to participate in SC2, facilitated interactions with the SC2 “donors,” and supplied drafts of the transactional documents.

The Subcommittee investigation found that BLIPS, OPIS, FLIP, and SC2 could not have been executed without the active and willing participation of the law firms, banks, investment advisory firms, and charitable organizations that made these products work. In the case of BLIPS, OPIS and FLIP, law firms and investment advisory firms helped draft complex transactional documents. Major banks, such as Deutsche Bank, HVB, UBS, and NatWest, provided purported loans for tens of millions of dollars essential to the orchestrated transactions. Wachovia Bank initially provided client

referrals to KPMG for FLIP sales, then later began its own efforts to sell FLIP to clients. Two investment advisory firms, Quellos Group LLC (“Quellos”) and Presidio Advisory Services (“Presidio”), participated directly in the FLIP, OPIS, or BLIPS transactions, even entering into partnerships with the clients. In the case of SC2, several pension funds agreed to accept corporate stock donations and sign redemption agreements to “sell” back the stock to the corporation after a specified period of time. In all four cases, Sidley Austin Brown & Wood agreed to provide a legal opinion letter attesting to the validity of the relevant tax product. Other law firms, such as Sherman and Sterling, prepared transactional documents and helped carry out specific transactions. In return, each of the professional firms was paid lucrative fees.

In the case of BLIPS, documents and interviews showed that banks and investment advisory firms knew the BLIPS transactions and “loans” were structured in an unusual way, had no reasonable potential for profit, and were designed instead to achieve specific tax aims for KPMG clients. For example, the BLIPS transactions required the bank to lend, on a non-recourse basis, tens of millions of dollars to a shell corporation with few assets and no ongoing business, to give the same shell corporation an unusual “loan premium” providing additional tens of millions of dollars, and to enter into interest rate swaps that, in effect, reduced the “loan’s” above-market interest rate to a much lower floating market rate.

Documents and interviews also disclosed that the funds “loaned” by the banks were never really put at risk. The so-called loan proceeds were instead deemed “collateral” for the “loan” itself under an “overcollateralization” provision that required the “borrower” to place 101% of the loan proceeds on deposit with the bank. The loan proceeds serving as cash collateral were then subject to severe investment restrictions and closely monitored by the bank. The end result was that only a small portion of the funds in each BLIPS transaction were ever placed at risk in true investments. Moreover, the banks were empowered to unilaterally terminate a BLIPS loan under a variety of circumstances including, for example, if the cash collateral were to fall below the 101% requirement. The banks and investment advisory firms knew that the BLIPS loan structure and investment restrictions made little economic sense apart from the client’s tax objectives, which consisted primarily of generating huge paper losses for KPMG clients who then used those losses to offset other income and shelter it from taxation.

Documents and interviews showed that the same circumstances existed for the FLIP and OPIS transactions – banks and investment advisory firms financed and participated in structured and tightly controlled financial transactions and loans primarily designed to generate tax losses on paper for clients, while protecting bank assets.

A professional organization that knowingly participates in an abusive tax shelter with no real economic substance violates the tax code’s prohibition against aiding or abetting tax evasion.<sup>13</sup> A related issue is whether and to what extent lawyers, bankers, investment advisors, tax exempt organizations, and others have an obligation to evaluate the transactions they are asked to carry out and refrain from participating in potentially abusive or illegal tax shelters. Another issue is whether

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<sup>13</sup>26 U.S.C. 6701.

professional organizations that participate in these types of transactions qualify as tax shelter promoters and, if so, are obliged under U.S. law to register the relevant transactions as tax shelters and maintain client lists.

These issues are particularly pressing for several professional firms involved in the KPMG transactions that may be tax shelter promoters in their own right. For example, Sidley Austin Brown & Wood is under investigation by the IRS for issuing more than 600 legal opinion letters supporting 13 questionable tax products, including BLIPS, FLIP and OPIS.<sup>14</sup> Deutsche Bank has sponsored a Structured Transactions Group that, in 1999, offered an array of tax products to U.S. and European clients seeking to “execute tax driven deals” or “gain mitigation” strategies.<sup>15</sup> Internal bank documents indicate that Deutsche Bank was aggressively marketing its tax products to large U.S. corporations and individuals, and planned to close billions of dollars worth of transactions.<sup>16</sup> At least two of the tax products being pushed by Deutsche Bank, BLIPS and the Customized Adjustable Rate Debt Facility (CARDS), were later determined by the IRS to be potentially abusive tax shelters.

Another set of issues arising from KPMG’s enlistment of other professionals to implement its tax products involves the role played by tax opinion letters. A tax opinion letter, sometimes called a legal opinion letter when issued by a law firm, is intended to provide written advice to a client on whether a particular tax product is permissible under the law and, if challenged by the IRS, how likely it would be that the challenged product would survive court scrutiny. Traditionally, such opinion letters were supplied by an independent tax expert with no financial stake in the transaction being evaluated, and an individualized letter was sent to a single client. The mass marketing of tax products to multiple clients, however, has been followed by the mass production of opinion letters by a professional firm that, for each letter sent to a client, is paid a handsome fee. The attractive profits available from such an arrangement have placed new pressure on the independence of the tax opinion letter provider.

In the four case histories featured in this Report, the Subcommittee investigation uncovered disturbing evidence related to how tax opinion letters were being developed and used in connection with KPMG’s tax products. In each of the four case histories, the Subcommittee investigation found that KPMG had drafted its own prototype tax opinion letter supporting the product and used this prototype as a template for the letters it actually sent to its clients. In addition, in all four case histories, KPMG arranged for an outside law firm to provide a second favorable opinion letter. Sidley Austin Brown & Wood, for example, issued hundreds of opinion letters supporting BLIPS,

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<sup>14</sup>See “Declaration of Richard E. Bosch,” IRS Revenue Agent, In re John Doe Summons to Sidley Austin Brown & Wood (N.D. Ill. 10/16/03).

<sup>15</sup>Email dated 4/3/02, from Viktoria Antoniadis to Brian McGuire and other Deutsche Bank personnel, “US GROUP 1 Pres,” DB BLIPS 6329-52, attaching a presentation dated 11/15/99, entitled “Structured Transactions Group North America,” at 6336.

<sup>16</sup>Id. at 6345-46.

FLIP and OPIS.<sup>17</sup> The evidence indicates that KPMG either directed its clients to Sidley Austin Brown & Wood to obtain the second opinion letter, or KPMG itself obtained the client's opinion letter from the law firm and delivered it to the client, apparently without the client's actually speaking to any of the lawyers at the firm.

The evidence raises serious questions about the independent status of Sidley Austin Brown & Wood in issuing the legal opinion letters supporting the KPMG tax products. The evidence indicates, for example, that KPMG collaborated with the law firm ahead of time to ensure it would supply a favorable opinion letter. In the case of BLIPS, KPMG and Sidley Austin Brown & Wood actually exchanged copies of their drafts, eventually issuing two, allegedly independent opinion letters that contain numerous, virtually identical paragraphs. Moreover, Sidley Austin Brown & Wood provided FLIP, OPIS, and BLIPS clients with nearly identical opinion letters that included no individualized legal advice. In many cases, the law firm apparently issued its letter without ever speaking with the client to whom the tax advice was directed. By routinely directing its clients to Sidley Austin Brown & Wood to obtain a second opinion letter, KPMG produced a steady stream of income for the law firm, further undermining its independent status. One document even indicates that Sidley Austin Brown & Wood was paid a fee in every case in which a client was told during a FLIP sales pitch about the availability of a second opinion letter from an outside law firm, whether or not the client actually purchased the letter. This type of close, ongoing, and lucrative collaboration raises serious questions about the independence of both parties and the value of their opinion letters in light of the financial stake that both firms had in the sale of the tax product being analyzed.

A second set of issues related to the tax opinion letters involves the accuracy and reliability of their factual representations. The tax opinion letters prepared by KPMG and Sidley Austin Brown & Wood in BLIPS, FLIP, and OPIS typically included a set of factual representations made by the client, KPMG, the participating investment advisory firm, and the participating bank. These representations were critical to the accounting firm's analysis upholding the validity of the tax product. In all three cases, the Subcommittee investigation discovered that KPMG had itself drafted the factual representations attributed to other parties. The evidence shows that prior to attributing factual representations to other professional firms involved in the transactions, KPMG presented draft statements to the parties beforehand and negotiated the wording. But in the case of the factual representations attributed to its client, the evidence indicates KPMG did not consult with the client beforehand and, in some cases, even refused, despite client objections, to allow the client to alter the KPMG-drafted representations.

Equally disturbing is that some of the key factual representations that KPMG made or attributed to its clients appear to contain false or misleading statements. For example, KPMG wrote in the prototype BLIPS opinion letter that the client "has represented to KPMG ... [that the client] independently reviewed the economics underlying the [BLIPS] Investment Fund before entering into the program and believed there was a reasonable opportunity to earn a reasonable pre-tax profit from

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<sup>17</sup>In the case of SC2, KPMG also arranged for Bryan Cave to issue a legal opinion supporting the tax product, but it is unclear whether Bryan Cave ever issued one.

the transactions.” In fact, it is doubtful that many BLIPS clients “independently reviewed” or understood the complicated BLIPS transactions or the “economics” underlying them. In addition, KPMG knew there was only a remote possibility – not a reasonable possibility – of a client’s earning a pre-tax profit in BLIPS. Nevertheless, since the existence of a reasonable opportunity to earn a reasonable profit was central to BLIPS’ having economic substance and complying with federal tax law, KPMG included the client representation in its BLIPS tax opinion letter.

#### **D. Avoiding Detection**

In addition to the many development, marketing, and implementation problems just described, the Subcommittee investigation uncovered disturbing evidence of measures taken by KPMG to hide its tax product activities from the IRS and the public. Despite its 500 active tax product inventory, KPMG has never registered, and thereby disclosed to the IRS the existence of, a single one of its tax products. KPMG has explained this failure by claiming that it is not a tax promoter and does not sell any tax products that have to be registered under the law. The evidence suggests, however, that KPMG’s failure to register may not be attributable to a good faith analysis of the technical merits of the tax products.

Five years ago, in 1998, a senior KPMG tax professional advocated in very explicit terms that, for business reasons, KPMG ought to ignore federal tax shelter requirements and not register the OPIS tax product with the IRS, even if required by law. In an email sent to several senior colleagues, this KPMG tax professional explained his reasoning. In that email, he assumed that OPIS qualified as a tax shelter, and then explained why the firm should not, even in this case, register it with the IRS as required by law. Among other reasons, he observed that the IRS was not vigorously enforcing the registration requirement, the penalties for noncompliance were much less than the potential profits from selling the tax product, and “industry norms” were not to register any tax products at all. The KPMG tax professional coldly calculated the penalties for noncompliance compared to potential fees from selling OPIS: “Based upon our analysis of the applicable penalty sections, we conclude that the penalties would be no greater than \$14,000 per \$100,000 in KPMG fees. ... For example, our average [OPIS] deal would result in KPMG fees of \$360,000 with a maximum penalty exposure of only \$31,000.” The senior tax professional also warned that if KPMG were to comply with the tax shelter registration requirement, this action would place the firm at such a competitive disadvantage in its sales that KPMG would “not be able to compete in the tax advantaged products market.” In short, he urged KPMG to knowingly, purposefully, and willfully violate the federal tax shelter law.

The evidence obtained by the Subcommittee indicates that, over the following five years, KPMG rejected several internal recommendations by tax professionals to register a tax product as a tax shelter with the IRS. For example, the Subcommittee investigation learned that, on at least two occasions, the head of KPMG’s Department of Professional Practice, a very senior tax official, had recommended that BLIPS and OPIS be registered as tax shelters, only to be overruled each time by the head of the entire Tax Services Practice. Instead of registering tax products with the IRS, KPMG instead apparently devoted resources to devising rationales for not registering them. For example, a fiscal year 2002 draft business plan for a KPMG tax group described two tax products that were

under development, but not yet approved, in part due to tax shelter registration issues. With respect to the first product, POPS, the business plan stated: “We have completed the solution’s technical review and have almost finalized the rationale for not registering POPS as a tax shelter.” With respect to the second product, described as a “conversion transaction ... that halves the taxpayer’s effective tax rate by effectively converting ordinary income to long term capital gain,” the business plan states: “The most significant open issue is tax shelter registration and the impact registration will have on the solution.”

KPMG’s concealment efforts did not stop with its years-long refusal to register any tax shelter with the IRS. KPMG also appears to have used improper reporting techniques on client tax returns to minimize the return information that could alert the IRS to the existence of its tax products. For example, in the case of OPIS and BLIPS, some KPMG tax professionals advised their clients to participate in the transactions through “grantor trusts” and then file tax returns in which all of the capital gains and losses from the transactions were “netted” at the grantor trust level, instead of each gain or loss being reported individually on the return. The intended result was that only a single, small net capital gain or loss would appear on the client’s personal income tax return.

A key KPMG tax expert objected to this netting approach when it was first suggested within the firm in 1998, writing to his colleagues in one email: “When you put the OPIS transaction together with this ‘stealth’ reporting approach, the whole thing stinks.” He wrote in a separate email: “You should all know that I do not agree with the conclusion ... that capital gains can be netted at the trust level. I believe we are filing misleading, and perhaps false, returns by taking this reporting position.” Despite these strongly worded emails from the KPMG tax professional with authority over this tax return issue, several KPMG tax professionals apparently went ahead and prepared client tax returns using grantor trust netting. In September 2000, in the same notice that declared BLIPS to be a potentially abusive tax shelter, the IRS explicitly warned against grantor trust netting: “In addition to other penalties, any person who willfully conceals the amount of capital gains and losses in this manner, or who willfully counsels or advises such concealment, may be guilty of a criminal offense.” In response, KPMG apparently contacted some BLIPS clients and advised them to re-file their returns.

KPMG used a variety of tax return reporting techniques in addition to grantor trust netting to avoid detection of its activities by the IRS. In addition, in the four cases examined by the Subcommittee, KPMG required some potential purchasers of the tax products to sign “nondisclosure agreements” and severely limited the paperwork used to explain the tax products. Client presentations were done on chalkboards or erasable whiteboards, and written materials were retrieved from clients before leaving a meeting. Another measure taken by senior KPMG tax professionals was to counsel staff not to keep certain revealing documentation in their files or to clean out their files, again, to limit detection of firm activity. Still another tactic discussed in several KPMG documents was explicitly using attorney-client or other legal privileges to limit disclosure of KPMG documents. For example, one handwritten document by a KPMG tax professional discussing OPIS issues states under the heading, “Brown & Wood”: “Privilege B&W can play a big role at providing protection in



this area.” None of these actions to conceal its activities seems consistent with what should be the practices of a leading public accounting firm.

### **E. Disregarding Professional Ethics**

In addition to all the other problems identified in the Subcommittee investigation, troubling evidence emerged regarding how KPMG handled certain professional ethics issues, including issues related to fees and auditor independence. The fees charged to KPMG clients raise several concerns. Some appear to be “contingency fees,” meaning fees which are paid only if a client obtains specified results from the services offered, such as achieving specified tax savings. More than 20 states prohibit the payment of contingency fees to accountants, and SEC, AICPA, and other rules constrain their use in various ways. Internal KPMG documents suggest that, in at least some cases, KPMG deliberately manipulated the way it handled certain tax products to circumvent contingency fee prohibitions. A document discussing OPIS fees, for instance, identifies the states that prohibit contingency fees and, then, rather than prohibit OPIS transactions in those states or require an alternative fee structure, directs KPMG tax professionals to make sure the OPIS engagement letter is signed, the engagement is managed, and the bulk of services is performed “in a jurisdiction that does not prohibit contingency fees.”

In the case of BLIPS, clients were charged a single fee equal to 7% of the “tax losses” to be generated by the BLIPS transactions. The client fee was typically paid to Presidio, a investment advisory firm, which then apportioned the fee amount among various firms according to certain factors. The fee recipients typically included KPMG, Presidio, a participating bank, and Sidley Austin Brown & Wood. This fee splitting arrangement may violate restrictions on contingency fees, client referral fees, and fees paid jointly to lawyers and non-lawyers.

KPMG’s tax products also raise auditor independence issues. Three of the banks involved in BLIPS, FLIP, and OPIS (Deutsche Bank, HVB, and Wachovia Bank), employ KPMG to audit their financial statements. SEC rules state that auditor independence is impaired when an auditor has a direct or material indirect business relationship with an audit client. KPMG apparently attempted to address the auditor independence issue by giving its clients a choice of banks to use in the transactions, including at least one bank that was not a KPMG audit client. It is unclear, however, whether individuals actually could choose what bank to use. Moreover, it is unclear how providing clients with a choice of banks alleviated KPMG’s conflict of interest, since it still had a direct or material, indirect business relationship with a bank whose financial statements were certified by KPMG auditors.

A second set of auditor independence issues involves KPMG’s decision to market tax products to its own audit clients. By engaging in this marketing tactic, KPMG not only took advantage of its auditor-client relationship, but also created a conflict of interest in those cases where it successfully sold a tax product to an audit client. The conflict of interest arises when the KPMG auditor reviewing the client’s financial statements is required, as part of that review, to examine the

client's tax return and its use of unusual tax strategies. In such situations, KPMG is, in effect, auditing its own work.

A third set of professional ethics issues involves conflict of interest concerns related to the legal representation of clients who, after purchasing a tax product from KPMG, have come under IRS scrutiny. The issues include whether KPMG should be referring these clients to a law firm that represents KPMG itself on unrelated matters, and whether a law firm that has a longstanding, close, and ongoing relationship with KPMG, representing it on unrelated matters, should also represent KPMG clients. While KPMG and the client have an immediate joint interest in defending the tax product that KPMG sold and the client purchased, their interests could quickly diverge if the suspect tax product is found to be in violation of federal tax law. This divergence in interests has been demonstrated repeatedly since 2002, as growing numbers of KPMG clients have filed suit against KPMG seeking a refund of past fees they paid to the firm and additional damages for KPMG's selling them an illegal tax shelter.

The following pages provide more detailed information about these and other problems uncovered during the Subcommittee investigation into the role of professional firms in the tax shelter industry.

The tax products featured in this Report were developed, marketed, and executed by highly skilled professionals in the fields of accounting, law, and finance. Historically, such professionals have been distinguished by their obligation to meet a higher standard of conduct in business than ordinary occupations. When it came to decisions by these professionals on whether to approve a questionable tax product, employ telemarketers to sell tax services, or omit required information from a tax return, one might have expected a thoughtful discussion or analysis of the firm's fiduciary duties, its ethical and professional obligations, or what should be done to protect the firm's good name. Unfortunately, evidence of those thoughtful discussions was virtually non-existent and considerations of professionalism seem to have had little, if any, effect on KPMG's mass marketing of its tax products.

## **IV. Recommendations**

Based upon its investigation to date and the above findings, the Subcommittee Minority staff recommends that the Subcommittee make the following policy recommendations.

- (1) Congress should enact legislation to increase penalties on promoters of potentially abusive and illegal tax shelters, clarify and strengthen the economic substance doctrine, and bar auditors from providing tax shelter services to their audit clients.
- (2) Congress should increase funding of IRS enforcement efforts to stop potentially abusive and illegal tax shelters, and the IRS should dramatically increase its enforcement efforts against tax shelter promoters.

- (3) The IRS and PCAOB should conduct a joint review of tax shelter activities by accounting firms, and take steps to clarify and strengthen federal and private sector procedures and prohibitions to prevent accounting firms from aiding or abetting tax evasion, promoting potentially abusive or illegal tax shelters, or engaging in related unethical or illegal conduct. The PCAOB should consider banning public accounting firms from providing tax shelter services to their audit clients and others.
- (4) The IRS and federal bank regulators should conduct a joint review of tax shelter activities at major banks, and clarify and strengthen bank procedures and prohibitions to prevent banks from aiding or abetting tax evasion, promoting potentially abusive or illegal tax shelters, or engaging in related unethical or illegal conduct.
- (5) The U.S. Department of Justice and IRS should conduct a joint review of tax shelter activities at major law firms, and take steps to clarify and strengthen federal and private sector rules to prevent law firms from aiding or abetting tax evasion, promoting potentially abusive or illegal tax shelters, or engaging in related unethical or illegal conduct. The U.S. Treasury Department should clarify and strengthen professional standards of conduct and opinion letter requirements in Circular 230 and explicitly address tax shelter issues.
- (6) Federal and private sector regulators should clarify and strengthen federal and private sector rules related to opinion letters advising on tax products, including setting standards for letters related to mass marketed tax products, requiring fair and accurate factual representations, and barring collaboration between a tax product promoter and a firm preparing an allegedly independent opinion letter.
- (7) The American Institute of Certified Public Accountants (AICPA), American Bar Association, and American Bankers Association should establish standards of conduct and procedures to prevent members of their professions from aiding or abetting tax evasion, promoting abusive or illegal tax shelters, or engaging in related unethical or illegal conduct, including by requiring a due diligence review of any tax-related transaction in which a member is asked to participate. Tax exempt organizations should adopt similar standards of conduct and procedures.
- (8) The AICPA, American Bar Association, and American Bankers Association should strengthen professional standards of conduct and ethics requirements to stop the development and mass marketing of tax products designed to reduce or eliminate a client's tax liability, and should prohibit their members from using aggressive sales tactics to market tax products, including by prohibiting use of cold calls and telemarketing, explicit revenue goals, and fees contingent on projected tax savings.
- (9) The AICPA and American Bar Association should strengthen professional standards of conduct and ethics requirements to prohibit the issuance of an opinion letter on a tax product when the independence of the author has been compromised by providing

accounting, legal, design, sales, or implementation assistance related to the product, by having a financial stake in the tax product, or by having a financial stake in a related or similar tax product.

## V. Overview of U.S. Tax Shelter Industry

### A. Summary of Current Law on Tax Shelters

The definition of an abusive tax shelter has changed and expanded over time to encompass a wide variety of illegal or potentially illegal tax evasion schemes. Existing legal definitions are complex and appear in multiple sections of the tax code.<sup>18</sup> These tax shelter definitions refer to transactions, partnerships, entities, investments, plans, or arrangements which have been devised, in whole or significant part, to enable taxpayers to eliminate or understate their tax liability. The General Accounting Office (GAO) recently summarized these definitions by describing “abusive shelters” as “very complicated transactions promoted to corporations and wealthy individuals to exploit tax loopholes and provide large, unintended tax benefits.”<sup>19</sup>

Over the past ten years, Federal statutes and regulations prohibiting illegal tax shelters have undergone repeated revision to clarify and strengthen them. Today, key tax code provisions not only prohibit tax evasion by taxpayers, but also penalize persons who knowingly organize or promote illegal tax shelters<sup>20</sup> or who knowingly aid or abet the filing of tax return information that understates a taxpayer’s tax liability.<sup>21</sup> Additional tax code provisions now require taxpayers and promoters to disclose to the IRS information about certain potentially illegal tax shelters.<sup>22</sup>

Recently, the IRS issued regulations to clarify and strengthen the law’s definition of a tax shelter promoter and the law’s requirements for tax shelter disclosure.<sup>23</sup> For example, these

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<sup>18</sup>See, e.g., 26 U.S.C. §§ 461(i)(3)(defining tax shelter for certain tax accounting rules); 6111(a), (c) and (d)(defining tax shelter for certain registration and disclosure requirements); and 6662(d)(2)(C)(iii)(defining tax shelter for application of understatement penalty).

<sup>19</sup>“Challenges Remain in Combating Abusive Tax Shelters,” testimony by Michael Brostek, Director, Tax Issues, GAO, before the U.S. Senate Finance Committee, No. GAO-04-104T (October 21, 2003)(hereinafter “GAO Testimony”) at 1.

<sup>20</sup>26 U.S.C. § 6700.

<sup>21</sup>26 U.S.C. § 6701.

<sup>22</sup>See, e.g., 26 U.S.C. §§ 6011 (taxpayer must disclose reportable transactions); 6111 (organizers and promoters must register potentially illegal tax shelters with IRS), 6112 (promoters must maintain lists of clients who purchase potentially illegal tax shelters and, upon request, disclose such client lists to the IRS).

<sup>23</sup>See, e.g., Treas. Reg. Sec. 301.6112-1 and Sec. 1.6011-4, which took effect on 2/28/03.

regulations now make it clear that tax shelter promoters include “persons principally responsible for organizing a tax shelter as well as persons who participate in the organization, management or sale of a tax shelter” and any person who is a “material advisor” on a tax shelter transaction.<sup>24</sup> Disclosure obligations, which apply to both taxpayers and tax shelter promoters, require disclosure to the IRS, under certain circumstances, of information related to six categories of potentially illegal tax shelter transactions. Among others, these disclosures include any transaction that is the same or similar to a “listed transaction,” which is a transaction that the IRS has formally determined, through regulation, notice, or other published guidance, “as having a potential for tax avoidance or evasion” and is subject to the law’s registration and client list maintenance requirements.<sup>25</sup> The IRS has stated in court that it “considers a ‘listed transaction’ and all substantially similar transactions to have been structured for a significant tax avoidance purpose” and refers to them as “potentially abusive tax shelters.”<sup>26</sup> The IRS has also stated in court that “the IRS has concluded that taxpayers who engaged in such [listed] transactions have failed or may fail to comply with the internal revenue laws.”<sup>27</sup> As of October 2003, the IRS had published 27 listed transactions.

In addition to the statutory and regulatory requirements and prohibitions, federal courts have developed over the years a number of common law doctrines to identify and invalidate illegal tax

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<sup>24</sup>Petition dated 10/14/03, “United States’ *Ex Parte* Petition for Leave to Serve IRS ‘John Doe’ Summons on Sidley Austin Brown & Wood,” (D.N.D. Ill.), at ¶ 8.

<sup>25</sup>*Id.* at ¶ 11. See also “Background and Present Law Relating to Tax Shelters,” Joint Committee on Taxation (JCX-19-02), 3/19/02 (hereinafter “Joint Committee on Taxation report”), at 33; GAO Testimony at 7. The other five categories of transactions subject to disclosure are transactions offered under conditions of confidentiality; including contractual protections to the “investor”; resulting in specific amounts of tax losses; generating a tax benefit when the underlying asset is held only briefly; or generating differences between financial accounts and tax accounts greater than \$10 million. GAO Testimony at 7.

<sup>26</sup>Petition dated 10/14/03, “United States’ *Ex Parte* Petition for Leave to Serve IRS ‘John Doe’ Summons on Sidley Austin Brown & Wood,” (D.N.D. Ill.), at ¶¶ 11-12.

<sup>27</sup>Petition dated 10/14/03, “United States’ *Ex Parte* Petition for Leave to Serve IRS ‘John Doe’ Summons on Sidley Austin Brown & Wood,” (D.N.D. Ill.), at ¶ 16.

shelters, including the economic substance,<sup>28</sup> business purpose,<sup>29</sup> substance-over-form,<sup>30</sup> step transaction,<sup>31</sup> and sham transaction<sup>32</sup> doctrines. A study by the Joint Committee on Taxation concludes that “[t]hese doctrines are not entirely distinguishable” and have been applied by courts in inconsistent ways.<sup>33</sup>

Bipartisan legislation to clarify and strengthen the economic substance and business purpose doctrines, as well as other aspects of federal tax shelter law, has been developed by the Senate Finance Committee. This legislation has been twice approved by the Senate during the 108<sup>th</sup> Congress, but has yet to become law.<sup>34</sup>

## **B. U.S. Tax Shelter Industry and Professional Organizations**

**Finding: The sale of potentially abusive and illegal tax shelters has become a lucrative business in the United States, and some professional firms such as accounting firms, banks, investment advisory firms, and law firms are major participants in the mass marketing of generic “tax products” to multiple clients.**

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<sup>28</sup>See, e.g., Gregory v. Helvering, 293 U.S. 465 (1935); ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998), cert. denied 526 U.S. 1017 (1999); Bail Bonds by Marvin Nelson, Inc. v. Commissioner, 820 F.2d 1543, 1549 (9<sup>th</sup> Cir. 1987)(“The economic substance factor involves a broader examination of ... whether from an objective standpoint the transaction was likely to produce economic benefits aside from a tax deduction.”).

<sup>29</sup>See, e.g., Gregory v. Helvering, 293 U.S. 465 (1935); Commissioner v. Transport Trading & Terminal Corp., 176 F.2d 570, 572 (2<sup>nd</sup> Cir. 1949), cert. denied 339 U.S. 916 (1949)(Judge Learned Hand)(“The doctrine of Gregory v. Helvering ... means that in construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation.”)

<sup>30</sup>See, e.g., Weiss v. Stearn, 265 U.S. 242, 254 (1924) (“Questions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participants; and when applying the provisions of the Sixteenth Amendment and income laws ... we must regard matters of substance and not mere form.”)

<sup>31</sup>See, e.g., Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945) (“The transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another using the latter as a conduit through which to pass title.”); Palmer v. Commissioner, 62 T.C. 684, 692 (1974).

<sup>32</sup>See, e.g., Gregory v. Helvering, 293 U.S. 465 (1935); Rice’s Toyota World v. Commissioner, 752 F.2d 89, 91-92 (4<sup>th</sup> Cir. 1985); United Parcel Service of America, Inc. v. Commissioner, 78 T.C.M. 262 at n. 29 (1999), rev’d 254 F.3d 1014 (11<sup>th</sup> Cir. 2001)(“Courts have recognized two basic types of sham transactions. Shams in fact are transactions that never occur. In such shams, taxpayers claim deductions for transactions that have been created on paper but which never took place. Shams in substance are transactions that actually occurred but which lack the substance their form represents.”).

<sup>33</sup>Joint Committee on Taxation report at 7.

<sup>34</sup>See, e.g., S. 476, the CARE Act of 2003 (108<sup>th</sup> Congress, first session), section 701 et seq.

Illegal tax shelters sold to corporations and wealthy individuals drain the U.S. Treasury of billions of dollars in lost tax revenues each year. According to GAO, a recent IRS consultant estimated that for the six year period, 1993-1999, the IRS lost on average between \$11 and \$15 billion each year from abusive tax shelters.<sup>35</sup> In actual cases closed between October 1, 2001, and May 6, 2003, involving just 42 large corporations, GAO reports that the IRS proposed abusive shelter-related adjustments for tax years, 1992 to 2000, totaling more than \$10.5 billion.<sup>36</sup> GAO reports that an IRS database tracking unresolved, abusive tax shelter cases over a number of years estimates potential tax losses of about \$33 billion from listed transactions and another \$52 billion from nonlisted abusive transactions, for a combined total of \$85 billion.<sup>37</sup>

GAO has also reported that IRS data provided in October 2003, identified about 6400 individuals and corporations that had bought abusive tax shelters and other abusive tax planning products, as well as almost 300 firms that appear to have promoted them.<sup>38</sup> According to GAO, as of June 2003, the IRS had approved investigations of 98 tax shelter promoters, including some directed at accounting or law firms.<sup>39</sup>

IRS Commissioner Mark Everson testified at a recent Senate Finance Committee hearing that: “A significant priority in the Service’s efforts to curb abusive transactions is our focus on promoters.”<sup>40</sup> He stated, “The IRS has focused its attention in the area of tax shelters on accounting and law firms, among others. The IRS has focused on these firms because it believes that, in the instances in which the IRS has acted, these firms were acting as promoters of tax shelters, and not simply as tax or legal advisers.”

Mr. Everson also described the latest generation of abusive tax shelters as complex, difficult-to-detect transactions developed by extremely sophisticated people:

“The latest generation of abusive tax transactions has been facilitated by the growth of financial products and structures whose own complexity and non-transparency have provided additional tools to allow those willing to design transactions intended to generate unwarranted tax benefits....[A]busive transactions that are used by corporations and individuals present formidable administrative challenges. The transactions themselves can be creative, complex

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<sup>35</sup>GAO Testimony at 12.

<sup>36</sup>*Id.* at 11.

<sup>37</sup>*Id.* at 10.

<sup>38</sup> *Id.* at 11.

<sup>39</sup>*Id.* at 16.

<sup>40</sup>Testimony of Mark Everson, IRS Commissioner, before the Senate Committee on Finance, “Tax Shelters: Who’s Buying, Who’s Selling and What’s the Government Doing About It?” (10/21/03), at 7.

and difficult to detect. Their creators are often extremely sophisticated, as are many of their users, who are often financially prepared and motivated to contest the Service's challenges."<sup>41</sup>

The Commissioner stated that due to the "growth in the volume of abusive transactions" and "a disturbing decline in corporate conduct and governance," among other factors, the IRS has enhanced its response to abusive transactions in general, and abusive tax shelters in particular.<sup>42</sup> He said that the Office of Tax Shelter Analysis (OTSA), first established in February 2000 within the Large and Mid-Size Business Division, is continuing to lead IRS tax shelter efforts. He stated that, "OTSA plans, centralizes and coordinates LMSB's tax shelter operations and collects, analyzes, and distributes within the IRS information about potentially abusive tax shelter activity."<sup>43</sup> Mr. Everson described a number of ongoing IRS tax shelter initiatives including efforts to increase enforcement resources, conduct promoter audits, enforce IRS document requests against accounting and law firms, implement global settlements for persons who used certain illegal tax shelters, develop proposed regulations to improve tax opinion letters and ethics rules for tax professionals appearing before the IRS, and issue additional notices to identify illegal tax shelters.

The Commissioner warned:

"[A]busive transactions can and will continue to pose a threat to the integrity of our tax administration system. We cannot afford to tolerate those who willfully promote or participate in abusive transactions. The stakes are too high and the effects of an insufficient response are too corrosive."<sup>44</sup>

Professional organizations like accounting firms, banks, investment advisers, and law firms are now key participants in the tax shelter industry. These firms specialize in producing tax shelters that utilize complex structured finance transactions, multi-million dollar loans, novel tax code interpretations, and expensive professional services requiring highly skilled professionals. These firms routinely enlist assistance from other respected professional firms and financial institutions to provide the accounting, investment, financing or legal services needed for the tax shelters to work.

During the past ten years, professional firms active in the tax shelter industry have expanded their role, moving from selling individualized tax shelters to specific clients, to developing generic tax products and mass marketing them to existing and potential clients. No longer content with responding to client inquiries, these firms are employing the same tactics employed by disreputable, tax shelter hucksters: churning out a continuing supply of new and abusive tax products, marketing

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<sup>41</sup>Id. at 2.

<sup>42</sup>Id. at 3.

<sup>43</sup>Id. at 8.

<sup>44</sup>Id. at 16.



them with hard sell techniques and telemarketer cold calls; and taking deliberate measures to hide their activities from the IRS.

## **VI. Four KPMG Case Histories**

### **A. KPMG In General**

KPMG International is one of the largest public accounting firms in the world, with over 700 offices in 152 countries.<sup>45</sup> In 2002, it employed over 100,000 people and had worldwide revenues of \$10.7 billion. KPMG International is organized as a Swiss “non-operating association,” functions as a federation of partnerships around the globe, and maintains its headquarters in Amsterdam.

KPMG LLP (hereinafter “KPMG”) is a U.S. limited liability partnership and a member of KPMG International. KPMG is the third largest accounting firm in the United States, and generates more than \$4 billion in annual revenues. KPMG was formed in 1987, from the merger of two long-standing accounting firms, Peat Marwick and Klynveld Main Goerdeler, along with their individual member firms. KPMG maintains its headquarters in New York and numerous offices in the United States and other countries. KPMG is run by a “Management Committee” made up of 15 individuals drawn from the firm’s senior management and major divisions.<sup>46</sup> KPMG’s Chairman and CEO is Eugene O’Kelly, who joined KPMG in 1972, became partner in 1982, and was appointed Chairman in 2002. KPMG’s Deputy Chairman is Jeffery M. Stein, who was also appointed in 2002. From

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<sup>45</sup>The general information about KPMG is drawn from KPMG documents produced in connection with the Subcommittee investigation; Internet websites maintained by KPMG LLP and KPMG International; and a legal complaint filed by the U.S. Securities and Exchange Commission (SEC) in SEC v. KPMG LLP, Civil Action No. 03-CV-0671 (D. S.D.N.Y.)(Jan. 29, 2003), alleging fraudulent conduct by KPMG and certain KPMG audit partners in connection with audits of certain Xerox Corporation financial statements.

<sup>46</sup>The 15 Management Committee members are the Chairman, Deputy Chairman, Chief Financial Officer, General Counsel, head of the Department of Professional Practice, head of the Department of Marketing and Communications, head of the Department of Human Resources, the two most senior officials in the Tax Services Practice, the two most senior officials in the Assurance Practice, and the most senior official in each of four industry-related “lines of business,” such as telecommunications and energy. Subcommittee interview of Jeffrey Stein (10/31/03).

2000 until 2002, Mr. Stein was the Vice Chairman for Tax heading KPMG's Tax Services Practice, and prior to that he served as head of operations, or second in command, of the Tax Services Practice.

KPMG's Tax Services Practice is a major division of KPMG. It provides tax compliance, tax planning, and tax return preparation services. The Tax Services Practice employs more than 10,300 tax professionals and generates approximately \$1.2 billion in annual revenues for the firm. These revenues have been increasing rapidly in recent years, including a 45% cumulative increase over four years, from 1998 to 2001.<sup>47</sup> The Tax Services Practice is headquartered in New York, has 122 U.S. offices, and maintains additional offices around the world. The current head of the Tax Service is Vice Chairman for Tax, Richard Smith.

The Tax Services Practice has over two dozen subdivisions, offices, "practices" or "groups" which over the years have changed missions and personnel. Many have played key roles in developing, marketing, or implementing KPMG's generic tax products, including the four products featured in this Report. One key group is the Washington National Tax Practice (WNT) which provides technical tax expertise to the entire KPMG firm. A WNT subgroup, The Tax Innovation Center, leads KPMG's efforts to develop new generic tax products. Another key group is the Department of Professional Practice (DPP) for Tax, which, among other tasks, reviews and approves all new KPMG tax products for sale to clients. KPMG's Federal Tax Practice addresses federal tax compliance and planning issues. KPMG's Personal Financial Planning (PFP) Practice focuses on selling "tax-advantaged" products to high net worth individuals and large corporations.<sup>48</sup> Through a subdivision known as the Capital Transaction Services (CaTS) practice, later renamed the Innovative Strategies (IS) practice, PFP led KPMG's efforts on FLIP, OPIS, and BLIPS.<sup>49</sup> KPMG's Stratecon Practice, which focuses on "business based" tax planning and tax products, led the firm's efforts on SC2. Innovative Strategies and Stratecon were disbanded in 2002, and their tax professionals assigned to other groups.<sup>50</sup>

Several senior KPMG tax professionals interviewed by the Subcommittee staff, when asked to describe KPMG's overall approach to tax services, indicated that the firm made a significant change in direction in the late 1990s, when it made a formal decision to begin devoting substantial resources

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<sup>47</sup>Internal KPMG presentation dated 7/19/01, by Rick Rosenthal and Marsha Peters, entitled "Innovative Tax Solutions." A chart included in this presentation tracks increases in the Tax Service's gross revenues from 1998 until 2001, showing a cumulative increase of more than 45% over the four-year period, from 1998 gross revenues of \$830 million to 2001 gross revenues of \$1.24 billion.

<sup>48</sup>Minutes dated 11/30/00, Monetization Solutions Task Force Teleconference, Bates KPMG 0050624-29, at 50625.

<sup>49</sup>Document dated 5/18/01, "PFP Practice Reorganization Innovative Strategies Business Plan – DRAFT," Bates KPMG 0050620-23, at 1.

<sup>50</sup>Stratecon appears to have been very active until its dissolution. See, e.g., email dated 4/8/02, from Larry Manth to multiple KPMG tax professionals, on "Stratecon Final Results for March 2002," depicting Stratecon's March 2002 revenues and operating expenses.

to developing and marketing tax products that could be sold to multiple clients. The Subcommittee staff was told that KPMG made this decision, in part, due to the success other accounting firms were experiencing in selling tax products; in part, due to the large revenues earned by the firm from selling a particular tax product to banks;<sup>51</sup> and, in part, due to new tax leadership that was enthusiastic about increasing tax product sales. Among other actions to carry out this decision, the firm established the Tax Innovation Center which was dedicated to generating new generic tax products. One senior KPMG tax professional told the Subcommittee staff that some KPMG partners considered it “important” for the firm to become an industry leader in producing generic tax products. He said that, of the many new products KPMG developed, some were “relatively plain vanilla,” while others were “aggressive.” He said that the firm’s policy was to offer only tax products which met a “more likely than not” standard, meaning the product had a greater than 50 percent probability of withstanding a challenge by the IRS, and that KPMG deliberately chose a higher standard than required by the AICPA, which permits firms to offer tax products with a “realistic possibility of success,” or a one-in-three chance of withstanding an IRS challenge.<sup>52</sup>

In recent years, KPMG has become the subject of IRS, SEC, and state investigations and enforcement actions in the areas of tax, accounting fraud, and auditor independence.<sup>53</sup> These enforcement actions include ongoing litigation by the IRS to enforce tax shelter related document requests and a tax promoter audit of the firm; SEC, California, and New York investigations into a potentially abusive tax shelter involving at least 10 banks that are allegedly using sham mutual funds established on KPMG’s advice; SEC and Missouri investigations or enforcement actions related to alleged KPMG involvement in accounting fraud at Xerox Corporation or General American Mutual Holding Co.; and auditor independence concerns leading to an SEC censure of KPMG for investing in AIM mutual funds while AIM was an audit client, and to an ongoing SEC investigation of tax product client referrals from Wachovia Bank to KPMG while Wachovia was a KPMG audit client. In addition, a number of taxpayers have filed suit against KPMG for allegedly selling them an illegal tax shelter or improperly involving them in work on illegal tax shelters.

## **B. KPMG’s Tax Shelter Activities**

**Finding: Although KPMG denies being a tax shelter promoter, the evidence establishes that KPMG has devoted substantial resources to, and obtained significant fees from, developing, marketing, and implementing potentially abusive and illegal tax shelters that U.S. taxpayers might otherwise have been unable, unlikely or unwilling to employ, costing the Treasury billions of dollars in lost tax revenues.**

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<sup>51</sup>For information about this tax product, see Appendix C, “Sham Mutual Fund Investigation.”

<sup>52</sup>KPMG’s policy is included in the KPMG Tax Services Manual - U.S., May 2002, KPMG Accounting & Reporting Publication, (hereinafter “KPMG Tax Services Manual”), § 24.5.2, at 24-3.

<sup>53</sup>Brief summaries of these matters are included in Appendix C.

KPMG has repeatedly denied being a tax shelter promoter. KPMG has denied it in court when opposing IRS document requests for information related to tax shelters,<sup>54</sup> and denied it in response to Subcommittee questions. KPMG has never registered any tax product with the IRS as a potentially abusive tax shelter.

KPMG does not refer to any of its tax products as “tax shelters” and objects to using that term to describe its tax products. Instead, KPMG refers to its tax products as “tax solutions” or “tax strategies.” The KPMG Tax Services Manual defines a “tax solution” as “a tax planning idea, structure, or service that potentially is applicable to more than one client situation and that is reasonable to believe will be the subject of leveraged deployment,” meaning sales to multiple clients.<sup>55</sup>

In response to a Subcommittee inquiry, KPMG provided the Subcommittee with a list of over 500 “active tax products” designed to be offered to multiple clients for a fee.<sup>56</sup> When the Subcommittee asked KPMG to identify the ten tax products that produced the most revenue for the firm in 2000, 2001, and 2002, KPMG denied having the ability to reliably track revenues associated with individual tax products and thus to identify with certainty its top revenue producers.<sup>57</sup> To respond to the Subcommittee’s request, KPMG indicated that it had “undertaken a good faith, reasonable effort to estimate the tax strategies that were likely among those generating the most revenues in the years requested.”<sup>58</sup> KPMG identified a total of 19 tax products that were top revenue-producers for the firm over the three year period.

The Subcommittee staff’s preliminary review of these 19 top revenue-producing tax products determined that six, OPIS, BLIPS, 401(k)ACCEL, CARDS, CLAS, and CAMPUS, are either within the scope of “listed transactions” already determined by the IRS to be potentially abusive tax shelters or within the scope of IRS document requests in an ongoing IRS review of KPMG’s tax shelter

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<sup>54</sup>See United States v. KPMG, Case No. 1: 02MS00295 (D.D.C. 9/6/02), “Answer to Petition to Enforce Internal Revenue Summonses,” at ¶1 (“KPMG asserts that it is not a tax shelter organizer, but a professional firm whose tax professionals provide advice and counseling on a one-on-one basis to clients and prospective clients concerning the clients’ tax situations.”)

<sup>55</sup>KPMG Tax Services Manual, §24.1.1, at 24-1.

<sup>56</sup>Untitled document, produced by KPMG on 2/10/03, Bates KPMG 0000009-91.

<sup>57</sup>See chart entitled, “Good Faith Estimate of Top Revenue-Generating Strategies,” attached to letter dated 8/8/03, from KPMG’s legal counsel to the Subcommittee, Bates KPMG 0001801 (“Because each tax strategy is tailored to a client's particular circumstances, the firm does not maintain any systematic, reliable method of recording revenues by tax product on a national basis, and therefore is unable to provide any definitive list or quantification of revenues for a 'top ten tax products' as requested by the Subcommittee.”).

<sup>58</sup>Id.

activities.<sup>59</sup> The Subcommittee determined that many, if not all, of the 19 tax products were designed to reduce the tax liability of corporations or individuals, and employed features such as structured transactions, complex accounting methods, and novel tax law interpretations, often found in illegal tax shelters. The Subcommittee staff briefly reviewed a number of other KPMG tax products as well<sup>60</sup> and found that they, too, carried indicia of a potentially abusive tax shelter.

KPMG insists that all of its tax products are the result of legitimate tax planning services. In legal pleadings seeking KPMG documents, however, the IRS has stated that a number of KPMG's tax products appear to be "tax shelters" and requested related documentation to determine whether the firm is complying with federal tax shelter laws.<sup>61</sup> The IRS specifically identified as "tax shelters" FLIP, OPIS, BLIPS, TRACT, IDV, 401(k) ACCEL, Contested Liabilities, Economic Liability Transfer, CLAS, CAMPUS, MIDCO, certain "Tax Treaty" transactions, PICO, and FOCUS.<sup>62</sup> The IRS also alleged that, according to information from a confidential source, "KPMG continues to hide from the IRS information about tax shelters it is now developing and marketing" and "KPMG continues to develop and aggressively market dozens of possibly abusive tax shelters."<sup>63</sup>

The Subcommittee staff selected three of KPMG's 19 top revenue producing tax products for more intensive study, OPIS, BLIPS and SC2, as well as an earlier tax product, FLIP, which KPMG had stopped selling after 1999, but which was the precursor to OPIS and BLIPS, and the subject of law suits filed in 2002 and 2003, by persons claiming KPMG had sold them an illegal tax shelter. All four of these tax products were explicitly designed to reduce or eliminate the tax liability of corporations or individuals. Three, FLIP, OPIS and BLIPS, have already been determined by the IRS to be illegal or potentially abusive tax shelters, and the IRS has penalized taxpayers for using them. A number of these taxpayers have, in turn, sued KPMG for selling them illegal tax shelters.<sup>64</sup> It is these four products that are featured in this Report.

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<sup>59</sup>Compare 19 tax products listed in the chart produced by KPMG on 8/8/03, Bates KPMG 0001801, to the tax products identified in United States v. KPMG, Case No. 1: 02MS00295 (D.D.C. 7/9/02), "Petition to Enforce Internal Revenue Service Summonses."

<sup>60</sup>These tax products included OTHELLO, TEMPEST, RIPSS, AND California REIT.

<sup>61</sup>United States v. KPMG, Case No. 1: 02MS00295 (D.D.C. 7/9/02), "Petition to Enforce Internal Revenue Service Summonses."

<sup>62</sup>Id.

<sup>63</sup>United States v. KPMG, Case No. 1: 02MS00295 (D.D.C. 7/9/02), "Declaration of Michael A. Halpert," Internal Revenue Agent, at ¶38.

<sup>64</sup>See, e.g., Jacoboni v. KPMG, Case No. 6:02-CV-510 (M.D. Fla. 4/29/02)(OPIS); Swartz v. KPMG, Case No. C03-1252 (W.D. Wash. 6/6/03)(BLIPS); Thorpe v. KPMG, Case No. 5-030CV-68 (E.D.N.C. 1/27/03)(FLIP/OPIS). In addition, a KPMG tax professional has sued KPMG for defamation in "retaliation for the Plaintiff's refusal to endorse or participate in [KPMG's] illegal activities and for his cooperation with government investigators." Hamersley v. KPMG, Case No. BC297905 (Los Angeles Superior Court 6/23/03).

The dispute over whether KPMG sells benign “tax solutions” or illegal “tax shelters” is more than a linguistic difference; it goes to the heart of whether respected institutions like this one have crossed the line of acceptable conduct. Shedding light is a memorandum prepared five years ago, in 1998, by a KPMG tax professional advising the firm not to register what was then a new tax product, OPIS, as a “tax shelter” with the IRS.<sup>65</sup> Here is the advice this tax professional gave to the second most senior Tax Services Practice official at KPMG:

“For purposes of this discussion, I will *assume* that we will conclude that the OPIS product meets the definition of a tax shelter under IRC section 6111(c).

Based on this assumption, the following are my conclusions and recommendations as to why KPMG should make the business/strategic decision not to register the OPIS product as a tax shelter. My conclusions and resulting recommendation [are] based upon the immediate negative impact on the Firm’s strategic initiative to develop a sustainable tax products practice and the long-term implications of establishing ... a precedent in registering such a product.

**First, the financial exposure to the Firm is minimal.** Based upon our analysis of the applicable penalty sections, we conclude that the penalties would be no greater than \$14,000 per \$100,000 in KPMG fees. ... For example, our average deal would result in KPMG fees of \$360,000 with a maximum penalty exposure of only \$31,000.

This further assumes that KPMG would bear 100 percent of the penalty. In fact ... the penalty is *joint and several* with respect to anyone involved in the product who was required to register. Given that, at a minimum, Presidio would also be required to register, our share of the penalties could be viewed as being only one-half of the amounts noted above. If other OPIS participants (e.g., Deut[s]che Bank, Brown & Wood, etc.) were also found to be promoters subject to the registration requirements, KPMG’s exposure would be further minimized. Finally, any ultimate exposure to the penalties are abatable if it can be shown that we had reasonable cause. ...

To my knowledge, the Firm has never registered a product under section 6111 ....

**Third, the tax community at large continues to avoid registration of all products.** Based upon my knowledge, the representations made by Presidio and Quadra, and Larry DeLap’s discussions with his counterparts at other Big 6 firms, *there are no tax products marketed to individuals by our competitors which are registered.* This includes income conversion strategies, loss generation techniques, and other related strategies.

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<sup>65</sup>Memorandum dated 5/26/98, from Gregg Ritchie to Jeffrey Stein, then head of operations in the Tax Services Practice, “OPIS Tax Shelter Registration,” Bates KPMG 0012031-33. Emphasis in original.

Should KPMG decide to begin to register its tax products, I believe that it will position us with a severe competitive disadvantage in light of industry norms to such degree that we will not be able to compete in the tax advantaged products market.

**Fourth, there has been (and, apparently, continues to be) a lack of enthusiasm on the part of the Service to enforce section 6111.** In speaking with KPMG individuals who were at the Service ... the Service has apparently *purposefully* ignored enforcement efforts related to section 6111. In informal discussions with individuals currently at the Service, WNT has confirmed that there are not many registration applications submitted and they do not have the resources to dedicate to this area.

**Finally, the guidance from Congress, the Treasury, and the Service is minimal, unclear, and extremely difficult to interpret when attempting to apply it to ‘tax planning products.’ ...**

I believe the rewards of a successful marketing of the OPIS product ... far exceed the financial exposure to penalties that may arise. Once you have had an opportunity to review this information, I request that we have a conference with the persons on the distribution list ... to come to a conclusion with respect to my recommendation. As you know, we must immediately deal with this issue in order to proceed with the OPIS product.”

This memorandum assumes that OPIS qualifies as a tax shelter under federal law and then advocates that KPMG not register it with the IRS as required by law. The memorandum advises KPMG to knowingly violate the law requiring tax shelter registration, because the IRS is not vigorously enforcing the registration requirement, the penalties for noncompliance are much less than the potential profits from the tax product, and “industry norms” are not to register any tax products at all. The memorandum warns that if KPMG were to comply with the tax shelter registration requirement, this action would place the firm at such a competitive disadvantage that KPMG would “not be able to compete in the tax advantaged products market.”

The Subcommittee has learned that some KPMG tax professionals agreed with this analysis,<sup>66</sup> while other senior KPMG tax professionals provided the opposite advice to the firm.<sup>67</sup> but the head of the Tax Services Practice, the Vice Chairman for Tax, ultimately decided not to register the tax product as a tax shelter. KPMG authorized the sale of OPIS in the fall of 1998.<sup>68</sup> Over the next two

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<sup>66</sup>See, e.g., email dated 5/26/98, from Mark Springer to multiple KPMG tax professionals, “Re: OPIS Tax Shelter Registration,” Bates KPMG 0034971 (“I would still concur with Gregg’s recommendation ... I don’t think we want to create a competitive DISADVANTAGE, nor do we want to lead with our chin.” Emphasis in original.)

<sup>67</sup>Lawrence DeLap, then DPP head, told the Subcommittee he had advised the firm to register OPIS as a tax shelter. Subcommittee interview of Lawrence DeLap (10/30/03).

<sup>68</sup>See email dated 11/1/98, from Larry DeLap to William Albaugh and other KPMG tax professionals, “OPIS,” Bates KPMG 0035702.

years, KPMG sold OPIS to more than 111 individuals. It earned fees in excess of \$28 million, making OPIS one of KPMG's top ten tax revenue producers in 2000. KPMG never registered OPIS as a tax shelter with the IRS. In 2001, the IRS issued Notice 2001-45 declaring tax products like OPIS to be potentially abusive tax shelters.

The following sections of this report describe the systems, procedures, and corporate culture behind KPMG's efforts to develop, market, and implement its tax products, as well as steps KPMG has taken to avoid detection of its activities by tax authorities and others. Each of these sections includes specific evidence drawn from the BLIPS, SC2, OPIS, and FLIP case histories. Appendices A and B provide more detailed descriptions of how BLIPS and SC2 worked.

## **(1) Developing New Tax Products**

**Finding: KPMG devotes substantial resources and maintains an extensive infrastructure to produce a continuing supply of generic tax products to sell to clients, using a process which pressures its tax professionals to generate new ideas, move them quickly through the development process, and approve, at times, illegal or potentially abusive tax shelters.**

KPMG prefers to describe itself as a tax advisor that responds to client inquiries seeking tax planning services to structure legitimate business transactions in a tax efficient way. The Subcommittee investigation has determined, however, that KPMG has also developed and supports an extensive internal infrastructure of offices, programs, and procedures designed to churn out a continuing supply of new tax products unsolicited by a specific client and ready for mass marketing.

**Drive to Produce New Tax Products.** In 1997, KPMG established the Tax Innovation Center, whose sole mission is to push the development of new KPMG tax products. Located within the Washington National Tax (WNT) Practice, the Center is staffed with about a dozen full-time employees and assisted by others who work for the Center on a rotating basis. A 2001 KPMG overview of the Center states that “[t]ax [s]olution development is one of the four priority activities of WNT” and “a significant percentage of WNT resources are dedicated to [t]ax [s]olution development at any given time.”<sup>69</sup>

Essentially, the Tax Innovation Center works to get KPMG tax professionals to propose new tax product ideas and then provides administrative support to develop the proposals into approved tax products and move them successfully into the marketing stage. As part of this effort, the Center maintains a “Tax Services Idea Bank” which it uses to drive and track new tax product ideas. The Center asks KPMG tax professionals to submit new ideas for tax products on “Idea Submission Forms” or “Tax Knowledge Sharing” forms with specified information on how the proposed tax

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<sup>69</sup>“Tax Innovation Center Overview,” Solution Development Process Manual (4/7/01), prepared by the KPMG Tax Innovation Center (hereinafter “TIC Manual”), at i.



product would work and who would be interested in buying it.<sup>70</sup> The Idea Submission Form asks the submitter to explain, for example, “how client savings are achieved,” “the tax, business, and financial statement benefits of the idea,” and “the revenue potential of this idea,” including “key target markets,” “the typical buyer,” and an estimated “average tax fee per engagement.”

In recent years, the Center has established a firm-wide, numerical goal for new tax idea submissions and applied ongoing pressure on KPMG tax professionals to meet this goal. For example, in 2001, the Center established this overall objective: “Goal: Deposit 150 New Ideas in Tax Services Idea Bank.”<sup>71</sup> On May 30, 2001, the Center reported on the Tax Services’ progress in meeting this goal as part of a larger power-point presentation on “year-end results” in new tax solutions and ideas development. For each of 12 KPMG “Functional Groups” within the Tax Services Practice, a one-page chart shows the precise number of “Deposits,” “Expected Deposits,” and “In the Pipeline” ideas which each group had contributed or were expected to contribute to the Tax Services Idea Bank. For example, the chart reports the total number of new ideas contributed by the e-Tax Group, Insurance Group, Passthrough Group, Personal Financial Planning Group, State and Local Tax (SALT) Group, Stratecon, and others. It shows that SALT had contributed the most ideas at 32, while e-Tax had contributed the least, having deposited only one new idea. It showed that, altogether, the groups had deposited 122 new ideas in the idea bank, with 38 more expected, and 171 “in the pipeline.”

In addition to reporting on the number of new ideas generated during the year, the Center reported on its efforts to measure and improve the profitability of the tax product development process. The year-end presentation reported, for example, on the Tax Innovation Center’s progress in meeting its goal to “Measure Solution Profitability,” noting that the Center had developed software systems that “captured solution development costs and revenue” and “[p]repared quarterly Solution Profitability reports.” It also discussed progress in meeting a goal to “Increase Revenue from Tax Services Idea Bank.” Among other measures, the Center proposed to “[s]et deployment team revenue goals for all solutions.”

**Development and Approval Process.** Once ideas are deposited into the Tax Services Idea Bank, KPMG has devoted substantial resources to transforming the more promising ideas into generic tax products that could be sold to multiple clients.

KPMG’s development and approval process for new tax products is described in its Tax Services Manual and Tax Innovations Center Manual.<sup>72</sup> Essentially, the process consists of three stages, each of which may overlap with another. In the first stage, the new tax idea undergoes an

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<sup>70</sup>“TIC Solution Development Process,” TIC Manual at 6.

<sup>71</sup>KPMG presentation dated 5/30/01, “Tax Innovation Center Solution and Idea Development - Year-End Results,” Bates XX at 4.

<sup>72</sup>KPMG Tax Services Manual, Chapter 24, pages 24-1 to 24-7.

initial screening “for technical and revenue potential.”<sup>73</sup> This initial analysis is supposed to be provided by a “Tax Lab” which is a formal meeting, arranged by the Tax Innovations Center, of six or more KPMG tax experts specializing in the tax issues or industry affected by the proposed product.<sup>74</sup> Promising proposals are also assigned one or more persons, sometimes referred to as “National Development Champions” or “Development Leaders,” to assist in the proposal’s initial analysis and, if warranted, shepherd the proposal through the full KPMG approval process. For example, the lead tax professional who moved BLIPS through the development and approval process was Jeffrey Eischeid, assisted by Randall Bickham, while for SC2, the lead tax professional was Lawrence Manth, assisted by and later succeeded by Andrew Atkin.

If a proposal survives the initial screening, in the second stage, it must undergo a thorough review by the Washington National Tax Practice (“WNT review”), which is responsible for determining whether the product meets the technical requirements of existing tax law.<sup>75</sup> WNT personnel often spend significant time identifying and searching for ways to resolve problems with how the proposed product is structured or is intended to be implemented. The WNT review must also include analysis of the product by the WNT Tax Controversy Services group “to address tax shelter regulations issues.”<sup>76</sup> WNT must “sign-off” on the technical merits of the proposal for it to be approved for sale to clients.

In the third and final stage, the product must undergo review and approval by the Department of Practice and Professionalism (“DPP review”). The DPP review must determine that the product not only complies with the law, but also meets KPMG’s standards for “risk management and professional practice.”<sup>77</sup> This latter review includes consideration of such matters as the substantive content of KPMG tax opinion and client engagement letters, disclosures to clients of risks associated with a tax product, the need for any confidentiality or marketing restrictions, how KPMG fees are to

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<sup>73</sup>TIC Manual at 5.

<sup>74</sup>The TIC Manual states that a Tax Lab is supposed to evaluate “the technical viability of the idea, the idea’s revenue generation potential above the Solution Revenue threshold, and a business case for developing the solution, including initial target list, marketing considerations, and preliminary technical analysis.” TIC Manual at 5.

<sup>75</sup>In an earlier version of KPMG’s tax product review and approval procedure, WNT did not have a formal role in the development and approval process, according to senior tax professionals interviewed by the Subcommittee. This prior version of the process, which was apparently the first, firm-wide procedure established to approve new generic tax products, was established in 1997, and operated until mid 1998. In it, a three-person Tax Advantaged Product Review Board, whose members were appointed by and included the head of DPP-Tax, conducted the technical review of new proposals. In 1998, when this responsibility was assigned to the WNT, the Board was disbanded. The earlier process was used to approve the sale of FLIP and OPIS, while the existing procedure was used to approve the sale of BLIPS and SC2. Subcommittee interview of Lawrence DeLap (10/30/03).

<sup>76</sup>KPMG Tax Services Manual, § 24.4.1, at 24-2.

<sup>77</sup>Id., § 24.5.2, at 24-3.

be structured, whether auditor independence issues need to be addressed, and the potential impact of a proposed tax product on the firm's reputation.<sup>78</sup>

Each of the three stages takes time, and the entire development and approval process can consume six months or longer. The process is labor-intensive, since it requires tax professionals to examine the suggested product, which is often quite complex, identify various tax issues, and suggest solutions to problems. The process often includes consultations with outside professionals, not only on tax issues, but also on legal, investment, accounting, and finance issues, since many of the products require layers of corporations, trusts, and special purpose entities; complex financial and securities transactions using arcane financial instruments; and multi-million-dollar lending transactions, all of which necessitate expert guidance, detailed paperwork, and logistical support.

The KPMG development and approval process is intended to encourage vigorous analysis and debate by the firm's tax experts over the merits of a proposed tax product and to produce a determination that the product complies with current law and does not impose excessive financial or reputational risk for the firm. All KPMG personnel interviewed by the Subcommittee indicated that the final approval that permitted a new tax product to go to market was provided by the head of the DPP. KPMG's Tax Services Manual states that the DPP "generally will not approve a solution unless the appropriate WNT partner(s)/principal(s) conclude that it is at least more likely than not that the desired tax consequences of the solution will be upheld if challenged by the appropriate taxing authority."<sup>79</sup> KPMG defines "more likely than not" as a "greater than 50 percent probability of success if [a tax product is] challenged by the IRS."<sup>80</sup> KPMG personnel told the Subcommittee that the WNT's final sign-off on the technical issues had to come before the DPP would provide its final sign-off allowing a new tax product to go to market.

Once approved, KPMG procedures required a new tax product to be accompanied by a number of documents before its release for sale to clients, including an abstract summarizing the product; a standard engagement letter for clients purchasing the product; an electronic powerpoint presentation to introduce the product to other KPMG tax professionals; and a "whitepaper" summarizing the technical tax issues and their resolution.<sup>81</sup> In addition, to "launch" the new product within KPMG, the Tax Innovation Center is supposed to prepare a "Tax Solution Alert" which serves "as the official notification" that the tax product is available for sale to clients.<sup>82</sup> This Alert is

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<sup>78</sup>Subcommittee interview of Lawrence DeLap (10/30/03). The Subcommittee staff was told that, since 1997, DPP-Tax has had very limited resources to conduct its new product reviews. Until 2002, for example, DPP-Tax had a total of less than ten employees; in 2003, the number increased to around or just above 20. In contrast, DPP-Assurance, which oversees professional practice issues for KPMG audit activity, has well over 100 employees.

<sup>79</sup>KPMG Tax Services Manual, § 24.5.2, at 24-3.

<sup>80</sup>*Id.*, § 41.19.1, at 41-10.

<sup>81</sup>*Id.*, § 24.4.2, at 24-2. See also TIC Manual at 10.

<sup>82</sup>TIC Manual at 10.

supposed to include a “digest” summarizing the product, a list of the KPMG “deployment team” members responsible for “delivering” the product to market, pricing information, and marketing information such as a “Solution Profile” of clients who would benefit from the tax product and “Optimal Target Characteristics” and the expected “Typical Buyer” of the product. The four case histories demonstrated that KPMG personnel sometimes, but not always, complied with the paperwork required by its procedures. For example, while SC2 was the subject of a “Tax Solution Alert,” BLIPS was not.

In addition to or in lieu of the required “whitepaper” explaining KPMG’s position on key technical issues, KPMG often prepared a “prototype” tax opinion letter laying out the firm’s analysis and conclusions regarding the tax consequences of the new tax product.<sup>83</sup> KPMG defines a “tax opinion” as “any written advice on the tax consequences of a particular issue, transaction or series of transactions that is based upon specific facts and/or representations of the client and that is furnished to the client or another party in a letter, a whitepaper, a memorandum, an electronic or facsimile communication, or other form.”<sup>84</sup> The tax opinion letter includes, at a minimum under KPMG policy, a statement of the firm’s determination that, if challenged by the IRS, it was “more likely than not” that the desired tax consequences of the new tax product would be upheld in court. The prototype tax opinion letter is intended to serve as a template for the tax opinion letters actually sent by KPMG to specific clients for a fee.

In addition to preparing its own tax opinion letter, in some cases KPMG seeks an opinion letter from an outside party, such as a law firm, to provide an “independent” second opinion on the validity of the tax product. KPMG made arrangements to obtain favorable legal opinion letters from an outside law firm in each of the case studies examined by the Subcommittee.

The tax product development and approval process just described is the key internal procedure at KPMG today to determine whether the firm markets benign tax solutions that comply with the law or abusive tax shelters that do not. The investigation conducted by the Subcommittee found that, in the case of FLIP, OPIS, BLIPS, and SC2, KPMG tax professionals were under pressure not only to develop the new products quickly, but also to approve products that the firm’s tax experts knew were potentially illegal tax shelters. In several of these cases, top KPMG tax experts participating in the review process expressed repeated concerns about the legitimacy of the relevant tax product. Despite these concerns, all four products were approved for sale to clients.

**BLIPS Development and Approval Process.** The development and approval process resulting in the marketing of the BLIPS tax product to 186 individuals illustrates how the KPMG

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<sup>83</sup>KPMG Tax Services Manual, § 41.17.1, at 41-8.

<sup>84</sup>*Id.*, § 41.15.1, at 41-8. A KPMG tax opinion often addresses all of the legal issues related to a new tax product and provides an overall assessment of the tax consequences of the new product. See, e.g., KPMG tax opinion on BLIPS. Other KPMG tax opinions address only a limited number of issues related to a new tax product and may provide different levels of assurance on the tax consequences of various aspects of the same tax product. See, e.g., KPMG tax opinions related to SC2.

process works.<sup>85</sup> BLIPS was first proposed as a KPMG tax idea in late 1998, and the generic tax product was initially approved for sale in May 1999. The product was finally approved for sale in August 1999, after the transactional documentation required by the BLIPS transactions was completed. One year later, in September 2000, the IRS issued Notice 2000-44, determining that BLIPS and other, similar tax products were potentially abusive tax shelters and taxpayers who used them would be subject to enforcement action.<sup>86</sup> After this notice was issued, KPMG discontinued sales of the product.

Internal KPMG emails disclose an extended, unresolved debate among WNT and DPP tax professionals over whether BLIPS met the technical requirements of federal tax law, a debate which continued even after BLIPS was approved for sale. Several outside firms were also involved in BLIPS' development including Sidley Austin Brown & Wood, a law firm, and Presidio Advisory Services, an investment advisory firm run by two former KPMG tax partners. Key documents at the beginning and during a key two-week period of the BLIPS approval process are instructive.

BLIPS was first proposed in late 1998, as a replacement product for OPIS, which had earned KPMG substantial fees. From the beginning, senior tax leadership put pressure on KPMG tax professionals to quickly approve the new product for sale to clients. For example, after being told that a draft tax opinion on BLIPS had been sent to WNT for review and "we can reasonably anticipate 'approval' in another month or so,"<sup>87</sup> the head of the entire Tax Services Practice wrote:

"Given the marketplace potential of BLIPS, I think a month is far too long – especially in the spirit of 'first to market'. I'd like for all of you, within the bounds of good professional judgement, to dramatically accelerate this timeline. ... I'd like to know how quickly we can get this product to market."<sup>88</sup>

Five days later, the WNT technical expert in charge of Personal Financial Planning (PFP) tax products -- who had been assigned responsibility for moving the BLIPS product through the WNT review process and was under instruction to keep the head of the Tax Services Practice informed of

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<sup>85</sup>See Appendix A for more information about BLIPS.

<sup>86</sup>IRS Notice 2000-44 (2000-36 IRB 255)(9/5/00).

<sup>87</sup>Email dated 2/9/99, from Jeffrey Eischeid to John Lanning, Doug Ammerman, Mark Watson and Larry DeLap, "BLIPS," Bates MTW 0001.

<sup>88</sup>Email dated 2/10/99, from John Lanning to multiple KPMG tax professionals, "RE: BLIPS," Bates MTW 0001. See also memorandum dated 2/11/99, from Jeffrey Zysik of TIC to "Distribution List," Bates MTW 0002 ("As each of you is by now aware, a product with a very high profile with the tax leadership recently was submitted to WNT/Tax Innovation Center. We are charged with shepherding this product through the WNT 'productization' and review process as rapidly as possible.")

BLIPS' status -- wrote to several colleagues asking for a "progress report." He added a postscript: "P.S. I don't like this pressure any more than you do."<sup>89</sup>

A few days later, on February 19, 1999, almost a dozen WNT tax experts held an initial meeting to discuss the technical issues involved in BLIPS.<sup>90</sup> Six major issues were identified, the first two of which posed such significant technical hurdles that, according to the WNT PFP technical reviewer, most participants, including himself, left the meeting thinking the product was "dead."<sup>91</sup> Some of the most difficult technical questions, including whether the BLIPS transactions had economic substance, were assigned to two of WNT's most senior tax partners who, despite the difficulty, took just two weeks to determine, on March 5, that their technical concerns had been resolved. The WNT PFP technical reviewer continued to work on other technical issues related to the project. Almost two months later, on April 27, 1999, he sent an email to the head of DPP stating that, with respect to the technical issues assigned to him, he would be comfortable with WNT's issuing a more-likely-than-not opinion on BLIPS.

Three days later, at meetings held on April 30 and May 1, a number of KPMG tax professionals working on BLIPS attended a meeting with Presidio to discuss how the investments called for by the product would actually be carried out. The WNT PFP technical reviewer told the Subcommittee staff that, at these meetings, the Presidio representative made a number of troubling comments that led him to conclude that the review team had not been provided all of the relevant information about how the BLIPS transactions would operate, and re-opened concerns about the technical merits of the product. For example, he told the Subcommittee staff that a Presidio representative had commented that "the probability of actually making a profit from this transaction is remote" and the bank would have a "veto" over how the loan proceeds used to finance the BLIPS deal would be invested. In his opinion, these statements, if true, meant the investment program at the heart of the BLIPS product lacked economic substance and business purpose as required by law.

On May 4, 1999, the WNT PFP technical reviewer wrote to the head of the DPP expressing doubts about approving BLIPS:

"Larry, while I am comfortable that WNT did its job reviewing and analyzing the technical issues associated with BLIPS, based on the BLIPS meeting I attended on April 30 and May 1, I am not comfortable issuing a more-likely-than-not opinion letter [with respect to] this product for the following reasons:

...[T]he probability of actually making a profit from this transaction is remote (possible, but remote);

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<sup>89</sup>Email dated 2/15/99, from Mark Watson to multiple KPMG tax professionals, "BLIPS Progress Report," Bates MTW 0004.

<sup>90</sup>"Meeting Summary" for meeting held on 2/19/99, Bates MTW 0009.

<sup>91</sup>Subcommittee interview of Mark Watson (11/4/03).

The bank will control how the 'loan' proceeds are invested via a veto power over Presidio's investment choices; and

It appears that the bank wants the 'loan' repaid within approximately 60 days ....

Thus, I think it is questionable whether a client's representation [in a tax opinion letter] that he or she believed there was a reasonable opportunity to make a profit is a reasonable representation. Even more concerning, however, is whether a loan was actually made. If the bank controls how the loan proceeds are used and when they are repaid, has the bank actually made a bona fide loan?

I will no doubt catch hell for sending you this message. However, until the above issues are resolved satisfactorily, I am not comfortable with this product."<sup>92</sup>

The DPP head responded: "It is not clear to me how this comports with your April 27 message [expressing comfort with BLIPS], but because this is a PFP product and you are the chief PFP technical resource, the product should not be approved if you are uncomfortable."<sup>93</sup> The WNT PFP technical reviewer responded that he had learned new information about how the BLIPS investments would occur, and it was this subsequent information that had caused him to reverse his position on issuing a tax opinion letter supporting the product.<sup>94</sup>

On May 7, 1999 the head of DPP forwarded the WNT PFP technical expert's email to the leadership of the tax group and noted: "I don't believe a PFP product should be approved when the top PFP technical partner in WNT believes it should not be approved."<sup>95</sup>

On May 8, 1999, the head of KPMG's Tax Services Practice wrote: "I must say that I am amazed that at this late date (must now be six months into this process) our chief WNT PFP technical

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<sup>92</sup>Email dated 5/4/99, from Mark Watson to Larry DeLap, Bates KPMG 0011916.

<sup>93</sup>Email dated 5/5/99, from Larry DeLap to Mark Watson, Bates KPMG 0011916.

<sup>94</sup>Email dated 5/5/99, from Mark Watson to Larry DeLap, Bates KPMG 0011915-16. Mr. Watson was not the only KPMG tax professional expressing serious concerns about BLIPS. See, e.g., email dated 4/6/99, from Steven Rosenthal to Larry DeLap, "RE: BLIPS," Bates MTW0024; email dated 4/26/99, from Steven Rosenthal to Larry DeLap, "RE: BLIPS Analysis," Bates MTW0026; email dated 5/7/99, from Steven Rosenthal to multiple KPMG professionals, "Who Is the Borrower in the BLIPS transaction," Bates MTW0028; email dated 8/19/99, from Steven Rosenthal to Mark Watson, Bates SMR 0045.

<sup>95</sup>Email dated 5/7/99, from Larry Delap to 3 KPMG tax professionals, with copies to John Lanning, Vice Chairman of the Tax Services Practice, and Jeffrey Stein, second in command of the Tax Services Practice, Bates KPMG 0011905. In the same email he noted that another technical expert, whom he had asked to review critical aspects of the project, had "informed me on Tuesday afternoon that he had substantial concern with the 'who is the borrower' issuer [sic]." Later that same day, May 7, the two WNT technical reviewers expressing technical concerns about BLIPS met with the two senior WNT partners who had earlier signed off on the economic substance issue, to discuss the issues.

expert has reached this conclusion. I would have thought that Mark would have been involved in the ground floor of this process, especially on an issue as critical as profit motive. What gives? This appears to be the antithesis of ‘speed to market.’ Is there any chance of ever getting this product off the launching pad, or should we simply give up???”<sup>96</sup>

On May 9, one of the senior WNT partners supporting BLIPS sent an email to one of the WNT technical reviewers objecting to BLIPS and asked him: “Based on your analysis ... do you conclude that the tax results sought by the investor are NOT ‘more likely than not’ to be realized?” The technical reviewer responded: “Yes.”<sup>97</sup>

On May 10, the head of the WNT sent an email to five WNT tax professionals:

“Gentlemen: Please help me on this. Over the weekend while thinking about WNT involvement in BLIPS I was under the impression that we had sent the transaction forward to DPP Tax on the basis that everyone had signed off on their respective technical issues(s) and that I had signed off on the overall more likely than not opinion. If this impression is correct, why are we revisiting the opinion other than to beef up the technical discussion and further refine the representations on which the conclusions are based. I am very troubled that at this late date the issue is apparently being revisited and if I understand correctly, a prior decision changed on this technical issue?! Richard, in particular, jog my memory on this matter since I based my overall opinion on the fact that everyone had signed off on their respective areas.”<sup>98</sup>

A few hours later, the head of WNT sent eight senior KPMG tax professionals, including the Tax Services Practice head, DPP head, and the WNT PFP technical reviewer, a long email message urging final approval of BLIPS. He wrote in part:

“Many people have worked long and hard to craft a tax opinion in the BLIPS transaction that satisfies the more likely than not standard. I believed that we in WNT had completed our work a month ago when we forwarded the [draft] opinion to Larry. ...

[T]his is a classic transaction where we can labor over the technical concerns, but the ultimate resolution - if challenged by the IRS - will be based on the facts (or lack thereof). In short, our opinion is only as good as the factual representations that it is based upon. ... The real ‘rubber meets the road’ will happen when the transaction is sold to investors, what the investors’ actual motive for investing the transaction is and how the transaction actually unfolds. ... Third, our reputation will be used to market the transaction. This is a given in these types of deals. Thus, we need to be concerned about who we are getting in bed with

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<sup>96</sup>Email dated 5/8/99, from John Lanning to four KPMG tax professionals, Bates KPMG 0011905.

<sup>97</sup>Email exchange dated 5/9/99, between Richard Smith and Steven Rosenthal, Bates SMR 0025 and SMR 0027.

<sup>98</sup>Email dated 5/10/99, from Philip Wiesner to multiple WNT tax professionals, Bates MTW 0031.



here. In particular, do we believe that Presidio has the integrity to sell the deal on the facts and representations that we have written our opinion on?! ...

Having said all the above, I do believe the time has come to shit and get off the pot. The business decisions to me are primarily two: (1) Have we drafted the opinion with the appropriate limiting bells and whistles ... and (2) Are we being paid enough to offset the risks of potential litigation resulting from the transaction? ... 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. ....<sup>99</sup>

Later the same day, the Tax Services operations head wrote in response to the email from the WNT head: “I think it’s shit OR get off the pot. I vote for shit.”<sup>100</sup>

The same day, the WNT PFP technical reviewer wrote to the head of the Tax Services Practice: “John, in my defense, my change in heart about BLIPS was based on information Presidio disclosed to me at a meeting on *May 1*. This information raised serious concerns in my mind about the viability of the transaction, and indicated that WNT had not been given complete information about how the transaction would be structured .... I want to make money as much as you do, but I cannot ignore information that raises questions as to whether the subject strategy even works. Nonetheless, I have sent Randy Bickham four representations that I think need to be added to our opinion letter. Assuming these representations are made, I am prepared to move forward with the strategy.”<sup>101</sup>

A meeting was held on May 10, to determine how to proceed. The WNT head, the senior WNT partner, and the two WNT technical reviewers decided to move forward on BLIPS, and the WNT head asked the technical reviewers to draft some representations that, when relied upon, would enable the tax opinion writers to reach a more likely than not opinion. The WNT head reported the outcome of the meeting in an email:

“The group of Wiesner, R Smith, Watson and Rosenthal met this afternoon to bring closure to the remaining technical tax issues concerning the BLIPS transaction. After a thorough discussion of the profit motive and who is the borrower issue, recommendations for additional representations were made (Mark Watson to follow up on with Jeff Eischeid) and the decision by WNT to proceed on a more likely than not basis affirmed. Concern was again expressed that the critical juncture will be at the time of the first real tax opinion when the investor, bank

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<sup>99</sup>Email dated 5/10/99, from Philip Wiesner to John Lanning and 8 other KPMG tax professionals, “RE: BLIPS,” Bates KPMG 0011904. See also email response dated 5/10/99, from John Lanning to Philip Wiesner and other KPMG tax professionals, “RE: BLIPS,” Bates MTW0036 (“you’ve framed the issues well”).

<sup>100</sup>Email dated 5/10/99, from Jeffrey Stein to Philip Weisner and others, Bates KPMG 0011903.

<sup>101</sup>Email dated 5/10/99, from Mark Watson to John Lanning and others, “FW: BLIPS,” Bates MTW 0039 (Emphasis in original.).

and Presidio will be asked to sign the appropriate representations. Finally, it should be noted that Steve Rosenthal expressed his dissent on the who is the investor issue, to wit, “although reasonable people could reach an opposite result, he could not reach a more likely than not opinion on that issue.”<sup>102</sup>

After receiving this email, the DPP head sent an email to the WNT PFP technical reviewer asking whether he would be comfortable with KPMG’s issuing a tax opinion supporting BLIPS. The WNT PFP technical reviewer wrote: “Larry, I don’t like this product and would prefer not to be associated with it. However, if the additional representations I sent to Randy on May 9 and 10 are in fact made, based on Phil Wiesner’s and Richard Smith’s input, I can reluctantly live with a more-likely-than-not opinion being issued for the product.”<sup>103</sup>

The DPP head indicated to the Subcommittee staff that he did not consider this tepid endorsement sufficient for him to sign off on the product. He indicated that he then met in person with his superior, the head of the Tax Services Practice, and told the Tax Services Practice head that he was not prepared to approve BLIPS for sale. He told the Subcommittee staff that the Tax Services Practice head was “not pleased” and instructed him to speak again with the technical reviewer.<sup>104</sup>

The DPP head told the Subcommittee staff that he then went back to the WNT PFP technical reviewer and telephoned him to discuss the product. The DPP head told the Subcommittee staff that, during this telephone conversation, the technical reviewer made a much clearer, oral statement of support for the product, and it was only after obtaining this statement from the technical reviewer that, on May 19, 1999, the DPP head approved BLIPS for sale to clients.<sup>105</sup> The WNT PFP technical reviewer, however, told the Subcommittee staff that he did not remember receiving this telephone call from the DPP head. According to him, he never, at any time after the May 1 meeting, expressed clear support for BLIPS’ approval. He also stated that an oral sign-off on this product contradicted the DPP head’s normal practice of requiring written product approvals.<sup>106</sup>

Over the course of the next year, KPMG sold BLIPS to 186 individuals and obtained more than \$50 million in fees, making BLIPS one of its highest revenue-producing tax products to date.

The events and communications leading to BLIPS’ approval for sale are troubling and revealing for a number of reasons. First, they show that senior KPMG tax professionals knew the proposed tax product, BLIPS, was “clearly one that the IRS would view as falling squarely within the

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<sup>102</sup>Email dated 5/10/99, from Philip Wiesner to multiple KPMG tax professionals, Bates KPMG 0009344.

<sup>103</sup>Email dated 5/11/99, from Mark Watson, WNT, to Lawrence DeLap, Bates KPMG 0011911.

<sup>104</sup>Subcommittee interview of Lawrence DeLap (10/30/03).

<sup>105</sup>Id.

<sup>106</sup>Subcommittee interview of Mark Watson (11/4/03).

tax shelter orbit.” Second, they show how important “speed to market” was as a factor in the review and approval process. Third, they show the interpersonal dynamics that, in this case, led KPMG’s key technical tax expert to reluctantly agree to approve a tax product that he did not support or want to be associated with, in response to the pressure exerted by senior Tax Services professionals to approve the product for sale.

The email exchange immediately preceding BLIPS’ approval for sale also indicates a high level of impatience by KPMG tax professionals in dealing with new, troubling information about how the BLIPS investments would actually be implemented by the outside investment advisory firm, Presidio. Questions about this outside firm’s “integrity” and how it would perform were characterized as questions of risk to KPMG that could be resolved with a pricing approach that provided sufficient funds “to offset the risks of potential litigation.” Finally, the email exchange shows that the participants in the approval process -- all senior KPMG tax professionals -- knew they were voting for a dubious tax product that would be sold in part by relying on KPMG’s “reputation.” No one challenged the analysis that the risky nature of the product justified the firm’s charging “a lot of money” for a tax opinion letter predicting it was more likely than not that BLIPS would withstand an IRS challenge.

Later documents show that key KPMG tax professionals continued to express serious concerns about the technical validity of BLIPS. For example, in July, two months after the DPP gave his approval to sell BLIPS, one of the WNT technical reviewers objecting to the tax product sent an email to his superiors in WNT noting that the loan documentation contemplated very conservative instruments for the loan proceeds and it seemed unlikely the rate of return on the investments would equal or exceed the loan and fees incurred by the borrower. He indicated that his calculations showed the planned foreign currency transactions would “have to generate a 240% annual rate of return” to break even. He also pointed out that, “Although the loan is structured as a seven-year loan, the client has a tremendous economic incentive to get out of loan as soon as possible due to the large negative spread.” He wrote: “Before I submit our *non-economic* substance comments on the loan documents to Presidio, I want to confirm that you are still comfortable with the economic substance of this transaction.”<sup>107</sup> His superiors indicated that they were.

A month later, in August, after completing a review of the BLIPS transactional documents, the WNT PFP technical reviewer again expressed concerns to his superiors in WNT:

“However before engagement letters are signed and revenue is collected, I feel it is important to again note that I and several other WNT partners remain skeptical that the tax results purportedly generated by a BLIPS transaction would actually be sustained by a court if challenged by the IRS. We are particularly concerned about the economic substance of the BLIPS transaction, and our review of the BLIPS loan documents has increased our level of concern.

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<sup>107</sup>Email dated 7/22/99, from Mark Watson to Richard Smith and Phil Wiesner, Bates MTW 0078.

“Nonetheless, since Richard Smith and Phil Wiesner – the WNT partners assigned with the responsibility of addressing the economic substance issues associated with BLIPS – have concluded they think BLIPS is a “more-likely-than-not” strategy, I am prepared to release the strategy once we complete our second review of the loan documents and LLC agreement and our comments thereon (if any) have been incorporated.”<sup>108</sup>

The other technical reviewer objecting to BLIPS wrote:

“I share your concerns. We are almost finished with our technical review of the documents that you gave us, and we recommend some clarifications to address these technical concerns. We are not, however, assessing the economic substance of the transaction (ie., is there a debt? Who is the borrower? What is the amount of the liability? Is there a reasonable expectation of profit?) I continue to be seriously troubled by these issues, but I defer to Phil Wiesner and Richard Smith to assess them.”<sup>109</sup>

The senior partners in WNT chose to go forward with BLIPS.

About six months after BLIPS tax products had begun to be sold to clients, an effort was begun within KPMG to design a modified “BLIPS 2000.”<sup>110</sup> One of the WNT technical reviewers who had objected to the original BLIPS again expressed his concerns:

“I am writing to communicate my views on the economic substance of the Blips, Grandfathered Blips, and Blips 2000 strategies. Throughout this process, I have been troubled by the application of economic substance doctrines ... and have raised my concerns repeatedly in internal meetings. The facts as I now know them and the law that has developed, has not reduced my level of concern.

In short, in my view, I do not believe that KPMG can reasonably issue a more-likely-than-not opinion on these issues.”<sup>111</sup>

When asked by Subcommittee staff whether he had ever personally concluded that BLIPS met

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<sup>108</sup>Email dated 8/4/99, from Mark Watson to Brockway, David Springer; Mark and Ammerman, Douglas, BATES SMR 0039.

<sup>109</sup>Id.

<sup>110</sup>Senior KPMG tax professionals, again, put pressure on its tax experts to quickly approve the BLIPS 2000 product. See, e.g., email dated 1/17/00, from Jeff Stein to Steven Rosenthal and others, “BLIPS 2000,” Bates SMR 0050 (technical expert is urged to analyze new product “so we can take this to market. Your attention over the next few days would be most appreciated.”).

<sup>111</sup>Email dated 3/6/00, from Steven Rosenthal to David Brockway, “Blips I, Grandfathered Blips, and Blips 2000,” Bates SMR 0056. See also memorandum dated 3/28/00, to David Brockway, “Talking points on significant tax issues for BLIPS 2000,” Bates SMR 0117-21 (identifying numerous problems with BLIPS).

the technical requirements of the federal tax code, the DPP head declined to say that he had. Instead, he said that, in 1999, he approved BLIPS for sale after determining that WNT had “completed” the technical approval process.<sup>112</sup> A BLIPS power point presentation produced by the Personal Financial Planning group in June, a few weeks after BLIPS’ approval for sale, advised KPMG tax professionals to make sure that potential clients were “willing to take an aggressive position with a more likely than not opinion letter.” The presentation characterized BLIPS as having “about a 10 risk on [a] scale of 1-10.”<sup>113</sup>

In September 2000, the IRS identified BLIPS as a potentially abusive tax shelter. The IRS notice characterized BLIPS as a product that was “being marketed to taxpayers for the purpose of generating artificial tax losses. ... [A] loss is allowable as a deduction ... only if it is bona fide and reflects actual economic consequences. An artificial loss lacking economic substance is not allowable.”<sup>114</sup> The IRS’ disallowance of BLIPS has not yet been tested in court. Rather than defend BLIPS in court, KPMG and many BLIPS purchasers appear to be engaged in settlement negotiations with the IRS to reduce penalty assessments.

**OPIS and FLIP Development and Approval Process.** OPIS and FLIP were the predecessors to BLIPS. Like BLIPS, both of these products were “loss generators” intended to generate paper losses that taxpayers could use to offset and shelter other income from taxation,<sup>115</sup> but both used different mechanisms than BLIPS to achieve this end. Because they were developed a number of years ago, the Subcommittee has more limited documentation on how OPIS and FLIP were developed. However, even this limited documentation establishes KPMG’s awareness of serious technical flaws in both tax products.

For example, in the case of OPIS, which was developed during 1998, a senior KPMG tax professional wrote a 7-page memorandum filled with criticisms of the proposed tax product.<sup>116</sup> The memorandum states: “In OPIS, the use of debt has apparently been jettisoned. If we can not structure a deal without at least some debt, it strikes me that all the investment banker’s economic justification for the deal is smoke and mirrors.” At a later point, it states: “The only thing that really distinguishes OPIS (from FLIPS) from a tax perspective is the use of an instrument that is purported to be a swap. ... However, the instrument described in the opinion is not a swap under I.R.C. §446. ... [A] fairly

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<sup>112</sup>Subcommittee interview of Lawrence DeLap (10/30/03).

<sup>113</sup>Power point presentation dated June 1999, by Carol Warley, Personal Financial Planning group, “BLIPS AND TRACT,” Bates KPMG 00496339-45, at 496340. Repeated capitalizations in original text not included.

<sup>114</sup>IRS Notice 2000-44 (2000-36 IRB 255)(9/5/00) at 255.

<sup>115</sup>See document dated 5/18/01, “PFP Practice Reorganization Innovative Strategies Business Plan – DRAFT,” Bates KPMG 0050620-23, at 1.

<sup>116</sup>Memorandum dated 2/23/98, from Robert Simon to Gregg Ritchie, Randy Bickham, and John Harris, concerning OPIS, Bates KPMG 0010729.

strong argument could be made that the U.S. investor has nothing more than a disguised partnership interest.”

The memorandum goes on:

“If, upon audit, the IRS were to challenge the transaction, the burden of proof will be on the investor. The investor will have to demonstrate, among other things, that the transaction was not consummated pursuant to a firm and fixed plan. Think about the prospect of having your client on the stand having to defend against such an argument. The client would have a difficult burden to overcome .... The failure to use an independent 3<sup>rd</sup> party in any of the transactions indicates that the deal is pre-wired.”

It also states: “If the risk of loss concepts of Notice 98-5 were applied to OPIS, I doubt that the investor’s ownership interest would pass muster.” And: “As it stands now, the Cayman company remains extremely vulnerable to an argument that it is a sham.” And: “No further attempt has been made to quantify why I.R.C. §165 should not apply to deny the loss. Instead, the argument is again made that because the law is uncertain, we win.” The memorandum observes: “We are the firm writing the [tax] opinions. Ultimately, if these deals fail in a technical sense, it is KPMG which will shoulder the blame.”

This memorandum was written in February 1998. OPIS was approved for sale to clients around September 1998. KPMG sold OPIS to 111 individuals, conducting 79 OPIS transactions on their behalf in 1998 and 1999.

In the case of FLIP, an email written in March 1998, by the Tax Services Practice’s second in command, identifies a host of significant technical flaws in FLIP, doing so in the course of discussing which of two tax offices in KPMG deserved credit for developing its replacement, OPIS.<sup>117</sup> The email states that efforts to find a FLIP alternative “took on an air of urgency when [DPP head] Larry DeLap determined that KPMG should discontinue marketing the existing product.” The email indicates that, for about six weeks, a senior KPMG tax professional and a former KPMG tax professional employed at Presidio worked “to tweak or redesign” FLIP and “determined that whatever the new product, it needed a greater economic risk attached to it” to meet the requirements of federal tax law.

Among other criticisms of FLIP, the email states: “Simon was the one who pointed out the weakness in having the U.S. investor purchase a warrant for a ridiculously high amount of money .... It was clear, we needed the option to be treated as an option for Section 302 purposes, and yet in truth the option [used in FLIP] was really illusory and stood out more like a sore thumb since no one in his right mind would pay such an exorbitant price for such a warrant.” The email states: “In kicking the

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<sup>117</sup>Email dated 3/14/98, from Jeff Stein to Robert Wells, John Lanning, Larry DeLap, Gregg Ritchie, and others, “Simon Says,” concerning FLIP, Bates 638010, filed by the IRS on June 16, 2003, as an attachment to Respondent’s Requests for Admission, Schneider Interests v. Commissioner, U.S. Tax Court, Docket No. 200-02.

tires on FLIP (perhaps too hard for the likes of certain people) Simon discovered that there was a delayed settlement of the loan which then raised the issue of whether the shares could even be deemed to be issued to the Cayman company. Naturally, without the shares being issued, they could not later be redeemed.” The email also observes: “[I]t was Greg who stated in writing to I believe Bob Simon that the ‘the OPIS product was developed in response to your and DPP tax’s concerns over the FLIP strategy. We listened to your input regarding technical concerns with respect to the FLIP product and attempt to work solutions into the new product ....”

This email was written in March 1998, after the bulk of FLIP sales, but it shows that the firm had been aware for some time of the product’s technical problems. After the email was written, KPMG sold FLIP to ten more customers in 1998 and 1999, earning more than \$3 million in fees for doing so. In August 2001, the IRS issued a notice finding both FLIP and OPIS to be potentially abusive tax shelters.<sup>118</sup> The IRS has since audited and penalized numerous taxpayers for using these illegal tax shelters.<sup>119</sup>

**SC2 Development and Approval Process.** The Subcommittee investigation also obtained documentation establishing KPMG’s awareness of flaws in the technical merits of SC2.<sup>120</sup>

Documents proceeding the April 2000 decision by KPMG to approve SC2 for sale reflect vigorous analysis and discussion of the product’s risks if challenged by the IRS. The documents also reflect, as in the BLIPS case, pressure to move the product to market quickly. For example, one month before SC2’s final approval, an email from a KPMG professional in the Tax Innovation Center stated: “As I was telling you, this Tax Solution is getting some very high level (Stein/Rosenthal) attention. Please review the whitepaper as soon as possible ....”<sup>121</sup>

On April 11, 2000, in the same email announcing SC2’s approval for sale, the head of the DPP wrote:

“This is a relatively high risk strategy. You will note that the heading to the preapproved engagement letter states that limitation of liability and indemnification provisions are not to be waived. ... You will also note that the engagement letter includes the following statement: You acknowledge receipt of a memorandum discussing certain risks associated with the

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<sup>118</sup>IRS Notice 2001-45 (2001-33 IRB 129)(8/13/01).

<sup>119</sup>See “Settlement Initiative for Section 302/318 Basis-Shifting Transactions,” IRS Announcement 2002-97 (2002-43 IRB 757)(10/28/02).

<sup>120</sup>See Appendix B for more detailed information on SC2.

<sup>121</sup>Email dated 3/13/00, from Phillip Galbreath to Richard Bailine, “FW: S-CAEPS,” Bates KPMG 0046889.

strategy .... It is essential that such risk discussion memorandum (attached) be provided to each client contemplating entering into an SC2 engagement.”<sup>122</sup>

The referenced memorandum, required to be given to all SC2 clients, identifies a number of risks associated with the tax product, most related to ways in which the IRS might successfully challenge the product’s legal validity. The memorandum states in part:

“The [IRS] or a state taxing authority could assert that some or all of the income allocated to the tax-exempt organization should be reallocated to the other shareholders of the corporation. ... The IRS or a state taxing authority could assert that some or all of the charitable contribution deduction should be disallowed, on the basis that the tax-exempt organization did not acquire equitable ownership of the stock or that the valuation of the contributed stock was overstated. ... The IRS or a state taxing authority could assert that the strategy creates a second class of stock. Under the [tax code], subchapter S corporations are not permitted to have a second class of stock. ... The IRS or a court might discount an opinion provided by the promoter of a strategy. Accordingly, it may be advisable to consider requesting a concurring opinion from an independent tax advisor.”<sup>123</sup>

Internally, KPMG tax professionals had identified even more technical problems with SC2 than were discussed in the memorandum given to clients. For example, KPMG tax professionals discussed problems with identifying a business purpose to explain the structure of the transaction -- why a donor who wanted to make a cash donation to a charity would first donate stock to the charity and then buy it back, instead of simply providing a straightforward cash contribution.<sup>124</sup> They also identified problems with establishing the charity’s “beneficial ownership” of the donated stock, since the stock was provided on the clear understanding that the charity would sell the stock back to the donor within a specified period of time.<sup>125</sup> KPMG tax professionals identified other technical

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<sup>122</sup>Email dated 4/11/00, from Larry DeLap to Tax Professional Practice Partners, “S-Corporation Charitable Contribution Strategy (SC2),” Bates KPMG 0052581-82. One of the KPMG tax partners to whom this email was forwarded wrote in response: “Please do not forward this to anyone.” Email dated 4/25/00, from Steven Messing to Lawrence Silver, “S-Corporation Charitable Contribution Strategy (SC2),” Bates KPMG 0052581.

<sup>123</sup>Undated KPMG document entitled, “S Corporation Charitable Contribution Strategy[:] Summary of Certain Risks,” marked “PRIVATE AND CONFIDENTIAL,” Bates KPMG 0049987-88.

<sup>124</sup>See, e.g., email dated 3/13/00, from Richard Bailene to Phillip Galbreath, “S-CAEPS,” Bates KPMG 0015744.

<sup>125</sup>See, e.g., email dated 3/13/00, from Richard Bailene to Phillip Galbreath, “S-CAEPS,” Bates KPMG 0015745; KPMG document dated 3/13/00, “S-Corporation Charitable Contribution Strategy – Variation #1,” Bates KPMG 0047895 (beneficial ownership is “probably our weakest link in the chain on SC2.”); memorandum dated 3/2/00, from William Kelliher to multiple KPMG tax professionals, “Comments on S-CAEPS ‘White Paper,’” Bates KPMG 0016853-61.



problems as well involving assignment of income, reliance on tax indifferent parties, and valuation issues.<sup>126</sup>

More than a year later, in December 2001, another KPMG tax professional expressed concern about the widespread marketing of SC2 because, if the IRS “gets wind of it,” the agency would likely mount a vigorous and “at least partially successful” challenge to the product:

“Going way back to Feb. 2000, when SC2 first reared its head, my recollection is that SC2 was intended to be limited to a relatively small number of large S corps. That plan made sense because, in my opinion, there was (and is) a strong risk of a successful IRS attack on SC2 if the IRS gets wind of it. ... Call me paranoid, but I think that such a widespread marketing campaign is likely to bring KPMG and SC2 unwelcome attention from the IRS. If so, I suspect a vigorous (and at least partially successful) challenge would result.”<sup>127</sup>

Together, the BLIPS, OPIS, FLIP, and SC2 evidence demonstrates that the KPMG development process led to the approval of tax products that senior KPMG tax professionals knew had significant technical flaws and were potentially illegal tax shelters. Even when senior KPMG professionals expressed forceful objections to proposed products, highly questionable tax products received technical and reputational risk sign-offs and made their way to market.

## **(2) Mass Marketing Tax Products**

**Finding: KPMG uses aggressive marketing tactics to sell its generic tax products, including by pressuring its tax professionals to increase sales to meet internal revenue targets; making sales pitches to existing clients; finding new clients through prospect lists, telemarketing, and referral arrangements; and even making cold calls to sell tax shelters to prospective buyers.**

Until recently, accounting firms were seen as traditional, professional firms that waited for clients to come to them with concerns, rather than affirmatively targeting potential clients for sales pitches on tax products. One of the more striking aspects of the Subcommittee investigation was discovery of the substantial efforts KPMG has expended to market its tax products, including

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<sup>126</sup>See, e.g., email dated 3/13/00, from Richard Bailene to Phillip Galbreath, “S-CAEPS,” Bates KPMG 0015746, and email from Mark Watson, “S-CAEPS,” Bates KPMG 0013790-93 (raising assignment of income concerns); emails dated 3/21/00 and 3/22/00, from Larry DeLap and Lawrence Manth, Bates KPMG 0015739-40 (raising tax indifferent party concerns); various emails between 7/28/00 and 10/25/00, among KPMG tax professionals, Bates KPMG 0015011-14 (raising tax indifferent party concerns); and memorandum dated 2/14/00, from William Kelliher to Richard Rosenthal, “S-Corp Charitable and Estate Planning Strategy (‘S-CAEPS’),” Bates KPMG 0047693-95 (raising valuation concerns).

<sup>127</sup>Email dated 12/20/01, from William Kelliher to David Brockway, “FW: SC2,” Bates, KPMG 0012723.

extensive efforts to target clients and, at times, use high-pressure sales tactics. Evidence in the four case studies shows that KPMG compiled and scoured prospective client lists, pushed its personnel to meet sales targets, closely monitored their sales efforts, advised its professionals to use questionable sales techniques, and even used cold calls to drum up business. The evidence also shows that, at times, KPMG marketed tax shelters to persons who appeared to have little interest in them or did not understand what they were being sold, and likely would not have used them to reduce their taxes without being approached by KPMG.

**Extensive Marketing Infrastructure.** As indicated in the prior section, KPMG’s marketing efforts for new tax products normally began long before a product was approved for sale. Potential “revenue analysis” was part of the earliest screening efforts for new products. In addition, when a new tax product is launched within the firm, the “Tax Solution Alert” is supposed to include key marketing information such as potential client profiles, “optimal target characteristics” of buyers, and the expected “typical buyer” of the product.

KPMG typically designates one or more persons to lead the marketing effort for a new tax product. These persons are referred to as the product’s “National Deployment Champions,” “National Product Champions,” or “Deployment Leaders.” In the four case studies investigated by the Subcommittee, the National Deployment Champion was the same person who served as the product’s National Development Champion and shepherded the product through the KPMG approval process. For example, the tax professional who led the marketing effort for BLIPS was, again, Jeffrey Eischeid, assisted by Randall Bickham, while for SC2 it was, again, Larry Manth, assisted and succeeded by Andrew Atkin.

National Deployment Champions have been given significant institutional support to market their assigned tax product. For example, KPMG maintains a national marketing office that includes marketing professionals and resources “dedicated to tax.”<sup>128</sup> Champions can draw on this resource for “market planning and execution assistance,” and to assemble a marketing team with a “National Marketing Director” and designated “area champions” to lead marketing efforts in various regions of the United States.<sup>129</sup> These individuals become members of the product’s official “deployment team.”

Champions can also draw on a Tax Services group skilled in marketing research to identify prospective clients and develop target client lists. This group is known as the Tax Services Marketing and Research Support group. Champions can also make use of a KPMG “cold call center” in Indiana. This center is staffed with telemarketers trained to make cold calls to prospective clients and set up a phone call or meeting with specified KPMG tax or accounting professionals to discuss services or

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<sup>128</sup>KPMG Tax Services Manual, §2.21.1, at 2-14.

<sup>129</sup>Id.

products offered by the firm. These telemarketers can and, at times, have made cold calls to sell specific tax shelters such as SC2.<sup>130</sup>

In addition to a cadre of expert marketing support personnel, National Deployment Champions are supported by powerful software systems that help them identify prospective clients and track KPMG sales efforts across the country. The Opportunity Management System (OMS), for example, is a software system that KPMG tax professionals have used to monitor with precision who has been contacted about a particular tax product, who made the contact on behalf of KPMG, the potential sales revenue associated with the sales contact, and the current status of each sales effort.

An email sent in 2000, by the Tax Services operations and Federal Tax Practice heads to 15 KPMG tax professionals paints a broad picture of what KPMG's National Deployment Champions were expected to accomplish:

“As National Deployment Champions we are counting on you to drive significant market activity. We are committed to providing you with the tools that you need to support you in your efforts. A few reminders in this regard.

The Tax Services Marketing and Research Support is prepared to help you refine your existing and/or create additional [client] target lists. ... Working closely with your National Marketing Directors you should develop the relevant prospect profile. Based on the criteria you specify the marketing and research teams can scour primary and secondary sources to compile a target list. This will help you go to market more effectively and efficiently.

Many of you have also tapped into the Practice Development Coordinator resource. Our team of telemarketers is particularly helpful ... to further qualify prospects [redaction by KPMG] [and] to set up phone appointments for you and your deployment team. ...

Finally tracking reports generated from OMS are critical to measuring your results. If you don't analyze the outcome of your efforts you will not be in a position to judge what is working and what is not. Toward that end you must enter data in OMS. We will generate reports once a month from OMS and share them with you, your team, Service Line leaders and the [Area Managing Partners]. These will be the focal point of our discussion with you when we revisit your solution on the Monday night call. You should also be using them on your bi-weekly team calls. ...

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<sup>130</sup>See, e.g., SC2 script dated 6/19 (no year provided, but likely 2000) developed for telemarketer calls to identify individuals interested in obtaining more information, Bates KPMG 0050370-71. A telemarketing script was also developed for BLIPS, but it is possible that no BLIPS telemarketing calls were made. BLIPS script dated 7/8/99, Bates KPMG 002560

Thanks again for assuming the responsibilities of a National Deployment Champion. We are counting on you to make the difference in achieving our financial goals.”<sup>131</sup>

In 2002, KPMG opened a “Sales Opportunity Center” to make it easier for its personnel to make use of the firm’s extensive marketing resources. An email announcing this Center stated the following:

“The current environment is changing at breakneck speed, and we must be prepared to respond aggressively to every opportunity.

We have created a Sales Opportunity Center to be the ‘eye of the needle’ – a single place where you can get access to the resources you need to move quickly, knowledgeably, and *effectively*.

This initiative reflects the efforts of Assurance (Sales, Marketing, and the Assurance & Advisory Services Center) and Tax (Marketing and the Tax Innovation Center), and is intended to serve as our ‘situation room’ during these fast-moving times. ...

The Sales Opportunity Center is a powerful demonstration of the Firm’s commitment to giving you what you need to meet the challenges of these momentous times. We urge you to take advantage of this resource as you pursue marketplace opportunities.”<sup>132</sup>

**Corporate Culture: Sell Sell Sell.** After a new tax product has been “launched” within KPMG, one of the primary tasks of a National Deployment Champion is to educate KPMG tax professionals about the new product and motivate them to sell it.

Champions use a wide variety of tools to make KPMG tax professionals aware of a new tax product. For example, they include product information in KPMG internal newsletters and email alerts, and organize conference calls and video conferences with KPMG tax offices across the country. Champions have also gone on “road shows” to KPMG field offices to make a personal presentation on a particular product. These presentations include how the product works, what clients to target, and how to respond to particular concerns. On some occasions, a presentation is videotaped and included in an office’s “video library” to enable KPMG personnel to view the presentation at a later date.

Documentation obtained by the Subcommittee shows that National Deployment Champions and senior KPMG tax officials expend significant effort to convince KPMG personnel to devote time and resources to selling new products. Senior tax professionals use general exhortations as well as

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<sup>131</sup>Email dated 8/6/00 from Jeffrey Stein to 15 National Deployment Champions, Bates KPMG 050016.

<sup>132</sup>Email dated 3/14/02, from Rick Rosenthal and other KPMG professionals, to “US Management Group,” (Emphasis in original.), Bates XX 001730-32.

specific instructions directed to specific field offices to increase their sales efforts. For example, after SC2 was launched, the head of KPMG's Federal Practice sent the following an email to the SC2 "area champions" around the country:

"I want to personally thank everyone for their efforts during the approval process of this strategy. It was completed very quickly and everyone demonstrated true teamwork. Thank you! Now let[']s SELL, SELL, SELL!!"<sup>133</sup>

The Federal Tax head also called specific KPMG offices to urge them to increase their SC2 sales. This type of instruction from a senior KPMG tax official apparently sent a strong message to subordinates about the need to sell the identified tax product. For example, a tax professional in a KPMG field office in Houston wrote the following after participating in a conference call on SC2 in which the Federal Tax head and the SC2 National Deployment Champion urged the office to improve its SC2 sales record:

"I don't know if you were on Larry Manth's call today, but Rosenthal led the initial discussion. There have been several successes .... We are behind.

This is THE STRATEGY that they expect significant value added fees by June 30.

The heat is on....."<sup>134</sup>

In the four case studies examined by the Subcommittee, National Deployment Champions did not end their efforts with phone calls and visits urging KPMG tax professionals to sell their tax product, they also produced detailed marketing plans, implemented them with the assistance of the "deployment team," and pressured their colleagues to increase SC2 sales. For example, one email circulated among two members of the SC2 deployment team and two senior KPMG tax professionals demonstrates the measures used to push sales:

"To memorialize our discussion, we agreed the following:

\* Over the next two weeks, Manth [SC2 National Deployment Champion] will deploy [Andrew] Atkin [on the SC2 deployment team] to call each of the SC2 area solution champions.

\* Andrew will work with the champion to establish a specific action plan for each opportunity. To be at all effective, the plans should [be] very specific as to who is going to do what when.

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<sup>133</sup>Email dated 2/18/00, from Richard Rosenthal to multiple KPMG tax professionals, Bates KPMG 0049236.

<sup>134</sup>Email dated 4/21/00, from Michael Terracina, KPMG office in Houston, to Gary Choate, KPMG office in Dallas, Bates KPMG 0048191.

... There should be agreement as to when Andrew will next follow-up with them to create a real sense of urgency and accountability.

\*Andrew will involve Manth where he is not getting a response within 24 hours or receiving inappropriate ‘pushback.’ Manth will enlist [David] Jones or Rick [Rosenthal, senior KPMG tax officials,] to help facilitate responsiveness where necessary given the urgency of the opportunity. ...

\*Manth believes inadequate resources are currently deployed to exploit the Midwest SCorp client and target population. Craig Pichette has not yet been able to dedicate enough time to this solution .... John Schrier (NE Stratecon) or Council Leak (SE Stratecon) could be effective ....

\*Resource[s] will be assigned to adequately address the market opportunity in Florida. ... Goals must be explicit ... including a percentage weighting based on expected time commitment. ...

Manth will explore with Rick the opportunity to form alliances with other accounting firms to drive distribution.”<sup>135</sup>

Senior KPMG tax officials also set overall revenue goals for various tax groups and urged them to increase their sales of designated tax products to meet those goals. For example, in an email alerting nearly 40 tax professionals in the “Stratecon West” group to a conference call on a “Kick Off Plan For ‘01,” a senior Stratecon professional, who was also the SC2 National Deployment Champion, wrote:

“Hello everyone. We will be having a conference call to kick-off our Stratecon marketing efforts to aggressively pursue closed deals by 6/30/01. The main purpose of the call is to discuss our marketing and targeting strategy and to get everyone acquainted with a number of Stratecon’s high-end solutions. If you have clients, at least one of these strategies should be applicable to your client base. As you all know, to reach plan in the West, we must aggressively pursue these high-end strategies.”<sup>136</sup>

Two months later, a member of the SC2 deployment team, who also worked for Stratecon, sent an email to an even larger group of 60 tax professionals, urging them to try a new, more appealing version of SC2. In a paragraph subtitled, “Why Should You Care?” he wrote:

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<sup>135</sup>Email dated 1/30/01, from David Jones to Larry Manth, Richard Rosenthal, and Wendy Klein, “SC2 - Follow-up to 1/29 Revisit,” Bates KPMG 0050389.

<sup>136</sup>Email dated 12/2/00, from Lawrence Manth to multiple tax professionals, Bates XX000021.

“In the last 12 months the original SC2 structure has produced \$1.25 million in signed engagements for the SE [Southeast]. ... Look at the last partner scorecard. Unlike golf, a low number is not a good thing... A lot of us need to put more revenue on the board before June 30. SC2 can do it for you. Think about targets in your area and call me.”<sup>137</sup>

The steady push for tax product sales continued. For example, three weeks later, the Stratecon tax professional sent an email to his colleagues stating, “Due to the significant push for year-end revenue, all West Region Federal tax partners have been invited to join us on this [conference] call and we will discuss our ‘Quick Hit’ strategies and targeting criteria.”<sup>138</sup> Six weeks after that, the same Stratecon official announced another conference call urging Stratecon professionals to discuss two “tax minimization opportunities for individuals” which will “have a quick revenue hit for us.”<sup>139</sup>

Stratecon was not alone in the push for sales. For example, in 2000, the former head of KPMG’s Washington National Tax Practice sent an email to all “US-WNT Tax Partners” urging them to “temporarily defer non-revenue producing activities” and concentrate for the “next 5 months” on meeting WNT’s revenue goals for the year.<sup>140</sup> The email states in part:

“Listed below are the tax products identified by the functional teams as having significant revenue potential over the next few months. ... [T]he functional teams will need ... WNT champions to work with the National Product champions to maximize the revenue generated from the respective products. ... Thanks for help in this critically important matter. As Jeff said, ‘We are dealing with ruthless execution - hand to hand combat - blocking and tackling.’ Whatever the mixed metaphor, let’s just do it.”

The evidence is clear that selling tax products was an important part of every tax professional’s job at KPMG.

**Targeting Clients.** KPMG’s marketing efforts included substantial efforts to identify prospective purchasers for its tax products. KPMG developed prospective client lists by reviewing both its own client base and seeking new clients through referrals and cold calls.

To review its own client base, KPMG has used software systems, including ones known as KMatch and RIA GoSystem, to identify former or existing clients who might be interested in a particular tax product. KMatch is “[a]n interactive software program that asks a user a series of

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<sup>137</sup>Email dated 2/22/01, from Council Leak to multiple tax professionals, Bates KPMG 0050822-23.

<sup>138</sup>Email dated 3/13/01, from Larry Manth to multiple KPMG tax professionals, “Friday’s Stratecon Call,” Bates XX 001439.

<sup>139</sup>Email dated 4/25/01, from Larry Manth to multiple KPMG tax professionals, “Friday’s Stratecon Call,” Bates XX 001438.

<sup>140</sup>Email dated 2/3/00, from Philip Wiesner to Us-WNT Tax Partners, Bates KPMG 0050888-90.

questions about a client's business and tax situation," uses the information to construct a "client profile," and then uses the profile to identify KPMG tax products that could assist the client to avoid taxation.<sup>141</sup> KPMG's Tax Innovation Center conducted a specific campaign requiring KPMG tax professionals to enter client data into the KMatch database so that, when subsequent tax products were launched, the resulting client profiles could be searched electronically to identify which clients would be eligible for and interested in the new product. RIA GoSystem is a separate internal KPMG database which contains confidential client data provided to KPMG to assist the firm in preparing client tax returns.<sup>142</sup> This database of confidential client tax information can also be searched electronically to identify prospective clients for new tax products and was actually used for that purpose in the case of SC2.<sup>143</sup>

The evidence indicates that KPMG also uses its assurance professionals – persons who provide auditing and related services to individuals and corporations – to identify existing KPMG audit clients who might be interested in new tax products. Among other documents evidencing the role of KPMG assurance professionals is the development and marketing of tax products that require the combined participation of both KPMG tax and assurance professionals. In 2000, for example, KPMG issued what it called its "first joint solution" requiring KPMG tax and assurance professionals to work together to sell and implement the product.<sup>144</sup> The tax product is described as a "[c]ollection of assurance and tax services designed to assist companies in ... realizing value from their intellectual property ... [d]elivered by joint team of KPMG assurance and tax professionals."<sup>145</sup> Internal KPMG documentation states that the purpose of the new product is "[t]o increase KPMG's market penetration of key clients and targets by enhancing the linkage between Assurance and Tax professionals."<sup>146</sup> Another KPMG document states: "Teaming with Assurance expands tax team's knowledge of client and industry[.] Demonstrates unified team approach that separates KPMG from

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<sup>141</sup>Presentation entitled, "KMatch Push Feature Campaign," undated, prepared by Marsha Peters of the Tax Innovation Center, Bates XX 001511.

<sup>142</sup>See, e.g., email dated 3/6/01, from US-GoSystem Administration to Andrew Atkin of KPMG, "RE; Florida S corporation search," Bates KPMG 0050826; Subcommittee interview of Councill Leak (10/22/03).

<sup>143</sup>Id.

<sup>144</sup>Presentation dated 7/17/00, "Targeting Parameters: Intellectual Property – Assurance and Tax," with attachment dated September 2000, entitled "Intellectual Property Services," at page 1 of the presentation, Bates XX 001567-94.

<sup>145</sup>Presentation dated 10/30/00, "Intellectual Property Services (IPS)," by Dut LeBlanc of Shreveport and Joe Zier of Silicon Valley, Bates XX 001580-94.

<sup>146</sup>Presentation dated 7/17/00, "Targeting Parameters: Intellectual Property – Assurance and Tax," with attachment dated September 2000, entitled "Intellectual Property Services," at page 1 of the attachment, Bates XX 001567-94.



competitors.”<sup>147</sup> Another KPMG document shows that KPMG used both its internal tax and assurance client lists to target clients for a sales pitch on the new product:

“The second tab of this file contains the draft target list [of companies]. This list was compiled from two sources an assurance and tax list. ... [W]e selected the companies which are assurance or tax clients, which resulted in the 45 companies on the next sheet. ... What should you do? Review the suspects with your assurance or tax deployment counterpart. ... Prioritize your area targets, and plan how to approach them.”<sup>148</sup>

Additional tax products which relied in part on KPMG audit partners followed. In 2002, for example, KPMG launched a “New Enterprises Tax Suite” product<sup>149</sup> which it described internally as “a cross-functional element of the Tax Practice that efficiently mines opportunities in the start-up and middle-market, high-growth, high-tech space.” A presentation on this new product states that KPMG tax professionals are “[t]eaming with Assurance ... [and] fostering cross-selling among assurance and tax professionals.”<sup>150</sup>

Other tax products explicitly called on KPMG tax professionals to ask their audit counterparts for help in identifying potential clients. For example, a “Middle Market Initiative” launched in 2001, identified seven tax products to be marketed to mid-sized corporations, including SC2. It explicitly called upon KPMG tax professionals to contact KPMG audit partners to identify appropriate mid-sized corporations, and directed these tax professionals to pitch one or more of the seven KPMG tax products to KPMG audit clients. “In order to maximize marketplace opportunities ... national and area

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<sup>147</sup>Presentation dated 10/30/00, “Intellectual Property Services (IPS),” by Dut LeBlanc of Shreveport and Joe Zier of Silicon Valley, Bates XX 001580-94.

<sup>148</sup>Presentation dated 7/17/00, “Targeting Parameters: Intellectual Property – Assurance and Tax,” with attachment dated September 2000, entitled “Intellectual Property Services,” at page 1 of the attachment, Bates XX 001567-94.

<sup>149</sup>See WNT presentation dated 9/19/02, entitled “Innovative Tax Solutions,” which, at 18-26, includes a presentation by Tom Hopkins of Silicon Valley, “New Enterprises Tax Suite,” Tax Solution Alert 00-31, Bates XX 001503-05. The Hopkins presentation states that the new product is intended to be used to “[l]everage existing client base (pull-through),” “[d]evelop and use client selection filters to refine our bets and reach higher market success,” and “[e]nhance relationships with client decisionmakers.” As part of a “Deployment Action Plan,” the presentation states that KPMG “[p]artners with revenue goals are given subscriptions to *Venture Wire* for daily lead generation” and that “[t]argeting is supplemented by daily lead generation from Fort Wayne” where KPMG’s telemarketing center is located.

<sup>150</sup>Presentation dated 3/6/00, “Post-Transaction Integration Service (PTIS) – Tax,” by Stan Wiseberg and Michele Zinn of Washington, D.C., Bates XX 001597-1611 (“Global collaborative service brought to market by tax and assurance ... May be appropriate to initially unbundle the serves (‘tax only,’ or ‘assurance only’) to capture an engagement”)

champions will coordinate with and involve assurance partners and managers in their respective areas.”<sup>151</sup>

In addition to electronic searches, National Deployment Champions regularly exhorted KPMG field personnel to review their client lists personally to identify those that might be interested in a new product. In the case of SC2, deployment team members asked KPMG tax professionals to review their client lists, not once, but twice:

“Attached above is a listing of all potential SC2 engagements that did not fly over the past year. In an effort to ensure we have not overlooked any potential engagement during the revenue push for the last half of [fiscal year] 2001, please review the list which is sorted by estimated potential fees. I’d like to revisit each of these potential engagements, and gather comments from each of you regarding the following. ... Would further communication/dialogue with any listed potential engagement be welcome? What were the reasons for the potential client’s declining the strategy?”<sup>152</sup>

In addition to reviewing its own client base, KPMG worked with outside parties, such as banks, law firms, and other accounting firms, to identify outside client prospects. One example is the arrangement KPMG entered into with First Union National Bank, now part of Wachovia Bank, in which Wachovia referred clients to KPMG in connection with FLIP. In this case, Wachovia told wealthy clients about the existence of the tax product and allowed KPMG to set up appointments at the bank or elsewhere to make client presentations on FLIP.<sup>153</sup> KPMG apparently did not pay Wachovia a direct referral fee for these clients, but if a client eventually agreed to purchase FLIP, a portion of the fees paid by the client to Quellos, a investment advisory firm handling the FLIP transactions, was forwarded by Quellos to Wachovia. KPMG also made arrangements for Wachovia client referrals related to BLIPS and SC2, again using First Union National Bank, but it is unclear whether the bank actually made any referrals for these tax products.<sup>154</sup> In the case of SC2, KPMG also worked with a variety of other outside parties, such as mid-sized accounting firms and

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<sup>151</sup>Email dated 8/14/01, from Jeff Stein and Walter Duer to “KPMG LLP Partners, Managers and Staff,” “Stratecon Middle Market Initiative,” Bates KPMG 0050369.

<sup>152</sup>Email dated 2/9/01, from Ty Jordan to multiple KPMG tax professionals, “SC2 revisit of stale leads,” Bates KPMG 0050814.

<sup>153</sup>Subcommittee interview of Wachovia Bank representatives (3/25/03).

<sup>154</sup>See, e.g., email dated 8/30/99, from Tom Newman to multiple First Union professionals, “next strategy,” Bates SEN 014622 (BLIPS “[f]ees to First Union will be 50 basis points if the investor is not a KPMG client, 25 bps if they are a KPMG client.”); email dated 11/30/01, from Councill Leak to Larry Manth, “FW: First Union Customer Services,” Bates KPMG 0050842-44 (“I provide my comments on how we are bringing SC2 into certain First Union customers.”). Because KPMG is also Wachovia’s auditor, questions have arisen as to whether their client referral arrangements violate SEC’s auditor independence rules. See Section VI(B)(5) of this Report for more information on the auditor independence issue.

automobile dealers, to locate and refer potential clients.<sup>155</sup> A large law firm headquartered in St. Louis expressed willingness not only to issue a confirming tax opinion for the SC2 transaction, but also to introduce KPMG “to some of their midwestern clients.”<sup>156</sup>

In addition to reviewing its own client base and seeking client referrals, KPMG used a variety of other means to identify prospective clients. In the case of SC2, for example, as part of its marketing efforts, KPMG obtained lists of S corporations in the states of Texas, North and South Carolina, New York, and Florida.<sup>157</sup> It obtained these lists from either state government, commercial firms, or its own databases. The Florida list, for example, was compiled using KPMG’s internal RIA-GOSystem containing confidential client data extracted from certain tax returns prepared by KPMG.<sup>158</sup> Some of the lists had large blocks of S corporations associated with automobile or truck dealers, real estate firms, home builders, or architects.<sup>159</sup> In some instances, KPMG tax professionals instructed KPMG telemarketers to contact the corporations to gauge interest in SC2.<sup>160</sup> In other cases, KPMG tax professionals contacted the corporations personally.

The lists compiled by KPMG produced literally thousands of potential SC2 clients, and through telemarketing and other calls, KPMG personnel made uncounted contacts across the country searching for buyers of SC2. In April 2001, the DPP apparently sent word to SC2 marketing teams to stop using telemarketing calls to find SC2 buyers,<sup>161</sup> but almost as soon as the no-call policy was

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<sup>155</sup>See, e.g., email dated 1/30/01, from David Jones to Larry Manth, Richard Rosenthal, and Wendy Klein, “SC2 - Follow-up to 1/29 Revisit,” Bates KPMG 0050389 (working to form accounting firm alliances).

<sup>156</sup>Memorandum dated 2/16/01, from Andrew Atkin to SC2 Marketing Group, “Agenda from Feb 16<sup>th</sup> call and goals for next two weeks,” Bates KPMG 0051135.

<sup>157</sup>See, e.g., email dated 8/14/00, from Postmaster-US to unknown recipients, “Action Required: Channel Conflict for SC2,” Bates KPMG 0049125 (S corporation list purchased from Dun & Bradstreet); memorandum dated 2/16/01, from Andrew Atkin to SC2 Marketing Group, “Agenda from Feb 16<sup>th</sup> call and goals for next two weeks,” Bates KPMG 0051135 (Texas S corporation list); email dated 3/7/01, from Councill Leak to multiple KPMG tax professionals, “South Florida SC2 Year End Push,” Bates KPMG 0050834 (Florida S corporation list); email dated 3/26/01, from Leonard Ronnie III, to Gary Crew, “RE: S-Corp Carolinas,” Bates KPMG 0050818 (North and South Carolina S corporation list); email dated 4/22/01, from Thomas Crawford to John Schrier, “RE: SC2 target list,” Bates KPMG 0050029 (New York S corporation list).

<sup>158</sup>Email dated 3/6/01, from US-GoSystem Administration to Andrew Atkin of KPMG, “RE: Florida S corporation search,” Bates KPMG 0050826. Subcommittee interview of Councill Leak (10/22/03).

<sup>159</sup>Email dated 11/17/00, from Jonathan Pullano to US-Southwest Tax Services Partners and others, “FW: SW SC2 Channel Conflict,” Bates KPMG 0048309.

<sup>160</sup>See, e.g., email dated 6/27/00, from Wendy Klein to Mark Springer and Larry Manth, “SC2: Practice Development Coordinators Involvement,” Bates KPMG 0049116; email dated 11/15/00, from Douglas Duncan to Michael Terracina and Gary Choat, “FW: SW SC2 Progress,” Bates KPMG 0048315-17.

<sup>161</sup>See email dated 4/22/01, from John Schrier to Thomas Crawford, “RE: SC2 target list,” Bates KPMG 0050029.

announced, some KPMG tax professionals were attempting to circumvent the ban asking, for example, if telemarketers could question S corporations about their eligibility and suitability to buy SC2, without scheduling future telephone contacts.<sup>162</sup> In December 2001, after being sent a list of over 3,100 S corporations targeted for telephone calls, a senior KPMG tax professional sent an email to the head of WNT complaining that the list appeared to indicate “the firm is intent on marketing the SC2 strategy to virtually every S corp with a pulse.”<sup>163</sup>

When KPMG representatives were first asked about KPMG’s use of telemarketers, they initially told the Subcommittee staff that telemarketing calls were against firm policy.<sup>164</sup> When asked about the Indiana cold call center which KPMG has been operating for years, the KPMG representatives said that the center’s telemarketers sought to introduce new clients to KPMG in a general way and did little more than arrange an appointment so that KPMG could explain to a potential client in person all of the services KPMG offers. When confronted with evidence of telemarketing calls for SC2, the KPMG representatives acknowledged that a few calls on tax products might have been made by telemarketers at the cold call center, but implied such calls were few in number and rarely led to sales. In a separate interview, when shown documents indicating that, in the case of SC2, KPMG telemarketers made calls to thousands of S corporations across the country, the KPMG tax professional being interviewed admitted these calls had taken place.<sup>165</sup>

**Sales Advice.** To encourage sales, KPMG would, at times, provide written advice to its tax professionals on how to answer questions about a tax product, respond to objections, or convince a client to buy a product.

For example, in the case of SC2, KPMG sponsored a meeting for KPMG “SC2 Team Members” across the country and emailed documents providing information about the tax product as well as “Appropriate Answers for Frequently Asked Shareholder Questions” and “Suggested Solutions” to “Sticking Points and Problems.”<sup>166</sup> The “Sticking Points” document provided the following advice to KPMG tax professionals trying to sell SC2 to prospective clients:

“1) ‘Too Good to be true.’ Some people believe that if it sounds too good to be true, it’s a sham. Some suggestions for this response are the following:

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<sup>162</sup>Email dated 4/23/01, from John Schrier to Thomas Crawford, “RE: SC2 target list,” Bates KPMG 0050029.

<sup>163</sup>Email dated 12/20/01, from William Kelliher to David Brockway, WNT head, Bates KPMG 0013311. A responsive email from Mr. Brockway on the same document states, “It looks like they have already tried over 2/3rds of possible candidates already, if I am reading the spread sheet correctly.”

<sup>164</sup>Subcommittee briefing by Jeffrey Eischeid and Timothy Speiss (9/12/03).

<sup>165</sup>Subcommittee interview of Councill Leak (10/22/03).

<sup>166</sup>“SC2 – Meeting Agenda” and attachments, dated 6/19/00, Bates KPMG 0013375-96.

- a) This transaction has been through KPMG's WNT practice and reviewed by at least 5 specialty groups. ... Many of the specialists are ex-IRS employees.
- b) Many sophisticated clients have implemented the strategy in conjunction with their outside counsel.
- c) At least one outside law firm will give a co-opinion on the transactions. ...
- e) Absolutely last resort – At least 3 insurance companies have stated that they will insure the tax benefits of the transaction for a small premium. This should never be mentioned in an initial meeting and Larry Manth should be consulted for all insurance conversations to ensure consistency and independence on the transaction.

2) 'I Need to Think About it.' ... We obviously do not want to seem too desperate but at the same time we need to keep this moving along. Some suggestions:

- a) 'Get Even' Approach. Perhaps a good time to revisit the strategy is at or near estimated tax payment time when the shareholder is making or has made a large estimated tax payment and is extremely irritated for having done so. ...
- b) Beenie Baby Approach. ... We call the client and say that the firm has decided to cap the strategy ...and the cap is quickly filling up. 'Should I put you on the list as a potential?' This is obviously a more aggressive approach, but will tell you if the client is serious about the deal.
- c) 'Break-up' Approach. This is a risky approach and should only be used in a limited number of cases. This approach entails us calling the client and conveying to them that they should no longer consider SC2 for a reason solely related to KPMG, such as the cap has been reached with respect to our city or region or ... the demand has been so great that the firm is shutting it down. This approach is used as a psychological tool to elicit an immediate response from the client. ...

5) John F. Brown Syndrome. This is named after an infamous attorney who could not get comfortable with anything about the strategy. We have had a number of clients with stubborn outside counsel with respect to the strategy itself, the engagement letter, or other aspects of the transaction. Here are some approaches:

- a. If we ... know he will not approve of the transaction we should tell this to the client and either walk or convince the client not to use the attorney or law firm for this deal. ...
- c. If the fee is substantial ... the last resort is to summarize a transaction with all the possible bells and whistles to make the deal as risk-free as possible. For example: The

client does SC2 with the following elements: 1) option to reacquire stock from [tax exempt organization], 2) insurance covering the tax benefits plus penalties ... and 3) outside opinion from an independent law firm. If the attorney is still uncomfortable, we need to convey this to the client and they can decide.”

This document is hardly the work product of a disinterested tax adviser. In fact, it goes so far as to recommend that KPMG tax professionals employ such hard-sell tactics as making misleading statements to their clients – claims that SC2 will be sold to only a limited number of people or that it is no longer being sold at all in order to “elicit an immediate response from the client.” The document also depicts attorneys raising technical concerns about SC2 as “stubborn” naysayers who need to be circumvented, rather than satisfied. In short, rather than present KPMG as a disinterested tax adviser, this type of sales advice is evidence of a company intent on convincing an uninterested or hesitant client to buy a product that the client would apparently be otherwise unlikely to purchase or use.

**Using Tax Opinions and Insurance as Marketing Tools.** Several documents obtained during the investigation demonstrate that KPMG deliberately traded on its reputation as a respected accounting firm and tax expert in selling questionable tax products to corporations and individuals. As described in the prior section on designing new tax products, the former WNT head acknowledged that KPMG’s “reputation will be used to market the [BLIPS] transaction. This is a given in these types of deals.” In the SC2 “Sticking Points” document, KPMG instructed its tax professionals to respond to client concerns about the product by pointing out that SC2 had been reviewed and approved by 5 KPMG tax specialty groups and by specialists who are former employees of the IRS.<sup>167</sup>

KPMG also used opinion letters as a marketing tool. Tax opinion letters are intended to provide written advice explaining whether a particular tax product is permissible under the law and, if challenged by the IRS, the likelihood that the tax product would survive court scrutiny. A tax opinion letter provided by a person with a financial stake in the tax product being analyzed has traditionally been accorded much less deference than an opinion letter supplied by a disinterested expert. As shown in the SC2 “Sticking Points” document just cited, if a client raised concerns about purchasing the product, KPMG instructed its tax professionals to respond that, “At least one outside law firm will give a co-opinion on the transactions.”<sup>168</sup> In another SC2 document, KPMG advises its tax professionals to tell clients worried about IRS penalties: “The opinion letters that we issue should get you out of any penalties. However, the Service could try to argue that KPMG is the promoter of the

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<sup>167</sup>“SC2 – Meeting Agenda” and attachments, dated June 19, 2000, at Bates KPMG 0013394.

<sup>168</sup>“SC2 – Meeting Agenda” and attachments, dated June 19, 2000, at Bates KPMG 0013394. Another document identified Bryan Cave, a law firm with over 600 professionals and offices in St. Louis, New York, and elsewhere, as willing “to issue a confirming tax opinion for the SC2 transaction.” Memorandum dated 2/16/01, from Andrew Atkin to SC2 Marketing Group, “Agenda from Feb 16<sup>th</sup> call and goals for the next two weeks,” Bates KPMG 0051135. See also email dated 7/19/00, from Robert Coplan of Ernst & Young to “Dickensg@aol.com,” Bates 2003EY011939 (“As you know, we go to great lengths to line up a law firm to issue an opinion pursuant to a separate engagement letter from the client that is meant to make the law firm independent from us.”)

strategy and therefore the opinions are biased and try and assert penalties. We believe there is very low risk of this result. If you desire additional assurance, there is at least one outside law firm in NYC that will issue a co-opinion. The cost ranges between \$25k - \$40k.”<sup>169</sup>

KPMG was apparently so convinced that an outside legal opinion increased the marketability of its tax products, that in the case of FLIP, it agreed to pay Sidley Austin Brown & Wood a fee in any sale where a prospective buyer was told that the law firm would provide a favorable tax opinion letter, regardless of whether the opinion was actually provided. A KPMG tax professional explained in an email: “Our deal with Brown and Wood is that if their name is used in selling the strategy they will get a fee. We have decided as a firm that B&W opinion should be given in all deals.”<sup>170</sup> This guaranteed fee arrangement also provided an incentive for Sidley Austin Brown & Wood to refer clients to KPMG.

On occasion, KPMG also used insurance as a marketing tool to convince reluctant buyers to purchase a KPMG tax product. In the case of SC2, the “Sticking Points” document advised KPMG tax professionals to tell clients about the existence of an insurance policy that, for a “small premium,” could guarantee SC2’s promised “tax benefits:”

“At least 3 insurance companies have stated that they will insure the tax benefits of the transaction for a small premium. This should never be mentioned in an initial meeting and Larry Manth should be consulted for all insurance conversations to ensure consistency and independence on the transaction.”<sup>171</sup>

According to KPMG tax professionals interviewed by Subcommittee staff, the insurance companies offering this insurance included AIG and Hartford.<sup>172</sup> KPMG apparently possessed sample insurance policies that promised to reimburse the policy holder for a range of items, including penalties or fines assessed by the IRS for using SC2, essentially insuring the policy holder against being penalized for tax evasion.<sup>173</sup> Once these policies were available, KPMG tax professionals were asked to re-visit potential clients who had declined the tax product and try again:

“Attached above is a listing of all potential SC2 engagements that did not fly over the past year. ... We now have a number of Insurance companies which would like to underwrite the

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<sup>169</sup>“SC2–Appropriate Answers for Frequently Asked Shareholder Questions,” included in an SC2 information packet dated 7/19/00, Bates KPMG 0013393.

<sup>170</sup>“Declaration of Richard E. Bosch,” IRS Revenue Agent, In re John Doe Summons to Sidley Austin Brown & Wood (N.D. Ill. 10/16/03) at ¶18, citing an email dated 10/1/97, from Gregg Ritchie to Randall Hamilton. (Capitalizations in original omitted.)

<sup>171</sup>“SC2 – Meeting Agenda” and attachments, dated June 19, 2000, Bates KPMG 0013375-96.

<sup>172</sup>See, e.g., Subcommittee interview of Lawrence Manth (11/6/03).

<sup>173</sup>Id.

tax risk inherent in the transaction. We may want to revisit those potential clients that declined because of audit risk.”<sup>174</sup>

Evidence obtained by the Subcommittee indicates that at least half a dozen SC2 purchasers also purchased SC2 insurance.

**Tracking Sales and Revenue.** KPMG repeatedly told the Subcommittee staff that it did not have the technical capability to track the sales or revenues associated with particular tax products.<sup>175</sup> However, evidence gathered by the Subcommittee indicates that KPMG could and did obtain specific revenue tracking information.

The Subcommittee learned, for example, that once a tax product was sold to a client and the client signed an engagement letter, KPMG assigned the transaction an “engagement number,” and recorded in an electronic database all revenues resulting from that engagement. This engagement data could then be searched and manipulated to provide revenue information and totals for individual tax products.

Specific evidence that revenue information was collected for tax products was obtained by the Subcommittee during the investigation from parties other than KPMG. For example, an SC2 “update” prepared in mid-2001, includes detailed revenue information, including total nationwide revenues produced by the tax product since it was launched, total nationwide revenues produced during the 2001 fiscal year, and FY01 revenues broken down by each of 6 regions in the United States.<sup>176</sup>

“Revenue since solution was launched:  
\$20,700,000

Revenue this fiscal year only:  
\$10,700,000

Revenue by Region this Fiscal Year

|            |             |
|------------|-------------|
| *West      | \$7,250,000 |
| *Southeast | \$1,300,000 |
| *Southwest | \$ 850,000  |

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<sup>174</sup>Email dated 2/9/01, from Ty Jordan to multiple KPMG tax professionals, “SC2 revisit of stale leads,” Bates KPMG 0050814.

<sup>175</sup>Subcommittee briefing by Jeffrey Eischeid (9/12/03); Subcommittee interview of Jeffrey Stein (10/31/03).

<sup>176</sup>Internal KPMG presentation, dated 6/18/01, by Andrew Atkin and Bob Huber, entitled “S-Corporation Charitable Contribution Strategy (SC2) Update,” Bates XX 001553.



|               |            |
|---------------|------------|
| *Mid-Atlantic | \$ 550,000 |
| *Midwest      | \$ 425,000 |
| *Northeast    | \$ 300,000 |

KPMG never produced this document to the Subcommittee.<sup>177</sup> However, one email related to SC2 that KPMG did produce states that monthly OMS “tracking reports” were used to measure sales results for specific tax products, and these reports were regularly shared with National Deployment Champions, Tax Service Line leaders, and Area Managing Partners.<sup>178</sup>

Moreover, KPMG’s Tax Innovation Center reported in 2001, that it had developed new software that “captured solution development costs and revenue” and that it had begun “[p]repar[ing] quarterly Solution Profitability reports.”<sup>179</sup> This information suggests that KPMG was refining its revenue tracking capabilities to be able to track not only gross revenues produced by a tax product, but also net revenues, and that it had begun collecting and monitoring this information on a regular basis. KPMG’s statement, “the firm does not maintain any systematic, reliable method of recording revenues by tax product on a national basis,”<sup>180</sup> was contradicted by the evidence.

**No Industry Slow-Down.** Some members of the U.S. tax profession have asserted that professional firms are beginning to turn away from marketing illegal tax shelters, so there is no need for investigations, reforms, or stronger laws in this area. KPMG has claimed that it is no longer marketing aggressive tax products designed to be sold to multiple clients. The Subcommittee investigation, however, found that, while a few professional firms have reduced or stopped selling generic tax products in the last two years, KPMG and other professional firms appear to be committed to continuing and deepening their efforts to develop and market generic, potentially abusive, tax products to multiple clients.

Evidence of KPMG’s commitment to ongoing tax product sales appears throughout this Report. For example, KPMG provided the Subcommittee with a 2003 list of more than 500 “active tax products” it intends to offer to multiple clients for a fee. Just last year, in 2002, KPMG established a “Sales Opportunity Center” which the firm itself has characterized as “a powerful demonstration of the Firm’s commitment to giving” KPMG professionals ready access to marketing

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<sup>177</sup>Another document provided to the Subcommittee by parties other than KPMG carefully traces the increase in the Tax Services Practice’s “gross revenue.” It shows a “45.5% Cumulative Growth” in gross revenue over a four year period, with \$829 million in FY98, \$1.001 million in FY99, \$1.184 million in FY00, and \$1.239 million in FY01. See chart entitled, “Tax Practice Growth Gross Revenue,” included in a presentation dated 7/19/01, entitled, “Innovative Tax Solutions,” by Marsha Peters of Washington National Tax, Bates XX 001503.

<sup>178</sup>Email dated 8/6/00 from Jeffrey Stein to 15 National Deployment Champions, Bates KPMG 050016.

<sup>179</sup>Internal KPMG presentation, dated 5/30/01, by the Tax Innovation Center, entitled “Tax Innovation Center Solution and Idea Development - Year-End Results,” Bates XX 001490-1502.

<sup>180</sup>Letter from KPMG to Subcommittee, dated 4/22/03, attached one-page chart entitled, “Good Faith Estimate of Top Revenue-Generating Strategies,” n.1.

tools to sell products and services to multiple clients. Also in 2002, the Tax Innovation Center helped develop new software to enable KPMG to track tax product development costs and net revenues, and issue quarterly tax product profitability reports. In 2003, KPMG's telemarketing center in Indiana continued to be staffed and ready for tax product marketing assistance.

Evidence of marketing campaigns shows KPMG sought to expand its tax product sales by targeting new market segments. In August 2001, for example, KPMG launched a "Middle Market Initiative" to increase its tax product sales to mid-sized corporations:

"Consistent with several other firm initiatives ... we are launching a major initiative in Tax to focus certain of our resources on the Middle Market. A major step in this initiative is driving certain Stratecon high-end solutions to these companies ... through a structured, proactive program. ... National and area champions of this initiative will meet with leadership ... to discuss solutions, agree on appropriate targets, and develop an area strategy .... In order to maximize marketplace opportunities ... national and area champions will coordinate with and involve assurance partners and managers in their respective areas. ... [C]hampions will also coordinate with the tax practice's proposed strategic alliance with mid-tier accounting firms. The goal for Stratecon is to close and implement engagements totaling \$15 M in revenues over the next 15 month period (FY ending 9/02)."<sup>181</sup>

The Middle Market Initiative identified seven KPMG tax products to be marketed to mid-sized corporations, including SC2. It explicitly called upon KPMG tax professionals to contact KPMG audit partners to identify appropriate mid-sized corporations, and then to pitch one or more of the seven KPMG tax products to KPMG audit clients. It is the Subcommittee staff's understanding that this marketing campaign is ongoing and successfully increasing KPMG tax product sales to mid-sized corporations across the United States.<sup>182</sup>

In December 2001, KPMG held an "FY02 Tax Strategy Meeting," to discuss "taking market leadership" in 2002. One email described the meeting as follows:

"Thank you for attending the FY02 Tax Strategy Meeting. It's now time to take action. As you enter the marketplace armed with the knowledge of 'Taking Market Leadership,' please remember to share your thoughts and experiences with us so we can better leverage the three key market pillars - Market Share, Client Centricity, and Market-Driven Solutions. ...

[W]e want to hear more about:

\* Teaming with Assurance; ...

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<sup>181</sup>Email dated 8/14/01, from Jeff Stein and Walter Duer to "KPMG LLP Partners, Managers and Staff," "Stratecon Middle Market Initiative," Bates KPMG 0050369.

<sup>182</sup>Subcommittee interview of Jeffrey Stein (10/31/03).

- \* How clients are responding to our services and solutions;
- \* Ideas for new services and solutions; and
- \* Best practices.”<sup>183</sup>

Additional evidence of KPMG’s continued involvement in the marketing of generic tax products comes from the chart prepared by KPMG, at the Subcommittee’s request, listing its top ten revenue producing tax products in 2000, 2001, and 2002.<sup>184</sup> The list of ten tax products for 2002 includes, among others, the “Tax-Efficient Minority Preferred Equity Sale Transaction” (TEMPEST) and the “Optional Tax-Deductible Hybrid Equity while Limiting Local Obligation” (OTHELLO).<sup>185</sup> Another KPMG chart, listing Stratecon’s tax products as of January 1, 2002, describes TEMPEST as a product that “creates capital loss,”<sup>186</sup> while OTHELLO “[c]reates a basis step-up in built-in gain asset and potential for double benefit of built-in losses.”<sup>187</sup> The minimum fee KPMG intends to charge clients for each of these products, TEMPEST and OTHELLO, is \$1 million.<sup>188</sup> KPMG has also indicated that each of the tax products listed on the Stratecon chart remained an “active tax product” as of February 10, 2003.<sup>189</sup>

A final example of evidence of KPMG’s ongoing commitment to selling generic tax products is a draft business plan for fiscal year 2002, prepared for the Personal Financial Planning (PFP) tax practice’s Innovative Strategies (IS) group.<sup>190</sup> This business plan indicates that, while the IS group’s marketing efforts had decreased after IRS issuance of new tax shelter notices, it had done all the preparatory work needed to resume vigorous marketing of new, potentially abusive tax shelters in 2002. The IS business plan first recounts the group’s past work on FLIP, OPIS, and BLIPS, noting that the millions of dollars in revenue produced from sales of these tax products had enabled IS to exceed its annual revenue goals in each year from 1998 until 2000. The business plan then states:

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<sup>183</sup>Email dated 12/12/01, from Dale Affonso to “Tax Personnel - LA & PSW.”

<sup>184</sup>KPMG chart entitled, “Good Faith Estimate of Top Revenue-Generating Strategies,” attached to letter dated 4/22/03, from KPMG’s legal counsel to the Subcommittee, Bates KPMG 0001801.

<sup>185</sup>Id.

<sup>186</sup>KPMG chart entitled “StrateconWest/FSG Solutions and Solution WIP – As of January 1, 2002,” Bates XX-001009-25.

<sup>187</sup>Id. at 2.

<sup>188</sup>Id. at 2 and 4.

<sup>189</sup>See undated document provided by KPMG to the Subcommittee on 2/10/03, “describing all active tax products included in Tax Products Alerts, Tax Solutions Alerts and Tax Service Ideas,” Bates KPMG 0000089-0000090.

<sup>190</sup>Document dated 5/18/01, “PFP Practice Reorganization Innovative Strategies Business Plan – DRAFT,” Bates KPMG 0050620-23, at 1. This document was authored by Jeffrey Eischeid, according to Mr. Eischeid. Subcommittee interview of Jeffrey Eischeid (11/3/03).

“The fiscal [2001] IS revenue goal was \$38 million and the practice has delivered \$16 million through period 10. The shortfall from plan is primarily attributable to the August 2000 issuance [by the IRS] of Notice 2000-44. This Notice specifically described both the retired BLIPS strategy and the then current [replacement, the Short Option Strategy or] SOS strategy. Accordingly, we made the business decisions to stop the implementation of ‘sold’ SOS transactions and to stay out of the ‘loss generator’ business for an appropriate period of time.”

The business plan then identified six tax products which had been approved for sale or were awaiting approval, and which were “expected to generate \$27 million of revenue in fiscal ‘02.”<sup>191</sup> Two of these strategies, called “Leveraged Private Split Dollar” and “Monetization Tax Advisory Services,” were not explained, but were projected to generate \$5 million in 2002 fees each.<sup>192</sup> Another tax product, under development and projected to generate \$12 million in 2002 fees, is described as:

“a gain mitigation solution, POPS. Judging from the Firm’s historic success in generating revenue from this type of solution, a significant market opportunity obviously exists. We have completed the solution’s technical review and have almost finalized the rationale for not registering POPS as a tax shelter.”<sup>193</sup>

Still another tax product, under development and projected to generate \$5 million in 2002 fees, is described as a “conversion transaction ... that halves the taxpayer’s effective tax rate by effectively converting ordinary income to long term capital gain. ... The most significant open issue is tax shelter registration and the impact registration will have on the solution.” The business plan estimates that, if the projected sales occur, “the planned revenue per [IS] partner would be \$3 million and the planned contribution per partner would equal or exceed \$1.5 million.”

The business plan provides this analysis:

“[T]here has been a significant increase in the regulation of ‘tax shelters.’ Not only is this regulatory activity dampening market appetite, it is changing the structural nature of the underlying strategies. Specifically, taxpayers are having to put more money at risk for a longer period of time in order to improve the business purpose economic substance arguments. All things considered, it is more difficult today to close tax advantaged

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<sup>191</sup>Id. at 3.

<sup>192</sup>Id. But see minutes dated 11/30/00, Monetization Solutions Task Force Teleconference, Bates KPMG 0050624-29, at 50627 (advocating KPMG design and implementation of “sophisticated entity structures that have elements of both financial product technology and tax technology,” including “monetization solutions that have been traditionally offered by the investment banks” such as “prepaid forwards, puts and calls, short sales, synthetic OID conveyances, and other derivative structures.”)

<sup>193</sup>Document dated 5/18/01, “PFP Practice Reorganization Innovative Strategies Business Plan – DRAFT,” Bates KPMG 0050620-23, at 2.

transactions. Nevertheless, we believe that the Innovative Strategies practice is a sustainable business opportunity with significant growth opportunity.”<sup>194</sup>

This and other evidence obtained by the Subcommittee during the past year indicate an ongoing, internal effort within KPMG to continue the development and sale of generic tax products to multiple clients.

### **(3) Implementing Tax Products**

#### **(a) KPMG’s Implementation Role**

**Finding: KPMG is actively involved in implementing the tax shelters which it sells to its clients, including by enlisting participation from banks, investment advisory firms, and tax exempt organizations; preparing transactional documents; arranging purported loans; issuing and arranging opinion letters; providing administrative services; and preparing tax returns.**

In many cases, KPMG’s involvement with a tax product sold to a client does not end with the sale itself. Many KPMG tax products, including the four examined by the Subcommittee, require the purchaser to carry out complex financial and investment activities in order to realize promised tax benefits. KPMG typically provided such clients with significant implementation assistance to ensure they realized the promised tax benefits on their tax returns. KPMG was also interested in successful implementation of its tax products, because the track record that built up over time for a particular product affected how KPMG could, in good faith, characterize that product to new clients. Implementation problems have also, at times, caused KPMG to adjust how a tax product is structured and even spurred development of a new product.

**Executing FLIP, OPIS, and BLIPS.** FLIP, OPIS, and BLIPS required the purchaser to establish a shell corporation, join a partnership, obtain a multi-million dollar loan, and engage in a series of complex financial and investment transactions that had to be carried out in a certain order and in a certain way to realize tax benefits. The evidence collected by the Subcommittee shows that KPMG was heavily involved in making sure the client transactions were completed properly.

As a first step, KPMG enlisted the participation of professional organizations to help design its products and carry them out. In the case of FLIP, which was the first of the four tax products to be developed, KPMG sought the assistance of investment experts at a small firm called Quellos to

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<sup>194</sup>Id. at 2.

design the complex series of financial transactions called for by the product.<sup>195</sup> Quellos, using contacts it had established in other business dealings, helped KPMG convince a major bank, UBS AG, to provide financing and participate in the FLIP transactions. Quellos worked with UBS to fine-tune the financial transactions, helped KPMG make client presentations about FLIP and, for those who purchased the product, helped complete the paperwork and transactions, using Quellos securities brokers. KPMG also enlisted help from Wachovia Bank, convincing the bank to refer bank clients who might be interested in the FLIP tax product.<sup>196</sup> In some cases, the bank permitted KPMG and Quellos to make FLIP presentations to its clients in the bank's offices.<sup>197</sup> KPMG also enlisted Sidley Austin Brown & Wood to issue a favorable legal opinion letter on the FLIP tax product.<sup>198</sup>

In the case of OPIS and BLIPS, KPMG, again, enlisted the help of Sidley Austin Brown & Wood, but used a different investment advisory firm. Instead of Quellos, KPMG obtained investment advice from Presidio Advisory Services. Presidio was formed in 1997, by two former KPMG tax partners one of whom was a key KPMG tax professional involved in the development and marketing of FLIP.<sup>199</sup> These two partners left the accounting firm, because they wanted to focus on the investment side of the generic tax products being developed by KPMG.<sup>200</sup> Unlike Quellos, which had substantial investment projects aside from FLIP, virtually all of Presidio's work over the following five years derived from KPMG tax products. Presidio's principles worked closely with KPMG tax professionals to design OPIS and BLIPS. Presidio's principals also helped KPMG obtain lending and securities services from three major banks, Deutsche Bank, HVB, and NatWest, to complete OPIS and BLIPS transactions.

In addition to enlisting the participation of legal, investment, and financial professionals, KPMG provided significant administrative support for the FLIP, OPIS and BLIPS transactions, using

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<sup>195</sup>Quellos was then known and doing business as Quadra Capital Management LLP or QA Investments, LLC.

<sup>196</sup>KPMG actually did business with First Union National Bank, which subsequently merged with Wachovia Bank.

<sup>197</sup>Subcommittee interview of First Union National Bank representatives (3/25/03).

<sup>198</sup>KPMG actually worked with Brown & Wood, a large New York law firm which subsequently merged with Sidley & Austin.

<sup>199</sup>The two former KPMG partners are John Larson and Robert Pfaff. These former KPMG partners also formed numerous other companies, many of them shells, to participate in business dealings including, in some cases, OPIS and BLIPS transactions. These related companies include Presidio Advisors, Presidio Growth, Presidio Resources, Presidio Volatility Management, Presidio Financial Group, Hayes Street Management, Holland Park, Prevad, Inc., and Norwood Holdings (collectively referred to as "Presidio").

<sup>200</sup>Subcommittee interview of John Larson (10/21/03); email dated 7/29/97, from Larry DeLap to multiple KPMG tax professionals, "Revised Memorandum," Bates KPMG JAC 331160, forwarding memorandum dated 7/29/97, from Bob Pfaff to John Lanning, Jeff Stein and others, "My Thoughts Concerning KPMG's Tax Advantaged Transaction Practice, Presidio's Relationship with KPMG, Transition Issues."

KPMG personnel to help draft and prepare transactional documents, and assist the investment advisory firms and the banks with paperwork. For example, when a number of loans were due to be closed in certain BLIPS transactions, two KPMG staffers were stationed at HVB to assist the bank with closing and booking issues.<sup>201</sup> Other KPMG employees were assigned to Presidio to assist in expediting BLIPS transactions and paperwork. KPMG also worked with Quellos, Presidio, and the relevant banks to ensure that the banks established large enough credit lines, with hundreds of millions of dollars, to allow a substantial number of individuals to carry out FLIP, OPIS, and BLIPS transactions.

When asked about KPMG's communications with the banks, the OPIS and BLIPS National Deployment Champion initially denied ever contacting bank personnel directly, claiming instead to have relied on Quellos and Presidio personnel to work directly with the bank personnel.<sup>202</sup> When confronted with documentary evidence of direct contacts, however, the Deployment Champion reluctantly admitted communicating on rare occasions with bank personnel. Evidence obtained by the Subcommittee, however, shows that KPMG communications with bank personnel were not rare. KPMG negotiated intensively with the banks over the factual representations that would be attributed to the banks in the KPMG opinion letters. On occasion, KPMG stationed its personnel at the banks to facilitate transactions and paperwork. The BLIPS National Deployment Champion met with NatWest personnel regarding the BLIPS transactions. In one instance in 2000, documents indicate that, when clients had exhausted the available credit at Deutsche Bank to conduct OPIS transactions, the Deployment Champion planned to meet with senior Deutsche Bank officials about increasing the credit lines so that more OPIS products could be sold.<sup>203</sup>

**Executing SC2.** In the case of SC2, the tax product could not be executed at all without a charitable organization willing to participate in the required transactions. KPMG took on the task of locating and convincing appropriate charities to participate in SC2 transactions. The difficulty of this task was evident in several KPMG documents. For example, one SC2 document warned KPMG personnel not to look for a specific charity to participate in a specific SC2 transaction until after an engagement letter was signed with a client because: "It is difficult to find qualifying tax exempts ... [O]f those that qualify only a few end up being interested and only a few of those will accept

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<sup>201</sup>Credit Request dated 9/26/99, Bates HVB 001166; Subcommittee interview of HVB representatives (10/29/03).

<sup>202</sup>Subcommittee interview of Jeffrey Eischeid (10/8/03).

<sup>203</sup>See, e.g., memorandum dated 8/5/98, from Doug Ammerman to "PFP Partners," "OPIS and Other Innovative Strategies," Bates KPMG 0026141-43 at 2; email dated 5/13/99, sent by Barbara Mcconnachie but attributed to Doug Ammerman, to John Lanning and other KPMG tax professionals, "FW: BLIPS," Bates KPMG 0011903 ("Jeff Eischeid will be attending a meeting ... to address the issue of expanding capacity at Deutsche Bank given our expectation regarding the substantial volume expected from this product.") It is unclear whether this meeting actually took place.

donations .... We need to be able to go to the tax-exempt with what we are going to give them to get them interested.”<sup>204</sup> In another email, the SC2 National Deployment Champion wrote:

“Currently we have five or six tax exempts that have reviewed the transaction, are comfortable they are not subject to UBIT [unrelated business income tax] and are eager to receive gifts of S Corp stock. These organizations are well established, solid organizations, but generally aren’t organizations our clients and targets have made gifts to in the past. This point hit painfully home when, just before signing our engagement letter for an SC2 transactions with a \$3 million fee, an Atlanta target got cold feet.”<sup>205</sup>

KPMG refused to identify to the Subcommittee any of the charities it contacted about SC2 or any of the handful of charities that actually participated in SC2 stock donations, claiming this was “tax return information” that it could not disclose. The Subcommittee was nevertheless able to identify and interview two charitable organizations which, between them, participated in more than half of the 58 SC2 transactions KPMG arranged.<sup>206</sup>

Both charities interviewed by Subcommittee staff indicated that they first learned of SC2 when contacted by KPMG personnel. Both used the same phrase, that KPMG had contacted them “out of the blue.”<sup>207</sup> Both charities indicated that KPMG personnel explained SC2 to them, convinced them to participate, introduced the potential SC2 donors to the charity, and supplied draft transactional documents. Both charities indicated that, with KPMG acting as a liaison, they then accepted S corporation stock donations from out-of-state residents whom they never met and with whom they had never had any prior contact.

KPMG also distributed to its personnel a document entitled, “SC2 Implementation Process,” listing a host of implementation tasks they should complete in each transaction. These tasks included technical, administrative, and logistical chores. For example, KPMG personnel were told they should evaluate the S corporation’s ownership structure and incorporation documentation; work with an outside valuation firm to determine the corporation’s enterprise value and the value of the corporate stock and warrants; and physically deliver the appropriate stock certificates to the charity accepting the client’s the stock donation.<sup>208</sup>

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<sup>204</sup>Attachment entitled, “Tax Exempt Organizations,” included in an SC2 information packet dated 7/19/00, “SC2 – Meeting Agenda,” Bates KPMG 0013387.

<sup>205</sup>Email dated 2/22/01, from Council Leak to multiple KPMG tax professionals, “SC2 Solution–New Development,” Bates KPMG 0050822.

<sup>206</sup>Subcommittee interviews with Los Angeles Department of Fire & Police Pension System (10/22/03) and the Austin Fire Relief and Retirement Fund (10/14/03).

<sup>207</sup>Id.

<sup>208</sup>“SC2 Implementation Process,” included in an SC2 information packet dated 7/19/00, Bates KPMG 0013385-86.



Both charities said that KPMG often acted as a go-between for the charity and the corporate donor, shuttling documents back and forth and answering inquiries on both sides. KPMG apparently also drafted and supplied draft transactional documents to the S corporations and corporate owners.<sup>209</sup> One of the pension funds informed the Subcommittee staff that, when one corporate donor needed to re-take possession of the corporate stock due to an unrelated business opportunity that required use of the stock, KPMG assisted in the mechanics of selling the stock back to the donor.<sup>210</sup>

The documentation shows that KPMG tax professionals also expended significant effort developing a “back-end deal” for SC2 donors, meaning a tax transaction that could be used by the S corporation owner to further reduce or eliminate their tax liability when they retake control of the S corporation and distribute some or all of the income that built up within the company while the charity was a shareholder. The SC2 National Deployment Champion wrote to more than 20 of his colleagues working on SC2 the following:

“Our estimate is that by 12/31/02, there will be approximately \$1 billion of income generated by S-corps that have implemented this strategy, and our goal is to maintain the confidentiality of the strategy for as long as possible to protect these clients (and new clients). ...

We have had our first redemption from the LAPD. Particular thanks to [a KPMG tax professional] and his outstanding relationship with the LAPD fund administrators, the redemption went smooth. [Three KPMG tax professionals] all worked together on structuring the back-end deal allowing for the shareholder to recognize a significant benefit, as well as getting KPMG a fee of approx. \$1 million, double the original SC2 fee!!

[Another KPMG tax professional] is in the process of working on a back-end solution to be approved by WNT that will provide S-corp shareholders additional basis in their stock which will allow for the cash build-up inside of the S-corporation to be distributed tax-free to the shareholders. This should provide us with an additional revenue stream and a captive audience. Our estimate is that if 50% of the SC2 clients implement the back-end solution, potential fees will approximate \$25 million.”<sup>211</sup>

This email communication shows that the key KPMG tax professionals involved with SC2 viewed the strategy as a way to defer and reduce taxes on substantial corporate income that was always intended to be returned to the control of the stock donor. It also shows that KPMG’s implementation efforts on SC2 continued long past the sale of the tax product to a client.

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<sup>209</sup>Subcommittee interview of Lawrence Manth (11/6/03).

<sup>210</sup>Subcommittee interview of William Stefka, Austin Fire Relief and Retirement Fund (10/14/03).

<sup>211</sup>Email dated 12/27/01, from Larry Manth to Andrew Atkin and other KPMG tax professionals, “SC2,” Bates KPMG 0048773. See also email dated 8/18/01, from Larry Manth to multiple KPMG tax professionals, “RE: New Solutions - WNT,” Bates KPMG 0026894.

**Preparing KPMG Opinion Letters.** In addition to helping clients complete the transactions called for in FLIP, OPIS, BLIPS, and SC2, when it came time for clients to submit tax returns at the end of the year or in subsequent years, KPMG was available to help its clients prepare their returns. In addition, whether a client's tax return was prepared by KPMG or someone else, KPMG supplied the client with a tax opinion letter explaining the tax benefits that the product provided and could be reflected in the client's tax return. In three of the cases examined by the Subcommittee, KPMG also arranged for its clients to obtain a second favorable opinion letter from an outside law firm. In the fourth case, SC2, KPMG knew of law firms willing to issue a second opinion letter, but it is unclear whether any were actually issued.

A tax opinion letter, sometimes called a legal opinion letter when issued by a law firm, is intended to provide written advice to a client on whether a particular tax product is permissible under the law and, if challenged by the IRS, how likely it would be that the challenged product would survive court scrutiny. The Subcommittee investigation uncovered disturbing evidence related to how opinion letters were being developed and used in connection with KPMG's tax products.

The first issue involves the accuracy and reliability of the factual representations that were included in the opinion letters supporting KPMG's tax products. In the four case histories, KPMG tax professionals expended extensive effort drafting a prototype tax opinion letter to serve as a template for the opinion letters actually sent by KPMG to its clients. One key step in the drafting process was the drafting of factual representations attributed to parties participating in the relevant transactions. Such factual representations play a critical role in the opinion letter by laying a factual foundation for its analysis and conclusions. Treasury regulations state:

The advice [in an opinion letter] must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner."<sup>212</sup>

KPMG stated in its opinion letters that its analysis relied on the factual representations provided by the client and other key parties. In the BLIPS prototype tax opinion, for example, KPMG stated that its "opinion and supporting analysis are based upon the following description of the facts and representations associated with the investment transactions undertaken by Investor."<sup>213</sup> The Subcommittee was told that Sidley Austin Brown & Wood relied on the same factual representations to compose the legal opinion letters that it drafted.

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<sup>212</sup>Treas. Reg. §1.6664-4(c)(1)(ii).

<sup>213</sup>Prototype BLIPS tax opinion letter prepared by KPMG, (12/31/99), Bates KPMG 0000405-417, at 1.

Virtually all of the FLIP, OPIS, and BLIPS opinion letters contained boilerplate repetitions of the factual representations attributed to the participating parties. For example, virtually all the KPMG FLIP clients made the same factual representations, worded in the same way. The same was true for KPMG's OPIS clients and for KPMG's BLIPS clients. Each of the banks that participated in BLIPS made factual representations that varied slightly from bank to bank, but did not vary at all for a particular bank. In other words, Deutsche Bank and HVB attested to slightly different versions of the factual representations attributed to the bank participating in the BLIPS transactions, but every BLIPS opinion letter that, for example, referred to Deutsche Bank, contained the exact same boilerplate language to which Deutsche Bank had agreed to attest.

The evidence is clear that KPMG took the lead in drafting the factual representations attributed to other parties, including the client or "investor" who purchased the tax product, the investment advisory firm that participated in the transactions, and the bank that provided the financing. In the case of the factual representations attributed to the investment advisory firm or bank, the evidence indicates that KPMG presented its draft language to the relevant party and then engaged in detailed negotiations over the final wording.<sup>214</sup> In the case of the factual representations attributed to a client, however, the evidence indicates KPMG did not consult with its client beforehand, even for representations purporting to describe, in a factual way, the client's intentions, motivations, or understanding of the tax product. KPMG alone, apparently without any client input, wrote the client's representations and then demanded that each client attest to them by returning a signed letter to the accounting firm.

The evidence indicates that KPMG not only failed to consult with its clients before attributing factual representations to them, it also refused to allow its clients to deviate from the KPMG-drafted representations, even when clients disagreed with the statements being attributed to them. For example, according to a court complaint filed by one KPMG client, Joseph Jacoboni, he initially refused to attest to the factual representations sent to him by KPMG about a FLIP transaction, because he had no first hand knowledge of the "facts" and did not understand the FLIP transaction.<sup>215</sup> According to Mr. Jacoboni, KPMG would not alter the client representations in any way and would not supply him with any opinion letter until he attested to the specific factual representations attributed to him by KPMG. After a standoff lasting nearly two months, with the deadline for his tax

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<sup>214</sup>See, e.g., email dated 3/27/00, from Jeffrey Eiseheid to Richard Smith, "Bank representation," and email dated 3/28/00, from Jeffrey Eiseheid to Mark Watson, "Bank representation," Bates KPMG 0025753 (depicting negotiations between KPMG and Deutsche Bank over factual representations to be included in opinion letter).

<sup>215</sup> Jacoboni v. KPMG, Case No. 6:02-CV-510 (M.D. Fla. 4/29/02) Complaint at paragraphs 16-17 ("[I]t seemed ridiculous to ask Mr. Jacoboni to sign the Representation Letter, which neither he [Mr. Jacoboni's legal counsel] nor Mr. Jacoboni understood. Moreover, Mr. Jacoboni had no personal knowledge of the factual representations in the letter and could not verify the facts as KPMG requested." Emphasis in original.); Subcommittee interview of Mr. Jacoboni's legal counsel (4/4/03).

return fast approaching, Mr. Jacoboni finally signed the representation letter attesting to the statements KPMG had drafted.<sup>216</sup>

Equally disturbing is that some of the key factual representations KPMG attributed to its clients appear to contain false or misleading statements. For example, in the BLIPS prototype letter, KPMG wrote: “Investor has represented to KPMG ... [that the] Investor independently reviewed the economics underlying the [BLIPS] Investment Fund before entering into the program and believed there was a reasonable opportunity to earn a reasonable pre-tax profit from the transactions.”<sup>217</sup> The existence of a client profit motive and the existence of a reasonable opportunity to earn a reasonable pre-tax profit are central factors in determining whether a tax product like BLIPS has a business purpose and economic substance apart from its tax benefits. It is the Subcommittee’s understanding that this client representation was repeated substantially verbatim in every BLIPS tax opinion letter KPMG issued.

The first stumbling block is the notion that every client who purchased BLIPS “independently” reviewed its “economics” beforehand, and “believed” there was a reasonable opportunity to make a reasonable profit. BLIPS was an enormously complicated transaction, with layers of structured finance, a complex loan, and intricate foreign currency trades. A technical analysis of its “economics” was likely beyond the capability of most of the BLIPS purchasers. In addition, KPMG knew there was only a remote possibility – not a reasonable possibility – of a client’s earning a profit in BLIPS.<sup>218</sup> Nevertheless, since the existence of a reasonable opportunity to earn a reasonable profit was critical to BLIPS’ having economic substance, KPMG included that questionable client representation in its BLIPS tax opinion letter.<sup>219</sup>

BLIPS was constructed so that the potential for client profit from the BLIPS transactions increased significantly if the client participated in all three phases of the BLIPS loan, which required a full seven years to finish. The head of DPP-Tax observed that KPMG had drafted a factual representation for inclusion in the prototype BLIPS tax opinion letter stating that, “The original intent of the parties was to participate in all three investment stages of the Investment Program.” He

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<sup>216</sup>Id. at paragraphs 18-19. Mr. Jacoboni also alleges that, despite finally signing the letter, he never received the promised tax opinion letter from KPMG.

<sup>217</sup>Prototype BLIPS tax opinion letter prepared by KPMG, (12/31/99), Bates KPMG 0000405-417, at 9.

<sup>218</sup>See email dated 5/4/99, from Mark Watson, WNT, to Larry DeLap, DPP, Bates KPMG 0011916 (quoting Presidio investment experts who set up the BLIPS transactions, KPMG tax expert states: “the probability of actually making a profit from this transaction is remote (possible, but remote).”).

<sup>219</sup>KPMG required the investment advisory firm, Presidio, to make this same factual representation, even though Presidio had informed KPMG personnel that “the probability of actually making a profit from this transaction is remote (possible, but remote).” The evidence indicates that both KPMG and Presidio knew there was only a remote possibility – not a reasonable possibility – of a client’s earning a profit in the BLIPS transaction, yet both continued to issue and stand behind an opinion letter attesting to what both knew was an inaccurate factual representation.

cautioned against including this factual representation in the opinion letter: “It seems to me that this [is] a critical element of the entire analysis and should not be blithely assumed as a “fact.” ... I would caution that if there were, say, 50 separate investors and all 50 bailed out at the completion of Stage I, such a representation would not seem credible.”<sup>220</sup>

The proposed representation was not included in the final version of the BLIPS prototype opinion letter, and the actual BLIPS track record supported the cautionary words of the DPP head. In 2000, the KPMG tax partner in charge of WNT wrote:

“Lastly, an issue that I am somewhat reluctant to raise but I believe is very important going forward concerns the representations that we are relying on in order to render our tax opinion in BLIPS I. In each of the 66 or more deals that were done at last year, our clients represented that they ‘independently’ reviewed the economics of the transaction and had a reasonable opportunity to earn a pretax profit. ... As I understand the facts, all 66 closed out by year-end and triggered the tax loss. Thus, while I continue to believe that we can issue the tax opinions on the BLIPS I deals, the issue going forward is can we continue to rely on the representations in any subsequent deals if we go down that road? ... My recommendation is that we deliver the tax opinions in BLIPS I and close the book on BLIPS and spend our best efforts on alternative transactions.”<sup>221</sup>

This email and other documentation indicate that KPMG was well aware that the BLIPS transactions were of limited duration and uniformly produced substantial tax losses that “investors” used to offset and shelter other income from taxation.<sup>222</sup> This growing factual record, showing that BLIPS investors invariably lost money, made it increasingly difficult for KPMG to rely on an alleged client representation about BLIPS’ having a reasonable profit potential. KPMG nevertheless continued to sell the product and to issue tax opinion letters relying on a critical client representation that KPMG had drafted without client input and attributed to its clients, but which KPMG knew or had reason to know, was unsupported by the facts.

**Discontinuing Sales.** Still another KPMG implementation issue involves decisions by KPMG to stop selling particular tax products. In all four of the case studies examined by the

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<sup>220</sup>Email dated 4/14/99, from Larry DeLap to multiple KPMG tax professionals, “RE: BLIPS,” Bates KPMG 0017578-79.

<sup>221</sup>Email dated 2/24/00, from Philip Wiesner to multiple KPMG tax professionals, “RE: BLIPS/OPIS,” Bates KPMG 0011789.

<sup>222</sup>Email dated 5/4/99, from Mark Watson, WNT, to Larry DeLap, DPP, Bates KPMG 0011916. See also document dated 5/18/01, “PFP Practice Reorganization Innovative Strategies Business Plan – DRAFT,” authored by Jeffrey Eischeid, Bates KPMG 0050620-23, at 1-2 (referring to BLIPS and its predecessors, FLIP and OPIS, as a “capital loss strategy,” “loss generator” or “gain mitigation solution”).

Subcommittee, KPMG stopped marketing the tax product within one or two years of its first sale.<sup>223</sup> The decision was made in each case by the head of DPP-Tax, after consultation with the product's Deployment Champion and other senior tax professionals.

When asked to explain why sales were discontinued, the DPP head offered several reasons for pulling a tax product off the market.<sup>224</sup> The DPP head stated that he sometimes ended the marketing of a tax product out of concern that a judge would invalidate the tax product "as a step transaction," using evidence that a number of persons who purchased the product engaged in a series of similar transactions.<sup>225</sup> Limiting the number of tax products sold limited the evidence that each resulted in a similar set of transactions orchestrated by KPMG. Limiting the number of tax products sold also limited information about them to a small circle and made it more difficult for the IRS to detect the activity.<sup>226</sup>

Evidence in the four case studies shows that internal KPMG directives to stop sales of a particular tax product were, at times, ignored or circumvented by KPMG tax professionals marketing the products. For example, the DPP head announced an end to BLIPS sales in the fall of 1999, but allowed KPMG tax professionals to complete numerous BLIPS sales in 1999 and 2000, to persons who had been approached before the marketing ban was announced.<sup>227</sup> These purchasers were referred to internally at KPMG as "grandfathered BLIPS" clients.<sup>228</sup> A handful of additional sales took place in 2000, over the objection of the DPP head, after his objection was overruled by head of the Tax Services Practice.<sup>229</sup> Also in 2000, some KPMG tax professionals attempted to restart BLIPS

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<sup>223</sup>See, e.g., email dated 12/29/01, from Larry DeLap to multiple KPMG tax professionals, "FW: SC2," Bates KPMG 0050562 (discontinuing SC2); email dated 10/1/99, from Larry DeLap to multiple KPMG tax professionals, "BLIPS," Bates KPMG 0011716 (discontinuing BLIPS); email dated 12/7/98, from Larry DeLap to multiple KPMG tax professionals, "OPIS," Bates KPMG 0025730 (discontinuing OPIS).

<sup>224</sup>Subcommittee interview of Lawrence DeLap (10/30/03).

<sup>225</sup>Id.

<sup>226</sup>See Section VI(B)(4) of this Report on "Avoiding Detection."

<sup>227</sup>See, e.g., email dated 10/13/99, from Carl Hasting to Dale Baumann, "RE: Year 2000 Blips Transactions," Bates KPMG 0006485 ("I thought we were told to quit marketing 200[0] BLIPS transactions."); email dated 10/13/99, from Dale Baumann to Carl Hasting and others, "RE: Year 2000 Blips Transactions," Bates KPMG 0006485 ("No marketing to clients who were not on the BLIPS 2000 list. The BLIPS 2000 list were for those individuals who we approached before Larry told us to stop marketing the strategy ....").

<sup>228</sup>See, e.g., two emails dated 10/1/99, from Larry DeLap to multiple KPMG tax professionals, "BLIPS," Bates KPMG 0011714.

<sup>229</sup>Subcommittee interview of Lawrence DeLap (10/30/03).

sales by developing a modified BLIPS product that would be sold to only extremely wealthy individuals.<sup>230</sup> This effort was ultimately unsuccessful in restarting BLIPS sales.

In the case of SC2, KPMG tax professionals simply did not comply with announced limits on the total number of SC2 products that could be sold or limits on the use of telemarketing calls to market the product.<sup>231</sup> In the case of FLIP and OPIS, additional sales, again, took place after the DPP head had announced an end to the marketing of the products.<sup>232</sup> The DPP head told Subcommittee staff that when he discontinued BLIPS sales in 1999, he was pressed by the BLIPS National Deployment Champion and others for an alternative product.<sup>233</sup> The DPP head indicated that, because of this pressure, he relented and allowed KPMG tax professionals to resume sales of OPIS, which he had halted a year earlier.

### **(b) Role of Third Parties in Implementing KPMG Tax Products**

FLIP, OPIS, BLIPS, and SC2 could not have been executed without the active and willing participation of the banks, investment advisors, lawyers, and charitable organizations that made these products work. The roll call of respected professional firms with direct and extensive involvement in the four KPMG case studies includes Deutsche Bank, HVB, NatWest, UBS, Wachovia Bank, and Sidley Austin, Brown & Wood. Smaller professional firms such as Quellos, and charitable organizations such as the Los Angeles Department of Fire & Police Pensions and the Austin Fire Fighters Relief and Retirement Fund, while less well known nationally, are nevertheless respected institutions who played critical roles in the execution of at least one of the four tax products.

**Finding: Some major banks and investment advisory firms have provided critical lending or investment services or participated as essential counter parties in potentially abusive or illegal tax shelters sold by KPMG in return for substantial fees or profits.**

**The Role of the Banks.** Five major banks participated in BLIPS, FLIP, and OPIS. Deutsche Bank participated in more than 50 BLIPS transactions in 1999 and 2000, providing credit lines that

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<sup>230</sup>See, e.g., email dated 6/20/00, from William Boyle of Deutsche Bank to other Deutsche Bank personnel, "Updated Presidio/KPMG trades," Bates DB BLIPS 03280 ("Presidio and KPMG are developing an expanded version of BLIP's which it will execute on a limited basis for its wealthy clientele. They anticipate executing approximately 10-15 deals of significant size (i.e. in the \$100-300m. Range).").

<sup>231</sup>See Section VI(B)(2) of this Report on "Mass Marketing Tax Products." See also, e.g., email dated 4/23/01, from John Schrier to Thomas Crawford, "RE: SC2 target list," Bates KPMG 0050029; email dated 12/20/01, from William Kelliher to David Brockway, "FW: SC2," Bates KPMG 0013311; and email response dated 12/29/01, from Larry DeLap to William Kelliher, David Brockway, and others, "FW: SC2," Bates KPMG 0013311.

<sup>232</sup>See, e.g., email dated 9/30/99, from Jeffrey Eischeid to Wolfgang Stolz and others, "OPIS," Bates QL S004593.

<sup>233</sup>Subcommittee interview of Lawrence DeLap (10/30/03).

totaled as much as \$2.8 billion.<sup>234</sup> Deutsche Bank also participated in about 60 OPIS transactions in 1998 and 1999. HVB participated in more than 30 BLIPS transactions in 1999 and 2000, providing BLIPS credit lines that apparently totaled nearly \$2.5 billion.<sup>235</sup> NatWest apparently also participated in a significant number of BLIPS transactions in 1999 and 2000, providing credit lines totaling more than \$1 billion.<sup>236</sup> UBS AG participated in 100 - 150 FLIP and OPIS transactions in 1997 and 1998, providing credit lines which, in the aggregate, were in the range of several billion Swiss francs.<sup>237</sup>

Two investment advisory firms also participated in the development, marketing and implementation of BLIPS, FLIP, and OPIS. Quellos participated in the development, marketing, and execution of FLIP. It participated in over 80 FLIP transactions with KPMG, as well as similar number of these transactions with PricewaterhouseCoopers and Wachovia Bank. It also executed some OPIS transactions for KPMG. Presidio participated in the development, marketing, and implementation of OPIS and BLIPS transactions, including the 186 BLIPS transactions related to 186

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<sup>234</sup>See, e.g., email dated 6/20/00, from William Boyle of Deutsche Bank to other Deutsche Bank personnel, "Updated Presidio/KPMG trades," Bates DB BLIPS 03280; chart entitled, "Presidio Advisory Services. Deal List 1999," Bates HVB000875 (BLIPS transactions for 1999); chart entitled, "Presidio Advisory Services. Deal List 2000," Bates HVCD00018-19 (BLIPS transactions for 2000).

<sup>235</sup>See, e.g., memorandum dated 8/19/03 (this date is likely in error), from Ted Wolf and Sylvie DeMetrio to Christopher Thorpe and others, "Presidio," Bates HVCD 00001; chart entitled, "Presidio Advisory Services. Deal List 1999," Bates HVB000875 (BLIPS transactions for 1999); chart entitled, "Presidio Advisory Services. Deal List 2000," Bates HVCD00018-19 (BLIPS transactions for 2000). See also credit request dated 1/6/00, Bates HVB 003320-30 (seeking approval of \$1.5 billion credit line for 2000, and noting that, in 1999, the bank "booked USD 950 million (out of USD 1.03 billion approved) ... all cash collateralized.")

<sup>236</sup>See, e.g., email dated 6/20/00, from William Boyle of Deutsche Bank to other Deutsche Bank personnel, "Updated Presidio/KPMG trades," Bates DB BLIPS 03280.

<sup>237</sup>See, e.g., UBS memorandum dated 12/21/99, from Teri Kemmerer Sallwasser to Gail Fagan, "Boss Strategy Meetings ...," Bates SEN-018253-57; Subcommittee interview of UBS representatives (4/4/03).



KPMG clients.<sup>238</sup> The Presidio principals even conducted a BLIPS transaction on their own behalf.<sup>239</sup>

The banks and investment advisory firms interviewed by the Subcommittee staff acknowledged obtaining lucrative fees for their participation in FLIP, OPIS, or BLIPS. Deutsche Bank internal documents state that the bank earned more than \$33 million from OPIS and expected to earn more than \$30 million for BLIPS.<sup>240</sup> HVB earned over \$5.45 million for the BLIPS transactions it completed in less than three months in 1999, and won approval of increased BLIPS transactions throughout 2000, “based on successful execution of previous transactions, low credit risk and excellent profitability.”<sup>241</sup>

The Subcommittee interviewed four of the five banks, most of which cooperated with the inquiry and were generally open and candid about their interactions with KPMG, their understanding of FLIP, OPIS and BLIPS, and their respective roles in these tax products. Evidence obtained by the Subcommittee shows that the banks knew they were participating in transactions whose primary purpose was to provide tax benefits to persons who had purchased tax products from KPMG. Some of the documentation also make it plain that the bank was aware that the tax product was potentially abusive and carried a risk to the reputation of any bank choosing to participate in it.

For example, a number of Deutsche Bank documents make it clear that the bank knew BLIPS was a tax related transaction and posed a reputational risk to the bank if the bank chose to participate in it. One Deutsche Bank official working to obtain bank approval to participate in BLIPS wrote:

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<sup>238</sup>See, e.g., email dated 3/14/98, from Jeff Stein to Robert Wells, John Lanning, Larry DeLap, Gregg Ritchie, and others, “Simon Says,” Bates 638010, filed by the IRS on June 16, 2003, as an attachment to Respondent’s Requests for Admission, Schneider Interests v. Commissioner, U.S. Tax Court, Docket No. 200-02, (describing the role of Presidio principal, Robert Pfaff, in the development of OPIS); Subcommittee interviews of John Larson (10/3/03 and 10/21/03).

<sup>239</sup>Subcommittee interviews of John Larson (10/3/03 and 10/21/03). Presidio discussed completing a BLIPS transaction on its own behalf with the assistance of HVB, but ultimately completed the transaction elsewhere. See, e.g., “Corporate Banking Division – Credit Request” dated 9/14/99, Bates HVB 000147-64; “Corporate Banking Division – Credit Request” dated 4/28/00, Bates HVB 004148-51; memorandum dated 9/14/99, from Robert Pfaff of Presidio to Dom DiGiorgio of HVB, “BLIPS loan test case,” Bates HB 000202; chart dated 9/14/99 entitled, “Presidio Ownership Structure,” Bates HVB 000215; undated document entitled, “Structural Differences in the Transaction for Presidio Principals,” Bates HVCD 00007; undated diagrams depicting BLIPS loans to Presidio principals, Bates HVB 004272-75.

<sup>240</sup>See undated document entitled, “New Product Committee Overview Memo: BLIPS Transaction,” Bates DB BLIPS 01959; email dated 4/28/99, from Francesco Piovanetti to Nancy Donohue, “presidio - w. revisions, I will call u in 1 min.,” Bates DB BLIPS 6911.

<sup>241</sup>See HVB credit request dated 1/6/00, Bates HVB 003320-30 (HVB “earned USD 4.45 million” from BLIPS loan fees and “approximately USD 1 million” from related foreign exchange activities for BLIPS transactions completed from October to December 1999); HVB document dated 8/6/00, from Thorpe, marked “DRAFT,” Bates HVB 001805.

“In this transaction, reputation risk is tax related and we have been asked by the Tax Department not to create an audit trail in respect of the Bank’s tax affairs. The Tax department assumes prime responsibility for controlling tax related risks (including reputation risk) and will brief senior management accordingly. We are therefore not asking R&R [Reputation & Risk] Committee to approve reputation risk on BLIPS. This will be dealt with directly by the Tax Department and [Deutsche Bank Chief Executive Officer] John Ross.”<sup>242</sup>

Another Deutsche Bank memorandum, prepared for the “New Product Committee” to use in reviewing BLIPS, included the following statements explaining the transaction:

“BLIPS will be marketed to High Net Worth Individual Clients of KPMG. ... Loan conditions will be such as to enable DB to, in effect, force (p)repayment after 60 days at its option. ... For tax and accounting purposes, repaying the [loan] premium amount will ‘count’ like a loss for tax and accounting purposes. ... At all times, the loan will maintain collateral of at least 101% to the loan + premium amount. ... It is imperative that the transaction be wound up after 45-60 days and the loan repaid due to the fact that the HNW individual will not receive his/her capital loss (or tax benefit) until the transaction is wound up and the loan repaid. ... At no time will DB Private Bank provide any tax advice to any individuals involved in the transactions. This will be further buttressed by signed disclaimers designed to protect and ‘hold harmless’ DB. ... DB has received a legal opinion from Shearman & Sterling which validates our envisaged role in the transaction and sees little or no risk to DB in the trade. Furthermore opinions have been issued from KPMG Central Tax department and Brown & Wood attesting to the soundness of the transactions from a tax perspective.”<sup>243</sup>

Still another Deutsche Bank document states: “For tax and accounting purposes, the [loan] premium amount will be treated as a loss for tax purposes.”<sup>244</sup>

Bank documentation indicates that a number of internal bank departments, including the tax, accounting, and legal departments, were asked to and did approve the bank’s participation in BLIPS. BLIPS was also brought to the attention of the bank’s Chief Executive Officer John Ross who made

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<sup>242</sup>Email dated 7/30/99, from Ivor Dunbar of Deutsche Bank, DMG UK, to multiple Deutsche Bank professionals, “Re: Risk & Resources Committee Paper - BLIPS,” unreadable Bates number. See also email dated 7/29/99 from Mick Wood to Francesco Piovanetti and other Deutsche bank personnel, “Re: Risk & Resources Committee Paper - BLIPS,” Bates DB BLIPS 6556 (paper prepared for the Risk & Resources Committee “skirts around the basic issue rather than addressing it head on (the tax reputational risk).”).

<sup>243</sup>Undated document entitled, “New Product Committee Overview Memo: BLIPS Transaction,” Bates DB BLIPS 01959-63.

<sup>244</sup>Email dated 7/1/99 from Francesco Piovanetti to Ivor Dunbar, “‘Hugo’ BLIPS Paper,” with attachment entitled, “Bond Linked Indexed Premium Strategy ‘BLIPS,’” Bates DB BLIPS 6585-87 at 6587.

the final decision on the bank's participation.<sup>245</sup> Minutes describing the meeting in which Mr. Ross approved the bank's participation in BLIPS state:

“[A] meeting with John Ross was held on August 3, 1999 in order to discuss the BLIPS product. [A bank representative] represented [Private Banking] Management's views on reputational risk and client suitability. John Ross approved the product, however insisted that any customer found to be in litigation be excluded from the product, the product be limited to 25 customers and that a low profile be kept on these transactions. ... John Ross also requested to be kept informed of future transactions of a similar nature.”<sup>246</sup>

Given the extensive and high level attention provided by the Bank regarding its participation in BLIPS, it seems clear that the bank had evaluated BLIPS carefully and knew what it was getting into.

Other evidence shows that Deutsche Bank was aware that the BLIPS loans were not run-of-the-mill commercial loans, but had unusual features. Deutsche Bank refused, for example, to sign a letter representing that the BLIPS loan structure, which included an unusual multi-million dollar “loan premium” credited to a borrower's account at the start of the loan,<sup>247</sup> was consistent with “industry standards.” The BLIPS National Deployment Champion had asked the bank to make this representation to provide “comfort that the loan was being made in line with conventional lending practices.”<sup>248</sup> When the bank declined to make the requested representation, the BLIPS National Deployment Champion tried a second time, only to report to his colleagues: “The bank has pushed back again and said they simply will not represent that the large premium loan is consistent with industry standards.”<sup>249</sup> He tried a third time and reported: “I've pushed really hard for our original language. To say they are resisting is an understatement.”<sup>250</sup> The final tax opinion letter issued by KPMG contained compromise language which said little more than the loan complied with the bank's own procedures: “The loan ... was approved by the competent authorities within [the Bank] as

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<sup>245</sup>See email dated 10/13/99, from Peter Sturzinger to Ken Tarr and other Deutsche Bank personnel, “Re: BLIPS,” attaching minutes dated 8/4/99, from a “Deutsche Bank Private Banking, Management Committee Meeting” that discussed BLIPS, Bates DB BLIPS 6520-6521.

<sup>246</sup>Id. at 6520.

<sup>247</sup>See Appendix A.

<sup>248</sup>Email dated 3/20/00, from Jeffrey Eischeid to Mark Watson, “Bank representation,” Bates KPMG 0025754.

<sup>249</sup>Email dated 3/27/00, from Jeffrey Eischeid to Richard Smith, “Bank representation,” Bates KPMG 0025753.

<sup>250</sup>Email dated 3/28/00, from Jeffrey Eischeid to Mark Watson, “Bank representation,” Bates KPMG 0025753.

consistent, in the light of all the circumstances such authorities consider relevant, with [the Bank's] credit and documentation standards."<sup>251</sup>

A year after Deutsche Bank began executing BLIPS transactions, a key bank official handling these transactions wrote an email which acknowledged the "tax benefits" associated with BLIPS and noted, again, the reputational risk these transactions posed to the bank:

"During 1999, we executed \$2.8b. of loan premium deals as part of the BLIP's approval process. At that time, NatWest and [HVB] had executed approximately \$0.5 b. of loan premium deals. I understand that we based our limitations on concerns regarding reputational risk which were heightened, in part, on the proportion of deals we have executed relative to the other banks. Since that time, [HVB], and to a certain extent NatWest, have participated in approximately an additional \$1.0-1.5 b. of grandfathered BLIP's deals. ... [HVB] does not have the same sensitivity to and market exposure as DB does with respect to the reputational risk from making the high-coupon loan to the client. ... As you are aware, the tax benefits from the transaction potentially arise from a contribution to the partnership subject to the high-coupon note and not from the execution of FX positions in the partnership, activities which we perform in the ordinary course of our business."<sup>252</sup>

This document shows that Deutsche Bank was fully aware of and had a sophisticated understanding of the tax aspects of BLIPS. To address the issue of reputational risk, the email went on to propose that, because HVB had a limited capacity to issue more BLIPS loans, and Deutsche Bank did not want to expose itself to increased reputational risk by making additional direct loans to BLIPS clients, "we would like to lend an amount of money to [HVB] equal to the amount of money [HVB] lends to the client. ... We would like tax department approval to participate in the aforementioned more complex trades by executing the underlying transactions and making loans to [HVB]." In other words, Deutsche Bank wanted to be the bank behind HVB, financing more BLIPS loans in exchange for fees and other profits.

Other Deutsche Bank documents suggest that the bank may have been helping KPMG find clients or otherwise marketing the BLIPS tax products. A November 1999 presentation by the bank's "Structured Finance Group," for example, listed BLIPS as one of several tax products the group was offering to U.S. and European clients seeking "gain mitigation."<sup>253</sup> The presentation listed as the bank's "strengths" its ability to lend funds in connection with BLIPS and its "relationships with [the]

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<sup>251</sup>KPMG prototype tax opinion letter on BLIPS, dated 12/31/99, at 11.

<sup>252</sup>Email dated 6/20/00, from William Boyle to multiple Deutsche Bank professionals, "Updated Presidio/KPMG trades," Bates DB BLIPS 03280.

<sup>253</sup>Email dated 4/3/02, from Viktoria Antoniadis to Brian McGuire and other Deutsche Bank personnel, "US GROUP 1 Pres," DB BLIPS 6329-52, attaching a presentation dated 11/15/99, entitled "Structured Transactions Group North America," at 6336, 6346.

‘promoters’<sup>254</sup> later named as Presidio and KPMG.<sup>255</sup> An internal bank email a few months earlier asked: “What is the status of the BLIPS. Are you still actively marketing this product[?]”<sup>256</sup>

The same document suggests that Deutsche Bank may have been a tax shelter promoter in its own right. For example, the document indicates that, in 1999, the Structured Transactions Group was offering over a dozen sophisticated tax products to U.S. and European clients seeking to “execute tax driven deals” or “gain mitigation” strategies.<sup>257</sup> The document indicates that Deutsche Bank was aggressively marketing these tax products to large U.S. corporations and individuals, and planning to close billions of dollars worth of transactions.<sup>258</sup> At least two of the tax products listed by Deutsche Bank, BLIPS and the Customized Adjustable Rate Debt Facility (CARDS), were later determined by the IRS to be potentially abusive tax shelters. During the late 1990s and early 2000, Deutsche Bank was also involved, either directly or through Bankers Trust (which Deutsche Bank acquired in June 1999), in a number of tax-driven transactions with Enron Corporation, including Project Steele, Project Cochise, Project Tomas and Project Valhalla.<sup>259</sup>

Despite the bank’s involvement in and sophisticated knowledge of generic tax products, when asked about BLIPS during a Subcommittee interview, the Deutsche Bank representative insisted that BLIPS was an investment strategy which, like all investment products, had tax implications. The bank representative also indicated that, despite handling BLIPS transactions for the bank, he did not understand the details of the BLIPS transactions, and downplayed any reputational risk that BLIPS might have posed to the bank.<sup>260</sup>

In contrast to Deutsche Bank’s stance, in which its representative’s oral information repeatedly contradicted its internal documentation, HVB representatives provided oral information that was fully consistent with the bank’s internal documentation. HVB’s representative

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<sup>254</sup>Id. at 6337.

<sup>255</sup>Id. at 6346.

<sup>256</sup>Email dated 7/19/99, involving multiple Deutsche Bank employees, “Update NY Issues,” Bates DB BLIPS 6775.

<sup>257</sup>Email dated 4/3/02, from Viktoria Antoniadis to Brian McGuire and other Deutsche Bank personnel, “US GROUP 1 Pres,” DB BLIPS 6329-52, attaching a presentation dated 11/15/99, entitled “Structured Transactions Group North America,” at 6336. See also undated document entitled, “Update on the Private Exchange Fund,” Bates DB BLIPS 6433 (describing the packaging of another tax product offered by the Structured Transactions Group).

<sup>258</sup>Id. at 6345-46.

<sup>259</sup>See “Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations,” Joint Committee on Taxation Staff (Report No. JCS-3-03, February 2003).

<sup>260</sup>Subcommittee interview of Deutsche Bank, (11/10/03).

acknowledged, for example, that HVB knew BLIPS had been designed and was intended to provide tax benefits to KPMG clients. The bank indicated that, at the time it became involved, it felt it had no obligation to refrain from participating in BLIPS, since KPMG had provided the bank with an opinion stating that BLIPS complied with federal tax law. For example, in one document seeking approval to provide a significant line of credit to finance BLIPS loans, HVB wrote this about the tax risks associated with BLIPS: “Disallowance of tax attributes. A review by the IRS could potentially result in a ruling that would disallow the [BLIPS] structure. ... We are confident that none of the foregoing would affect the bank or its position in any meaningful way for the following reasons. ... KPMG has issued an opinion that the structure will most likely be upheld, even if challenged by the IRS.”<sup>261</sup> A handwritten document prepared by HVB personnel is even more direct. It characterizes the 7% fee charged to KPMG clients for BLIPS as “paid by investor for tax sheltering.”<sup>262</sup> This document also states that the bank “amortizes premium over the life of loan for tax purposes.”

When it became clear that the IRS would list BLIPS as an abusive tax shelter, an internal HVB memorandum again acknowledged that BLIPS was a tax transaction and ordered a halt to financing the product, while disavowing any liability for the bank’s role in carrying out the BLIPS transactions:

“[I]t is clear that the tax benefits for individuals who have participated in the [BLIPS] transaction will not be grandfathered because Treasury believe that their actions were contrary to current law .... It is not likely that KPMG/Presidio will go forward with additional transactions .... As we have stated previously, we anticipate no adverse consequences for the HVB since we have not promoted the transaction. We have simply been a lender and nothing in the notice implies a threat to our position.

In view of the tone of the notice we will not book any new transactions and will cancel our existing unused [credit] lines prior to the end of this month.”<sup>263</sup>

HVB’s representative explained to the Subcommittee staff that the apparent bank risk in lending substantial sums to a shell corporation had been mitigated by the terms of the BLIPS loan which gave the bank virtually total control over the BLIPS loan proceeds and enabled the bank to ensure the loan and loan premium would be repaid.<sup>264</sup> The bank explained, for example, that from the start of the loan, the borrower was required to maintain collateral equal to 101% of the loan proceeds and loan premium and could place these funds only in a narrow range of bank-approved

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<sup>261</sup>Credit request dated 9/26/99, Bates HVB 001166.

<sup>262</sup>Undated one-page, handwritten document outlining BLIPS structure entitled, “Presidio,” which Alex Nouvakhov of HVB acknowledged during his Subcommittee interview had been written by him, Bates HVB 000204.

<sup>263</sup>Memorandum dated 8/16/00, from Dom DeGiorgio and Richard Pankuch to Christopher Thorpe and others, “Presidio BLIPS Transactions,” Bates HVB 003346.

<sup>264</sup>Subcommittee interview of HVB representative (10/29/03).

investments.<sup>265</sup> That meant the bank treated not only all of the loan proceeds and loan premium as collateral, but also additional funds supplied by the KPMG client to meet the 101% collateral requirement. HVB wrote: “We are protected in our documentation through a minimum overcollateralization ratio of 1.0125 to 1 at all times. Violation of this ratio triggers immediate acceleration under the loan agreements without notice.”<sup>266</sup> HVB also wrote: “The Permitted Investments ... are either extremely conservative in nature ... or have no collateral value for margin purposes.”<sup>267</sup> KPMG put it this way: “Lender holds all cash as collateral in addition to being custodian and clearing agent for Partnership. ... All Partnership trades can only be executed through Lender or an affiliate. ... Lender must authorize trades before execution.”<sup>268</sup>

Deutsche Bank and HVB were not the only banks involved in executing KPMG tax products. Another was Wachovia Bank, acting through First Union National Bank, which not only referred bank clients to KPMG to purchase FLIP, but also directly sold FLIP to many of its clients, and considered becoming involved with BLIPS and SC2 as well.<sup>269</sup> A 1999 Wachovia internal email demonstrates that the bank was fully aware that it was being asked to facilitate transactions designed to reduce or eliminate tax liability for KPMG clients:

“[A] KPMG investment/tax strategy ... was voted and approved by the due diligence subcommittee last week. This means that the Risk Oversight Committee will have this particular strategy on its agenda at its Wednesday meeting. ... The strategy will service to offset either ordinary income or capital gains (\$20 million minimum).

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<sup>265</sup>See, e.g., email dated 10/29/99, from Richard Pankuch to Erwin Volt, “KWG I capital treatment for our Presidio Transaction,” Bates HVB 000352 (“Our structure calls for all collateral to be placed in a collateral account pledged to the bank.”); email dated 9/24/99, from Richard Pankuch to Christopher Thorpe and other HVB professionals, “Re: Presidio,” Bates HVB 000682 (“all collateral is in our own hands and subject to the Permitted Investment requirement”). Compare undated Deutsche Bank document, likely prepared in 1999, “New Product Committee Overview Memo: BLIPS Transaction,” Bates DB BLIPS 01959-63, at 1961 (“At all times, the loan will maintain collateral of at least 101% to the loan + loan premium amount. If the amount goes below this limit, the loan will be unwound and the principal + premium repaid.”); email dated 7/1/99, from Francesco Piovanetti to Ivor Dunbar, “‘Hugo’ BLIPS Paper,” with attachment entitled, “Bond Linked Indexed Premium Strategy ‘BLIPS’,” Bates HVB DB BLIPS 6885-87 (“The loan proceeds (par and premium) will be held in custody at DB in cash or money market deposits. ... Loan conditions will be such as to enable DB to, in effect, force prepayment after sixty days at its option.”).

<sup>266</sup>BLIPS credit request dated 9/14/99, Bates HVB 000155. See also Memorandum dated 7/29/99, from William Boyle to Mick Wood and other Deutsche Bank personnel, “GCI Risk and Resources Committee – BLIPS Transaction,” Bates DB BLIPS 06566, at 3 (The BLIPS loan “will be overcollateralized and should the value of the collateral drop below a 1.0125:1.0 ratio, DB may liquidate the collateral immediately and apply the proceeds to repay amounts due under the Note and swap agreements.”)

<sup>267</sup>BLIPS credit request dated 9/14/99, Bates HVB 000155.

<sup>268</sup>Document dated 3/4/99, “BLIPS – transaction description and checklist,” Bates KPMG 0003933-35.

<sup>269</sup>See Section VI(2) of this Report for discussion of Wachovia’s client referral activities.

There are several critical point that should be noted with respect to this strategy if we get it approved. Many of these points related to Sandy Spitz' concern (and KPMG's concern) that First Union has a very high profile across our franchise for being associated with 'tax' strategies: namely, FLIP and BOSS. Sandy does not want this kind of high profile to be associated with this new strategy.

In order to address some of Sandy's concerns and lower our profile ...

\*The strategy has an KPMG acronym which will not be shared with the general First Union community. We will probably assign a generic name ....

\*No one-pager will be distributed to our referral sources describing the strategy. ...

\*Fees to First Union will be 50 basis points if the investor is not a KPMG client, 25 bps if they are a KPMG client. ...

I have written up a technical summary of the tax opinion since Sandy will only allow us to read a draft copy of the opinion in his office without making a copy."<sup>270</sup>

Clearly, First Union was well aware that it was handling products intended to help clients reduce or eliminate their taxes and was worried about its own high profile from being "associated with 'tax' strategies" like FLIP.

In addition to its participation in KPMG-developed tax products, First Union helped develop and market the BOSS tax product sold by PricewaterhouseCoopers ("PWC"), which was later determined by the IRS to be a potentially abusive tax shelter. First Union had in its files the following document advocating the bank's involvement with BOSS:

"The proposed transaction takes advantage of an anomaly in current tax law which we expect will be closed down by legislation as soon as Congress finds out about it. We make this investment available only to select clients in order to limit the number of people who know about it. We hope that will delay the time Congress finds out about it, but at some point, it is likely that they will find out and enact legislation to shut it down. First Union acts as sales agent for PwC with respect to this transaction, since the bankers are in a very good position to know when a client has entered into a significant transaction which might have generated significant taxable income. Pricewaterhouse-Coopers would provide a Tax Opinion Letter which would say that if the entity were examined by the IRS, the transaction would 'more likely than not' be successfully upheld."<sup>271</sup>

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<sup>270</sup>Email dated 8/30/99, from Tom Newman to multiple First Union professionals, "next strategy," Bates SEN-014622.

<sup>271</sup>Memorandum dated 12/21/99, from Teri Kemmerer Sallwasser to Gail Fagan, "Boss Strategy Meetings ..." Bates SEN-018253-57.



This document provides additional, unmistakable evidence that First Union knew it was participating in transactions whose primary purpose was to reduce or eliminate clients' taxes.

Still another bank that handled KPMG tax products is UBS AG, now one of the largest banks in the world. UBS was convinced by Quellos and KPMG to participate in numerous FLIP and OPIS transactions in 1997 and 1998, referred to collectively by UBS as "redemption transactions."

UBS documentation clearly and repeatedly describes these transactions as tax-related. For example, one UBS document explaining the transactions is entitled: "U.S. Capital Loss Scheme - UBS 'redemption trades.'" It states:

"The essence of the UBS redemption trade is the creation of a capital loss for U.S. tax purposes which may be used by a U.S. tax resident to off-set any capital gains tax liability to which it would otherwise be subject. The tax structure was originally devised by KPMG .... In October 1996, UBS was approached jointly by Quadra ... and KPMG with a view to it seeking UBS' participation in a scheme that implemented the tax loss structure developed by KPMG. The role sought of UBS was one purely of execution counterparty. ... It was clear from the outset - and has been continually emphasised since - that UBS made no endorsement of the scheme and that its connection with the structure should not imply any implicit confirmation by UBS that the desired tax consequences will be recognized by the U.S. tax authorities. ... UBS undertook a thorough investigation into the propriety of its proposed involvement in these transactions. The following steps were undertaken: [redacted by UBS as 'privileged material']<sup>272</sup>

At another point, the UBS document explains the "Economic Rationale" for redemption transactions to be: "Tax benefit for client,"<sup>273</sup> while still another UBS document states: "The motivation for this structure is tax optimisation for U.S. tax residents who are enjoying capital gains that are subject to U.S. tax. The structure creates a capital loss from a U.S. tax point of view (but not from an economic point of view) which may be offset against existing capital gains."<sup>274</sup>

In February 1998, an unidentified UBS "insider" sent a letter to UBS management in London "to let you know that [UBS unit] Global Equity [D]erivatives is currently offering an illegal capital gains tax evasion scheme to US tax payers," meaning the redemption transactions. The letter continued:

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<sup>272</sup>UBS internal document dated 3/1/99, "Equities Large/Heavily Structured Transaction Approval," with attachment entitled, "U.S. Capital Loss Scheme - UBS 'redemption trades,'" Bates UBS 000009-15.

<sup>273</sup>Id. at UBS000010.

<sup>274</sup>UBS internal document dated 11/13/97, "Description of the UBS 'Redemption' Structure," Bates UBS 000031.

This scheme is costing the US Internal Revenue [S]ervice several hundred million dollars a year. I am concerned that once IRS comes to know about this scheme they will levy huge financial/criminal penalties on UBS for offering tax evasion schemes. ... In 1997 several billion dollars of this scheme was sold to high networth US tax payers, I am told that in 1998 the plan is continu[ing] to market this scheme and to offer several new US tax avoidance schemes involving swaps.

My sole objective is to let you know about this scheme, so that you can take some concrete steps to minimise the financial and reputational damage to UBS. ...

P.S. I am sorry I cannot disclose my identity at this time because I don't know whether this action of mine will be rewarded or punished.<sup>275</sup>

In response to the letter, UBS halted all redemption trades for several months.<sup>276</sup> UBS apparently examined the nature of transactions as well as whether they should be registered in the United States as tax shelters. UBS later resumed selling the products, stopping only after KPMG discontinued the sales.<sup>277</sup>

The UBS documents show that the bank was well aware that FLIP and OPIS were designed and sold to KPMG clients as ways to reduce or eliminate their U.S. tax liability. The bank apparently justified its participation in the transactions by reasoning that its participation did not signify its endorsement of the transactions and did not constitute aiding or abetting tax evasion. The bank then proceeded to provide the financing that made these tax products possible.

**The Role of the Investment Advisors.** Bank personnel were not the only financial professionals assisting KPMG with BLIPS, FLIP, and OPIS. Investment experts also played key roles in designing, marketing, and implementing the three tax products, working closely with KPMG tax professionals throughout the process. For example, the investment experts involved with BLIPS, FLIP, and OPIS helped KPMG with designing the specific financial transactions, making client presentations, obtaining financing from the banks, preparing the transactional documents, establishing the required shell corporations and partnerships, and facilitating the completion of individual client transactions. In the case of FLIP, investment experts at Quellos, then known as Quadra, provided these services. In the case of OPIS, both Quellos and Presidio provided these services. In the case of BLIPS, these services were generally provided by Presidio.

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<sup>275</sup>Letter dated 2/12/98, addressed to SBC Warburg Dillon Read in London, Bates UBS 000038.

<sup>276</sup>See email dated 3/27/98, from Chris Donegan of UBS to Norm Bontje of Quadra and others, "Re: Redemption Trade," UBS 000039 ("Wolfgang and I are presently unable to execute any redemption transactions on UBS stock. The main reason for this seems to be a concern within UBS that this trade should be registered as a tax shelter with the IRS.").

<sup>277</sup>Subcommittee interview with UBS representative (10/28/03).

A memorandum sent by a Quellos investment expert to a banker at UBS explained the investment company's role in FLIP and the nature of the tax product itself as follows:

“KPMG approach us as to whether we could affect the security trades necessary to achieve the desired tax results. I indicated that I felt we could and they are currently not looking elsewhere for assistance in executing the transaction.

The tax opportunity created is extremely complex, and is really based more on the structuring of the entities involved in the securities transactions rather than the securities transactions themselves. KPMG has assured me that prior to spending much time, beyond just conceptually seeing if we can do it, they would provide Quadra and any counterparty (UBS) with the necessary legal opinions and representatives letters as to why they are recommending this transaction to their clients. Assuming their tax analysis is complete, our challenge is to design a series of securities/derivatives trades that meet the required objectives.

In summary, this tax motivated transaction is designed for U.S. companies requiring a tax loss. The way this loss is generated is through the U.S. company exercising a series of options to acquire majority ownership in a Foreign investment (Fund). The tax benefits are created for U.S. Co. based on the types of securities transactions done in the foreign investment Fund and shifting the cost basis to the parent U.S. Company. ...

If a U.S. company/individual has a \$100 million dollar capital gain they own taxes, depending on their tax position, ranging from \$28 million to \$35 million. As a result, they are more than willing to pay \$2 to \$4 million to generate a tax loss to offset the capital gain and corresponding taxes. ...

I have told KPMG that we should be able to execute the transaction once they have a commitment from a potential client. KPMG has already had a number of preliminary meetings with potential clients and one of their challenges was to identify a party that can manage the Fund level and facilitate the transactions with Foreign Co. Given your ability to act as Foreign Co., and facilitate the securities trades, I have told them to stop looking. Once they have a firm client, then we can map out the various details to execute the transaction.”<sup>278</sup>

This document leaves no doubt that Quellos was fully aware that FLIP was a “tax motivated transaction” designed for companies or individuals “requiring a tax loss.”

Quellos was successful in convincing UBS to participate in not only FLIP, but also OPIS transactions throughout 1997 and 1998, as described earlier. Quellos may also have been a tax shelter promoter in its own right. For example, in addition to its dealings with KPMG on FLIP and OPIS, Quellos teamed up with First Union National Bank and PWC to execute about 80 FLIP transactions

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<sup>278</sup>Memorandum dated 8/12/96, from Jeff Greenstein of Quellos to Wolfgang Stolz of UBS, Bates UBS000002.

for them. In addition, Quellos held discussions with KPMG regarding at least two tax products that Quellos itself had developed, but it is unclear whether sales of these products actually took place.<sup>279</sup> A UBS document stated that Quellos' "specialty is providing tax efficient investment schemes for high net worth U.S. individuals and their investment vehicles."<sup>280</sup>

Presidio played a similar role in the design, marketing, and implementation of OPIS and BLIPS. Presidio's principals are former KPMG partners who knew the KPMG tax professionals working on OPIS and BLIPS. These Presidio principals were repeatedly identified by KPMG as members of "the working group" developing OPIS and were described as having contributed to the design and implementation of OPIS.<sup>281</sup> Moreover, Presidio initially brought the idea for BLIPS to KPMG, and was thoroughly involved in the development, marketing, and implementation of the product. On May 1, 1999, prior to the final approval of BLIPS, Presidio representatives made a detailed presentation to KPMG tax professionals on how the company was planning to implement the BLIPS transactions.<sup>282</sup> During the presentation, among other points, Presidio representatives disclosed that there was only a "remote" possibility that any investor would actually profit from the contemplated foreign currency transactions, and that the banks providing the financing planned to retain, under the terms of the contemplated BLIPS "loans," an effective "veto" over how the "loan proceeds" could be invested. These statements, among others, caused KPMG's key technical reviewer in the Washington National Tax group to reconsider his approval of the BLIPS product, in

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<sup>279</sup>See, e.g., email dated 12/10/99, from Douglas Ammerman to multiple KPMG tax professionals, "Innovative Strategy Development," Bates KPMG 0036736 (discusses KPMG working with Quellos on two products that Quellos had developed, called FORTS, a "loss generating strategy," and WEST, a "conversion strategy.").

<sup>280</sup>Undated UBS internal document, "Memorandum on USB' involvement in U.S. Capital Loss Generation Scheme (the 'CLG Scheme')," Bates UBS 000006.

<sup>281</sup>See, e.g., memorandum dated 3/13/98, from Robert Simon to Jeff Stein and Sandy Smith, all of KPMG, "OPIS," Bates KPMG 0010262 ("The attached went to the entire working group (Pfaff, Ritchie, R.J. Ruble of Brown & Wood, Bickham, and Larson)."); email dated 3/14/98 from Jeff Stein to multiple KPMG tax professionals, "Simon Says," Bates 638010, filed by the IRS on June 16, 2003, as an attachment to Respondent's Requests for Admission, Schneider Interests v. Commissioner, U.S. Tax Court, Docket No. 200-02 ("By the way - anybody who does not have a copy of the Pfaff letter, let me know and I will fax it over to you. In addition in case you want a copy of the November 6, 1997 memo detailing the proposed LLC structure written by Simon to 'The Working Group' which included Ritchie, Pfaff, Larson, Bickahm [sic] and R.J. Ruble of the law firm of Brown & Wood let me know and I will fax it over to you as well."). Robert Pfaff and John Larson are the former KPMG tax partners who left the firm to open Presidio.

<sup>282</sup>See, e.g., email dated 5/10/99, from Mark Watson to John Lanning and others, "FW: BLIPS," Bates MTW 0039; email dated 5/5/99, from Mark Watson to Larry DeLap, Bates KPMG 0011915-16. See also, e.g., memorandum dated 4/20/99, from Amir Makov of Presidio to John Rolfe of Deutsche Bank, "BLIPS friction costs," Bates DB BLIPS 01977 (showing Presidio's role in planning the BLIPS transactions; includes statement: "On day 60, Investor exits partnership and unwinds all trades in partnership.")

part because he felt he had “not been given complete information about how the transaction would be structured.”<sup>283</sup>

When BLIPS was eventually approved over the objections of the WNT technical reviewer, Presidio played a key role in making client presentations to sell the product and in executing the actual BLIPS transactions. One of the most important roles Presidio played in BLIPS was, in each BLIPS transaction, to direct two of the companies it controlled, Presidio Growth and Presidio Resources, to enter into a “Strategic Investment Fund” partnership with the relevant BLIPS client. This partnership was central to the entire BLIPS transaction, since it was this partnership that assumed and repaid the purported “loan” that gave rise to the BLIPS client’s “tax loss.” In each BLIPS transaction, a Presidio company acted as the managing partner for the partnership and contributed a small portion of the funds used in the BLIPS transactions. Presidio also performed administrative tasks that, while more mundane, were critical to the success of the the tax product. For example, when BLIPS was just starting to get underway, Presidio took several steps to facilitate the transactions, including stationing personnel at one of the law firms preparing the transactional documents.<sup>284</sup>

When a problem arose indicating that currency conversions in two BLIPS transactions had been timed in such a way that they would create negative tax consequences for the BLIPS clients, Presidio apparently took the lead in correcting the “errors.” An email sent by Presidio to HVB states:

“I know that Steven has talked to you regarding the error for Roanoke Ventures. I have also noted an error for Mobil Ventures. None of the Euro’s should have been converted to [U.S. dollars] in 1999. Due to the tax consequences that result from these sales, it is critical that these transactions be reversed and made to look as though they did not occur at all.”<sup>285</sup>

Other documents suggest that, as Presidio requested, the referenced 1999 currency trades were somehow “reversed” and then executed the next month in early 2000.<sup>286</sup> HVB told Subcommittee

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<sup>283</sup>See Section VI(B)(1) of this Report discussing the BLIPS development and approval process; email dated 5/10/99, from Mark Watson to John Lanning and others, “FW: BLIPS,” Bates MTW 0039.

<sup>284</sup>Email dated 5/13/99, from Barbara Mcconnachie to multiple KPMG tax professionals, “FW: BLIPS,” Bates MTW 0045 (“Presidio has 2 individuals permanently housed at Sherman & Sterling to assist in the necessary documentation.”). Sherman & Sterling prepared many of the key transactional documents for BLIPS transactions involving Deutsche Bank.

<sup>285</sup>Email dated 12/28/99, from Kerry Bratton of Presidio to Alexandre Nouvakhov and Amy McCarthy of HVB, “FX Confirmations,” Bates HVB 002035.

<sup>286</sup>See, e.g., memorandum dated 12/23/99, from Kerry Bratton of Presidio to Amy McCarthy of HVB, “Transfer Instructions,” Bates HVB 001699; memorandum dated 1/19/00, from Steven Buss at Presidio to Alex Nouvakhov at HVB, “FX Instructions - Mobile Ventures LLC,” Bates HVB 001603; email dated 1/19/00, from Alex Nouvakhov at HVB to Matt Dunn at HVB, “Presidio,” Bates HVB 001601 (“We need to sell Euros for another Presidio account and credit their [U.S. dollar] DDA account. It is the same deal as the one for Roanoke you did earlier today.”); email dated 1/19/00, from Alex Nouvakhov at HVB to Steven Buss at Presidio, “Re: mobile,” Bates

staffers that they had been unaware of this matter and would have to research the transactions to determine whether, in fact, trades or paperwork had been altered.<sup>287</sup>

Presidio has worked with KPMG on a number of tax products in addition to the four examined in this Report. A Presidio representative told the Subcommittee staff that 95 percent of the company's revenue came from its work with KPMG.<sup>288</sup>

**Finding: Some law firms have provided legal services that facilitated KPMG's development and sale of potentially abusive or illegal tax shelters, including by providing design assistance or collaborating on allegedly "independent" opinion letters representing to clients that a tax product would withstand an IRS challenge, in return for substantial fees.**

**The Role of the Law Firms.** The evidence obtained by the Subcommittee during the course of the investigation determined that one law firm, Sidley Austin Brown & Wood, played a significant and ongoing role in the development, marketing, and implementation of the four KPMG tax products featured in this Report.

Sidley Austin Brown & Wood is currently being audited by the IRS to evaluate the firm's "role ... in the organization and sale of tax shelters" and compliance with federal tax shelter requirements.<sup>289</sup> In court pleadings, the IRS has alleged the following:

[I]t appears that [Sidley Austin Brown & Wood] was involved in the organization and sale of transactions which were or later became 'listed transactions,' or that may be other 'potentially abusive tax shelters.' The organization and sale of these transactions appears to have been coordinated by [primarily] ... Raymond J. Ruble. ... During the investigation, I learned that [Sidley Austin Brown & Wood] issued approximately 600 opinions with respect to certain listed transactions promoted (or co-promoted) by, among others, KPMG, Arthur Andersen, BDO Seidman, Diversified Group, Inc., and Ernst & Young. ... The IRS has identified transactions for which [Sidley Austin Brown & Wood] provided opinions, ... FLIPS, OPIS, COBRA, BLIPS and CARDS, as 'listed transactions.'<sup>290</sup>

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HVB 001602; memorandum dated 1/19/00, from Steven Buss at Presidio to Timothy Schifter at KPMG, "Sale Confirmation," Bates HVB 001600.

<sup>287</sup>Subcommittee interview of HVB bank representatives (10/29/03).

<sup>288</sup>Subcommittee interview of John Larson (6/20/03).

<sup>289</sup>"Declaration of Richard E. Bosch," IRS Revenue Agent, In re John Doe Summons to Sidley Austin Brown & Wood (N.D. Ill. 10/16/03) at ¶ 5.

<sup>290</sup>Id. ¶¶ 9,10,12.

The IRS also alleges that, in response to a December 2001 disclosure initiative in which taxpayers obtained penalty waivers in exchange for identifying their tax shelter promoters, 80 disclosure statements named Sidley Austin Brown & Wood as “promoting, soliciting, or recommending their participation in certain tax shelters.”<sup>291</sup> The IRS also alleges that the law firm provided approximately 600 opinions for at least 13 tax products, including FLIP, OPIS and BLIPS.<sup>292</sup>

Information obtained by the Subcommittee indicates that Sidley Austin Brown & Wood, through the efforts of Mr. Ruble, did more than simply draft opinion letters supporting KPMG tax products; the law firm formed an alliance with KPMG to develop and market these tax products. IRS court pleadings, for example, quote a December 1997 email in which Mr. Ruble states: “This morning my managing partner, Tom Smith, approved Brown & Wood LLP working with the newly conformed tax products group at KPMG on a joint basis in which we would jointly develop and market tax products and jointly share in the fees.”<sup>293</sup> An internal KPMG memorandum around the same time states: “[W]e need to consummate a formal strategic alliance with Brown & Wood.”<sup>294</sup>

Three months later, an internal KPMG memorandum discussing an upcoming meeting between KPMG and Brown & Wood states that KPMG tax professionals intended to discuss “how to institutionalize the KPMG/B&W relationship.”<sup>295</sup> Among other items, KPMG planned to discuss “the key profit-drivers for our joint practice,” citing in particular KPMG’s “Customer list” and “Financial commitment” and Brown & Wood’s “Institutional relationships within the investment banking community.” The memorandum states that KPMG also planned to discuss “[w]hat should be the profit-split between KPMG, B&W and the tax products group/implementor for jointly-developed products,” and suggesting that in “a 7% deal” KPMG, B&W and the “Implementor” should split the net profits evenly, after awarding a “finder’s allocation” to the party who found the tax product purchaser. Still other documents indicate that Sidley Austin Brown & Wood, through Mr. Ruble, became a member of a working group that jointly developed OPIS.<sup>296</sup> Evidence obtained by the

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<sup>291</sup>*Id.* at ¶ 14.

<sup>292</sup>*Id.* at ¶ 27(a).

<sup>293</sup>*Id.* at ¶ 15, citing an email dated 12/15/97, from R.J. Ruble.

<sup>294</sup>Memorandum dated 12/97/97, from Randall Bickham to Gregg Ritchie, “Business Model - Brown & Wood Strategic Alliance,” Bates KPMG 0047228.

<sup>295</sup>Memorandum dated 3/2/98, from Randall Bickham to Gregg Ritchie, “B&W Meeting,” Bates KPMG 0047225-27.

<sup>296</sup>See, e.g., memorandum dated 3/13/98, from Robert Simon to Jeff Stein and Sandy Smith, all of KPMG, “OPIS,” Bates KPMG 0010262 (“The attached went to the entire working group (Pfaff, Ritchie, R.J. Ruble of Brown & Wood, Bickham, and Larson).”); email dated 3/14/98 from Jeff Stein to multiple KPMG tax professionals, “Simon Says,” Bates 638010, filed by the IRS on June 16, 2003, as an attachment to Respondent’s Requests for Admission, *Schneider Interests v. Commissioner*, U.S. Tax Court, Docket No. 200-02 (“By the way - anybody who does not have a copy of the Pfaff letter, let me know and I will fax it over to you. In addition in case you want a copy of the November 6, 1997 memo detailing the proposed LLC structure written by Simon to ‘The Working

Subcommittee also indicates that Sidley Austin Brown & Wood, through Mr. Ruble, was an active participant in the development of BLIPS, expending significant time working with KPMG tax professionals to author their respective opinion letters.

In the case histories examined by the Subcommittee, once the design of a KPMG tax product was complete and KPMG began selling the product to clients, Sidley Austin Brown & Wood's primary implementation role became one of issuing legal opinion letters to the persons who had purchased the products. Sidley Austin Brown & Wood, through Mr. Ruble, wrote literally hundreds of legal opinions supporting FLIP, OPIS, and BLIPS.<sup>297</sup> In the case of SC2, KPMG had apparently made arrangements for clients to obtain a second opinion from either Sidley Austin Brown & Wood<sup>298</sup> or Bryan Cave, another major law firm,<sup>299</sup> but it is unclear how many SC2 buyers, if any, took advantage of these arrangements and bought a second opinion.

Traditionally, second opinion letters are supplied by a disinterested tax expert with no financial stake in the transaction being evaluated, and this expert sends an individualized letter to a single client. Certain IRS penalties, in fact, can be waived if a taxpayer relies "in good faith" on expert tax advice.<sup>300</sup> The mass marketing of tax products to multiple clients, however, has been followed by the mass production of opinion letters that, for each letter sent to a client, earns its author a handsome fee. Since there are few costs associated with producing new opinion letters, once a prototype opinion letter has been completed for the generic tax product, the mass production of largely boilerplate opinion letters has become a lucrative business for firms like Sidley Austin Brown & Wood. The attractive profits available from these letters have also created new incentives for law firms to team up with tax product promoters to become the preferred source for a second opinion letter. This profit motive undermines an arms-length relationship between the two opinion writers.

Actions taken by Sidley Austin Brown & Wood and KPMG to collaborate on their respective opinion letters raises additional questions about the law firm's independent status. The evidence indicates that the law firm collaborated extensively with KPMG in the drafting of the BLIPS, FLIP and OPIS opinion letters. This collaboration included joint identification, research, and analysis of key legal and tax issues; discussions about the best way to organize and present the reasoning used in their respective letters; and joint efforts to identify necessary factual representations by the participating parties in the transactions being analyzed. In the case of FLIP, Mr. Ruble faxed a copy

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Group' which included Ritchie, Pfaff, Larson, Bickahm [sic] and R.J. Ruble of the law firm of Brown & Wood let me know and I will fax it over to you as well.").

<sup>297</sup>See "Declaration of Richard E. Bosch," IRS Revenue Agent, In re John Doe Summons to Sidley Austin Brown & Wood (N.D. Ill. 10/16/03) at ¶18, citing an email by KPMG tax professional Gregg Ritchie.

<sup>298</sup>Subcommittee interview of Lawrence Manth (11/6/03).

<sup>299</sup>See memorandum dated 2/16/01, from Andrew Atkin to SC2 Marketing Group, "Agenda from Feb 16<sup>th</sup> call and goals for next two weeks," Bates KPMG 0051135.

<sup>300</sup>See 26 U.S.C. § 6662(d)(2)(C)(i); Treas.Reg. §§ 1.6662-4(g)(4)(ii) and 1.6664-4(c)(1).



of his draft opinion letter to KPMG before issuing it.<sup>301</sup> In the case of BLIPS, Sidley Austin Brown & Wood and KPMG actually exchanged copies of their respective draft opinion letters and conducted a detailed “side-by-side” review “to make sure we each cover everything the other has.”<sup>302</sup> The result was two, allegedly independent opinion letters containing numerous, virtually identical paragraphs.

KPMG used the availability of a second opinion letter from Sidley Austin Brown & Wood as a marketing tool to increase sales of its tax products, telling clients that having this second letter would help protect them from accuracy-related penalties if the IRS were to later invalidate a tax product.<sup>303</sup> Many clients were apparently swayed by this advice and sought an opinion letter from the law firm. Evidence obtained by the Subcommittee indicates that the opinion letters provided by the law firm were, like KPMG’s opinion letters, virtually identical in content and reflected little, if any, individualized client interaction or legal advice. In some cases, KPMG arranged to obtain a client’s opinion letter directly from the law firm and delivered it to the client, apparently without the client’s ever speaking to any Sidley Austin Brown & Wood lawyer. One individual told the Subcommittee staff that after KPMG sold him FLIP, KPMG arranged for him to obtain a favorable opinion letter from Sidley Austin Brown & Wood without his ever contacting the law firm or directly speaking with a lawyer.<sup>304</sup> An individual testifying at a recent Senate Finance Committee hearing testified that he had received a Sidley Austin Brown & Wood opinion letter for COBRA, a tax product he had purchased from Ernst & Young, by picking up the letter from the accounting firm’s office. He testified that he never communicated with anyone at the law firm.<sup>305</sup> This type of evidence suggests that the law firm’s focus was not on providing individualized legal advice to clients, but on churning out boilerplate opinion letters for a fee.

By routinely directing clients to Sidley Austin Brown & Wood to obtain a second opinion letter, KPMG produced a steady stream of income for the law firm. In the case of BLIPS, FLIP, and OPIS, Sidley Austin Brown & Wood was apparently paid at least \$50,000 per opinion. One

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<sup>301</sup>Facsimile cover sheet dated 2/26/97, from R.J. Ruble to David Lippman and John Larson at KPMG, Bates XX 001440.

<sup>302</sup>Email dated 9/24/99, from R.J. Ruble of Brown & Wood, to Jeffrey Eischeid and Rick Bickham of KPMG, Bates KPMG 0033497; followed by other emails exchanged between Brown & Wood and KPMG personnel, from 9/25/99 to 10/29/99, Bates KPMG 0033496-97.

<sup>303</sup>See, e.g., KPMG document dated 6/19/00, entitled “SC2 – Meeting Agenda,” Bates KPMG 0013375-96, at 13393; see also Section VI(B)(2) of this Report on using tax opinion letters as a marketing tool.

<sup>304</sup>Jacoboni v. KPMG, Case No. 02-CV-510 (D.M.D. Fla. 4/29/02), at ¶19 (“Mr. Jacoboni later received a copy of a ‘concurring opinion’ dated August 31, 1998, from the law firm Brown & Wood, LLP, which was requested by Dale Baumann of KPMG. The Brown & Wood concurring opinion was mailed from new York to Mr. Jacoboni in Florida.”); Subcommittee interview of legal counsel to Joseph Jacoboni (4/4/03).

<sup>305</sup>See testimony of Henry Camferdam regarding his purchase of COBRA, Senate Finance Committee hearing, “Tax Shelters: Who’s Buying, Who’s Selling, and What’s the Government Doing About It?” (10/21/03)(Camferdam: “I never talked to anyone at Brown & Wood. In fact, all of their documents were sent to us via [Ernst & Young] – not directly to us.”).

document indicates that Sidley Austin Brown & Wood was paid this fee in every case where its name was mentioned during a sales pitch for BLIPS, whether or not the client actually purchased the law firm's opinion letter. Other evidence indicates that in some BLIPS transactions expected to produce a very large "tax loss" for the client, Sidley Austin Brown & Wood was paid more than \$50,000 for its opinion letter.

Sidley Austin Brown & Wood provided opinion letters not only to KPMG, but also to other firms selling similar tax products. For example, the law firm also issued favorable opinion letters for COBRA, a tax product similar to OPIS, but sold by Ernst & Young. An email seems to suggest that when a client sought a tax opinion letter for a product from Ernst & Young and was turned down, Sidley Austin Brown & Wood may have advised the client to try KPMG instead. The internal Ernst & Young email states:

"[Redacted name] told me that during the January meeting, Richard Shapiro gave him the name of R.J. Rubell [sic] at Brown and Wood and said that they could contact him directly regarding the tax opinion and other issues. He did that. Rubell said that Brown and Wood stands by the deal and is willing to issue the same opinion letter as before. They and others do not see the risk that E&Y sees. Apparently, B&W is also working with Diversified and KPMG and Rubell steered them in that direction."<sup>306</sup>

It is unclear exactly what problem is being addressed, but this email raises concerns about opinion letter shopping and about the propriety of the law firm's steering clients away from Ernst & Young, apparently because that firm refused to issue a requested letter, and toward KPMG.

In short, in exchange for substantial fees, Sidley Austin Brown & Wood provided legal services that facilitated KPMG's development and sale of potentially abusive or illegal tax shelters such as FLIP, OPIS and BLIPS, including by providing design assistance and collaborating on allegedly "independent" opinion letters representing to clients that the KPMG tax products would withstand an IRS challenge.

**Finding: Some charitable organizations have participated as essential counter parties in a highly questionable tax shelter developed and sold by KPMG, in return for donations or the promise of future donations.**

**The Role of the Charitable Organizations.** SC2 transactions could not have taken place at all without the willing participation of a charitable organization. To participate in SC2 transactions, a charity had to undertake a number of non-routine and potentially expensive, time-consuming tasks. For example, the charity had to agree to accept an S corporation stock donation, which for many charities is, in itself, unusual; make sure it is exempt from the unrelated business income tax (hereinafter "UBIT") and would not be taxed for any corporate income earned during the time when

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<sup>306</sup>Email dated 2/11/00, from Alexander Eckman to David G. Johnson and others, subject line redacted, Bates 2003EY011640.

the charity was a shareholder; sign a redemption agreement; determine how to treat the stock donation on its financial statements; and then hold the stock for several years before receiving any cash donation for its efforts. Moreover, relatively few charities are exempt from the UBIT, and those that are – like pension funds – do not normally receive large contributions from private donors.

KPMG approved SC2 for sale to clients in March 2000, and discontinued all sales 18 months later, around September 2001, after selling the tax product to about 58 S corporations. The SC2 sales produced fees exceeding \$26 million for KPMG, making SC2 one of KPMG's top ten revenue producers in 2000 and 2001. Although KPMG refused to identify the charities that participated in the SC2 transactions, the Subcommittee was able to identify and interview two which, between them, participated in more than half of the SC2 transactions KPMG arranged.

The two charities interviewed by the Subcommittee staff indicated that they would not have participated in the SC2 transactions absent being approached, convinced, and assisted by KPMG. The Los Angeles Department of Fire & Police Pensions System is a \$10 billion pension fund that serves the police and fire departments in the city of Los Angeles in California. The Austin Fire Fighters Relief and Retirement Fund is a much smaller pension fund serving the fire departments in Austin, Texas.

Based upon information provided to the Subcommittee, it appears that, out of the about 58 SC2 tax products sold by KPMG in 2000 and 2001, the Los Angeles pension fund participated in 29 of the SC2 transactions, while the Austin pension fund participated in five. The Los Angeles pension fund indicated that, as a result of the SC2 transactions, it is currently holding stock valued at about \$7.3 million from 16 S corporations, and has sold back donated stock to 13 corporations in exchange for cash payments totaling about \$5.5 million. Both pension funds told the Subcommittee that the SC2 stock donors and their corporations had generally been from out-of-state. The Los Angeles pension fund indicated that it had received stock from S corporations in Arizona, Georgia, Hawaii, Missouri, and North Carolina. The Austin pension fund indicated that it had received stock from S corporations in California, Mississippi, New Jersey, and New York. Both pension funds indicated that they had not met any of the SC2 donors until KPMG introduced them to the charities.

Both charities indicated to the Subcommittee staff that, in determining whether to participate in the SC2 transactions, they relied on KPMG's representation that the transactions complied with federal tax law. The Los Angeles pension fund also obtained from an outside law firm a legal opinion letter on the narrow issue of whether the charity had the legal authority to accept a donation of S corporation stock. In analyzing this issue, the law firm notes first in the legal opinion letter that all of the facts recited about the transaction had been provided to the law firm by a KPMG tax professional.<sup>307</sup> The letter concludes that the pension fund may accept an S corporation stock donation from an unrelated third party: "Although this is a very unusual transaction, and there is almost no statutory, regulatory or other authority addressing the issue, we believe the Plan is

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<sup>307</sup>Letter dated 12/30/99, from Seyfarth, Shaw, Fairweather & Geraldson to the Los Angeles pension fund, at 3.

permitted to accept a contribution.” The letter also states, however, that the law firm had not been asked to provide any legal advice about the substance of the SC2 transaction itself, that it had not been given any documentation to review, and that it was not offering any opinion on “the impact of the transaction on the ‘donor’ from a tax or other standpoint.”<sup>308</sup>

Apparently, neither charity obtained a legal or tax opinion letter or other written legal advice, from KPMG or any other firm, on whether the SC2 tax product and related transactions complied with federal tax law or whether the charity’s participation in SC2 transactions could be viewed as aiding or abetting tax evasion. The two pension funds told the Subcommittee that they simply relied on KPMG’s reputation as a reputable firm in assuming the donation strategy was within the law.

Both pension funds told the Subcommittee that, in every SC2 transaction, it was their expectation that they would not retain ownership of the donated stock, but would sell it back to the stock donor after the expiration of the period of time indicated in the redemption agreement. They also indicated that they did not expect to obtain significant amounts of money from the S corporation during the period in which the charity was a stockholder but expected, instead, to obtain a large cash payment at the time the charity sold the stock back to the donor. Moreover, the charities told the Subcommittee staff that their expectations have, in fact, been met, and the SC2 transactions have been carried out as planned by KPMG, the donors, and the charities. These facts and expectations raise serious questions about whether the SC2 transactions ever truly passed ownership of the stock to the charity or acted merely as an assignment of income for a specified period time to the charitable organization.

In the case of BLIPS, FLIP, OPIS, and SC2, major banks, investment advisory firms, law firms, and charitable organizations provided critical services or acted as essential counterparties in the transactions called for by the tax products. Each obtained lucrative fees, often totaling in the millions of dollars, for their participation. Despite the complexity, frequency, and size of the transactions and their clear connection to tax avoidance schemes, none of the participating organizations presented to the Subcommittee a reasoned, contemporaneous analysis of the tax shelter, reputational risk, ethical, or professional issues justifying the organization’s role in facilitating these highly questionable and abusive tax transactions.

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<sup>308</sup>Id. The letter states:

“You have asked us to advise you concerning the ability of the L.A. Fire & Police Pension System (the ‘Plan’) to accept a contribution from an unrelated third party in the form of nonvoting stock of a closely held California S corporation. ... It should be noted that, from a procedural and due-diligence standpoint, (1) we have not been asked to conduct, and we have not conducted, any investigation into the company and/or the individual involved, (2) we have not yet reviewed any of the underlying documentation in connection with the donation or the possible future redemption of the stock, and offer no opinion on such agreements or their impact on any of the views expressed in this letter, (3) we have not examined, or opined in any way about, the impact of the transaction on the “donor” from a tax or other standpoint, and (4) we have not checked the investment against any investment policy guidelines that may have been adopted by the Board.”

#### **(4) Avoiding Detection**

**Finding: KPMG has taken steps to conceal its tax shelter activities from tax authorities, including by claiming it is a tax advisor and not a tax shelter promoter, failing to register potentially abusive tax shelters, restricting file documentation, imposing marketing restrictions, and using improper tax return reporting to minimize detection by the IRS or others.**

Evidence obtained by the Subcommittee in the four KPMG case studies shows that KPMG has taken a number of steps to conceal its tax shelter activities from IRS, law enforcement, and the public. In the first instance, it has simply denied being a tax shelter promoter and claimed that tax shelter information requests do not apply to its products. Second, evidence in the FLIP, OPIS, BLIPS, and SC2 case histories indicate that KPMG took a number of precautions in the way it designed, marketed, and implemented these tax products to avoid or minimize detection of its activities.

**No Tax Shelter Disclosure.** KPMG's public position is that it does not develop, sell or promote tax shelters, as explained earlier in this Report. As a consequence, KPMG has not voluntarily registered, and thereby disclosed to the IRS, a single one of its tax products. A memorandum quoted at length earlier in this Report<sup>309</sup> establishes that, in 1998, a KPMG tax professional advised the firm not to register the OPIS tax product with the IRS, even if OPIS qualified as a tax shelter under the law, citing competitive pressures and a perceived lack of enforcement or effective penalties for noncompliance with the registration requirement. Another document discussing registration of OPIS had this to say: "Must register the product. B&W concerns – risk is too high. Confirm w/ Presidio that they will register."<sup>310</sup> The head of DPP-Tax told the Subcommittee staff that he had recommended registering not only OPIS, but also BLIPS, but was overruled in each instance by the top official in charge of the Tax Services Practice.<sup>311</sup>

Other documents show that consideration of tax shelter registration issues were a required step in the tax product approval process, but rather than resulting in IRS registrations, KPMG appears to have devoted resources to devising rationales for not registering a product with the IRS. KPMG's Tax Services Manual states that every new tax product must be analyzed by the WNT Tax Controversy Services group "to address tax shelter regulations issues."<sup>312</sup> For example, one internal document analyzing tax shelter registration issues discusses the "policy argument" that KPMG's tax

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<sup>309</sup>See Section VI(B) of this report.

<sup>310</sup>Handwritten notes dated 3/4/98, author not indicated, regarding "Brown & Wood" and "OPIS," Bates KPMG 0047317. Emphasis in original. "B&W" refers to Brown & Wood, the law firm that worked with KPMG on OPIS. Presidio is an investment firm that worked with KPMG on OPIS.

<sup>311</sup>Subcommittee interview of Lawrence DeLap (10/30/03).

<sup>312</sup>KPMG Tax Services Manual, § 24.4.1, at 24-2.

“advice ... does not meet the paradigm of 6111(c) registration” and identifies other flaws with the legal definition of “tax shelter” that may excuse registration. The email also suggests possibly creating a separate entity to act as the registrant for KPMG tax products:

“If we decide we will be registering in the future, thought should be given to establishing a separate entity that meets the definition of an organizer for all of our products with registration potential. This entity, rather than KPMG, would then be available through agreement to act as the registering organizer .... If such an entity is established, KPMG can avoid submitting its name as the organizer of a tax shelter on Form(s) 8264 to be filed in the future.”<sup>313</sup>

Another KPMG document, a fiscal year 2002 draft business plan for the Personal Financial Planning Practice, describes two tax products under development, but not yet approved, due in part to pending tax shelter registration issues.<sup>314</sup> The first, referred to as POPS, is described as “a gain mitigation solution.” The business plan states: “We have completed the solution’s technical review and have almost finalized the rationale for not registering POPS as a tax shelter.” The second product is described as a “conversion transaction ... that halves the taxpayer’s effective tax rate by effectively converting ordinary income to long term capital gain.” The business plan notes: “The most significant open issue is tax shelter registration and the impact registration will have on the solution.”

The IRS has issued “listed transactions” that explicitly identify FLIP, OPIS and BLIPS as potentially abusive tax shelters. Due to these tax products and others, the IRS is investigating KPMG to determine whether it is a tax shelter promoter and is complying with the tax shelter requirements in Federal law.<sup>315</sup> KPMG continues flatly to deny that it is a tax shelter promoter and has continued to resist registering any of its tax products with the IRS.

A second consequence of KPMG’s public denial that it is a tax shelter promoter has been its refusal fully to comply with the document requests made by the IRS for lists of clients who purchased tax shelters from the firm. In a recent hearing before the Senate Finance Committee, the U.S. Department of Justice stated that, although the client-list maintenance requirement enacted by Congress “clearly precludes any claim of identity privilege for tax shelter customers regardless of

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<sup>313</sup>Email dated 5/11/98, from Jeffrey Zysik to multiple KPMG tax professionals, “Registration,” Bates KPMG 0034805-06. See also email dated 5/12/98, from Jeffrey Zysik to multiple KPMG tax professionals, “Registration requirements,,” Bates KPMG 0034807-11 (reasonable cause exception, tax shelter definitions, number of registrations required); email dated 5/20/98, from Jeffrey Zysik to multiple KPMG tax professionals, “Misc. Tax Reg. issues,” Bates KPMG 0034832-33 (“reasonable cause exception for not registering”; application of regulatory “tax shelter ratio” to identify tax shelters; “establishing a separate entity to act as the entity registering ALL tax products .... Otherwise we must submit our name as the tax shelter organizer.”).

<sup>314</sup>Document dated 5/18/01, “PFP Practice Reorganization Innovative Strategies Business Plan – DRAFT,” Bates KPMG 0050620-23, at 2.

<sup>315</sup>See United States v. KPMG, Case No. 1: 02MS00295 (D.D.C. 9/6/02).

whether the promoters happen to be accountants or lawyers, the issue continues to be the subject of vigorous litigation.”<sup>316</sup> The Department pointed out that one circuit court of appeals and four district courts had already ruled that accounting firms, law firms, and a bank must divulge client information requested by the IRS under the tax shelter laws, but certain accounting firms were continuing to contest IRS document requests. At the same hearing, the former IRS chief counsel characterized the refusal to disclose client names by invoking either attorney-client privilege or Section 7525 of the tax code as “frivolous,” while also noting that one effect of the ensuing litigation battles “was to delay [promoter] audits to the point of losing one or more tax years to the statute of limitations.”<sup>317</sup>

IRS Commissioner, Mark Everson, testified at the same hearing that the IRS had filed suit against KPMG in July 2002, “to compel the public accounting firm to disclose information to the IRS about all tax shelters it has marketed since 1998.”<sup>318</sup> He stated, “Although KPMG has produced many documents to the IRS, it has also withheld a substantial number.”

Some of the documents obtained by the Subcommittee during its investigation illustrate the debate within KPMG over responding to the IRS requests for client names and other information. In April 2002, one KPMG tax professional wrote:

“I have two clients who are about to file [tax returns] for 2001. We have discussed with each of them what is happening between KPMG and IRS and both do not plan to disclose at this time. Since Larry’s message indicated the information requested was to respond to an IRS summons, I am concerned we are about to turn over a new list of names for transactions I believe IRS has no prior knowledge of. I need to know immediately if that is what is happening. It will obviously have a material effect on their evaluation of whether they wish to disclose and what positions they wish to take on their 2001 returns. Since April 15<sup>th</sup> is Monday, I need a response. ... [I]f we are responding to what appears to be an IRS fishing expedition, it is going to reflect very badly on KPMG. Several clients have seriously questioned whether we are doing everything we can to protect their interests.”<sup>319</sup>

**Tax Return Reporting.** KPMG also took a number of questionable steps to minimize the amount of information reported in tax returns about the transactions involved in its tax products in order to limit IRS detection.

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<sup>316</sup>Testimony of Eileen J. O’Connor, Assistant Attorney General for the Tax Division, U.S. Department of Justice, before the Senate Committee on Finance, “Tax Shelters: Who’s Buying, Who’s Selling and What’s the Government Doing About It?” (10/21/03), at 3.

<sup>317</sup>Testimony of B. John Williams, Jr. former IRS chief counsel, before the Senate Committee on Finance, “Tax Shelters: Who’s Buying, Who’s Selling and What’s the Government Doing About It?” (10/21/03), at 4-5.

<sup>318</sup>Testimony of Mark W. Everson, IRS Commissioner, before the Senate Committee on Finance, “Tax Shelters: Who’s Buying, Who’s Selling and What’s the Government Doing About It?” (10/21/03), at 11.

<sup>319</sup>Email dated 4/9/02, from Deke Carbo to Jeffrey Eischeid, “Larry’s Message,” Bates KPMG 0024467.

Perhaps the most disturbing of these actions was first taken in tax returns reporting transactions related to OPIS. To minimize information on the relevant tax returns and avoid alerting the IRS to the OPIS tax product, some KPMG tax professionals advised their OPIS clients to participate in the transactions through “grantor trusts.” These KPMG tax professionals also advised their clients to file tax returns in which all of the losses from the OPIS transactions were “netted” with the capital gains realized by the taxpayer at the grantor trust level, instead of reporting each individual gain or loss, so that only a single, small net capital gain or loss would appear on the client’s personal income tax return. This netting approach, advocated in an internally-distributed KPMG memorandum,<sup>320</sup> elicited intense debate within the firm. KPMG’s top WNT technical tax expert on the issue of grantor trusts wrote the following in two emails over the span of four months:

“I don’t think netting at the grantor trust level is a proper reporting position. Further, we have never prepared grantor trust returns in this manner. What will our explanation be when the Service and/or courts ask why we suddenly changed the way we prepared grantor trust returns/statements only for certain clients? When you put the OPIS transaction together with this ‘stealth’ reporting approach, the whole thing stinks.”<sup>321</sup>

“You should all know that I do not agree with the conclusion reached in the attached memo that capital gains can be netted at the trust level. I believe we are filing misleading, and perhaps false, returns by taking this reporting position.”<sup>322</sup>

One of the tax professionals selling OPIS wrote:

“This ‘debate’ ... [over grantor trust netting] affects me in a significant way in that a number of my deals were sold giving the client the option of netting .... Therefore, if they ask me to net, I feel obligated to do so. These sales were before Watson went on record with his position and after the memo had been outstanding for some time.

What is our position as a group? Watson told me he believes it is a hazardous professional practice issue. Given that none of us wants to face such an issue, I need some guidance.”<sup>323</sup>

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<sup>320</sup>“Grantor Trust Reporting Requirements for Capital Transactions,” KPMG WNT internal memorandum (2/98).

<sup>321</sup>Email dated 9/2/98, from Mark Watson to John Gardner, Jeffrey Eischeid, and others; “RE:FW: Grantor trust memo,” Bates KPMG 0035807. See also email dated 9/3/98, from Mark Watson to Jeffrey Eischeid and John Gardner, “RE:FW: Grantor trust memo,” Bates KPMG 0023331-32 (explaining objections to netting at the grantor trust level).

<sup>322</sup>Email dated 1/21/99, from Mark Watson to multiple KPMG tax professionals, “RE: Grantor trust reporting,” Bates KPMG 0010066.

<sup>323</sup>Email dated 1/21/99, from Carl Hasting to Jeffrey Eischeid, “FW: Grantor trust reporting,” Bates KPMG 0010066.



The OPIS National Deployment Champion responded: “[W]e concluded that each partner must review the WNT memo and decide for themselves what position to take on their returns - after discussing the various pros and cons with their clients.”<sup>324</sup>

The technical reviewer who opposed grantor trust netting told the Subcommittee staff that it was his understanding that, as the top WNT technical expert, his technical judgement on the matter should have stopped KPMG tax professionals from using or advocating the use of this technique and thought he had done so, before leaving for a KPMG post outside the United States. He told the Subcommittee staff he learned later, however, that the OPIS National Deployment Champion had convened a conference call without informing him and told the participating KPMG tax professionals that they could use the netting technique if they wished. He indicated that he also learned that some KPMG tax professionals were apparently advising BLIPS clients to use grantor trust netting to avoid alerting the IRS to their BLIPS transactions.<sup>325</sup>

In September 2000, the IRS issued Notice 2000-44, invalidating the BLIPS tax product. This Notice included a strong warning against grantor trust netting:

“[T]he Service and the Treasury have learned that certain persons who have promoted participation in transactions described in this notice have encouraged individual taxpayers to participate in such transactions in a manner designed to avoid the reporting of large capital gains from unrelated transactions on their individual income tax returns (Form 1040). Certain promoters have recommended that taxpayers participate in these transactions through grantor trusts and ... advised that the capital gains and losses from these transactions may be netted, so that only a small net capital gain or loss is reported on the taxpayer’s individual income tax return. In addition to other penalties, any person who willfully conceals the amount of capital gains and losses in this manner, or who willfully counsels or advises such concealment, may be guilty of a criminal offense ....”<sup>326</sup>

The technical reviewer who had opposed using grantor trust netting told the Subcommittee that, soon after this Notice was published, he had received a telephone call from his WNT replacement informing him of the development and seeking his advice. He indicated that it was his understanding that a number of client calls were later made by KPMG tax professionals.<sup>327</sup>

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<sup>324</sup>Email dated 1/22/99, from Jeffrey Eischeid to Carl Hasting, “FW: Grantor trust reporting,” Bates KPMG 0010066. Other OPIS tax return reporting issues are discussed in other KPMG documentation including, for example, memorandum dated 12/21/98, from Bob Simon/Margaret Lukes to Robin Paule, “Certain U.S. International Tax Reporting Requirements re: OPIS,” Bates KPMG 0050630-40.

<sup>325</sup>Subcommittee interview of Mark Watson (11/4/03).

<sup>326</sup>IRS Notice 2000-44 (2000-36 IRB 255)(9/5/00) at 256.

<sup>327</sup>Subcommittee interview of Mark Watson (11/4/03). See also Memorandum of Telephone Call, dated 5/24/00, from Kevin Pace regarding a telephone conversation with Carl Hastings, Bates KPMG 0036353 (“[T]here is quite a bit of activity in the trust area ... because they have figured out that trusts are a common element in some of

Other tax return reporting concerns also arose in connection with BLIPS. In an email with the subject line, "Tax reporting for BLIPS," a KPMG tax professional sent the following message to the BLIPS National Deployment Champion: "I don't know if I missed this on a conference call or if there's a memo floating around somewhere, but could we get specific guidance on the reporting of the BLIPS transaction. ... I have 'IRS matching' concerns." The email later continues:

"One concern I have is the IRS trying to match the Deutsche dividend income which contains the Borrower LLC's FEIN [Federal Employer Identification Number][.] (I understand they're not too efficient on matching K-1's but the dividends come through on a 1099 which they do attempt to match). I wouldn't like to draw any scrutiny from the Service whatsoever. If we don't file anything for Borrower LLC we could get a notice which would force us to explain where the dividends ultimately were reported. Not fatal but it is scrutiny nonetheless."<sup>328</sup>

About a month later, another KPMG tax professional wrote to the BLIPS National Deployment Champion:

"We spoke to Steven Buss about the possibility of re-issuing the Presidio K-1s in the EIN of the member of the single member [limited liability corporations used in BLIPS]. He said that you guys hashed it out on Friday 3/24 and in a nutshell, Presidio is not going to re-issue K-1s.

David was wondering what the rationale was since the instructions and PPC say that single member LLCs are disregarded entities so 1099s, K-1s should use the EIN of the single member."<sup>329</sup>

She received the following response:

"It was discussed on the national conference call today. Tracey Stone has been working with Mark Ely on the issue. Ely has indicated that while the IRS may have the capability to match ID numbers for partnerships, they probably lack the resources to do so. While technically the K-1's should have the social security number of the owner on them, it is my understanding that Mark has suggested that we not file a partnership for the single member LLC and that Presidio not file amended K-1s. ... Tracey indicated that Mark did not like the idea of having

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these shelter deals. So our best intelligence is that you are increasing your odds of being audited, not decreasing your odds by filing that Grantor Trust return. So we have discontinued doing that.")

<sup>328</sup>Email dated 2/15/00, from Robert Jordan to Jeffrey Eischeid, "Tax reporting for BLIPS," Bates KPMG 0006537.

<sup>329</sup>Email dated 3/28/00, from Jean Monahan to Jeffrey Eischeid and other KPMG tax professionals, "presidio K-1s," Bates KPMG 0024451. See also email dated 3/22/00, unidentified sender and recipients, "Nondisclosure," Bates KPMG 0025704.

us prepare partnership returns this year because then the IRS would be looking for them in future years.”<sup>330</sup>

Additional emails sent among various KPMG tax professionals discuss whether BLIPS participants should extend or amend their tax returns, or file certain other tax forms, again with repeated references to minimizing IRS scrutiny of client return information.<sup>331</sup>

In the case of FLIP, KPMG tax professionals devised a different approach to avoiding IRS detection.<sup>332</sup> Again, the focus was on tax return reporting. The idea was to arrange for the offshore corporation involved in FLIP transactions to designate a fiscal year that ended in some month other than December in order to extend the year in which the corporation would have to report FLIP gains or losses on its tax return. For example, if the offshore corporation were to use a fiscal year ending in June, FLIP transactions which took place in August 1997, would not have to be reported on the corporation’s tax return until after June 1998. Meanwhile, the individual taxpayer involved with the same FLIP transactions would have reported the gains or losses in his or her tax return for 1997. The point of arranging matters so that the FLIP transactions would be reported by the corporation and individual in tax returns for different years was simply to make it more difficult for the IRS to detect a link between the two participants in the FLIP transactions.

In the case of SC2, KPMG advised its tax professionals to tell potential buyers worried about being audited:

“[T]his transaction is very stealth. We are not generating losses or other highly visible items on the S-corp return. All income of the S-corp is allocated to the shareholders, it just so happens that one shareholder [the charity] will not pay tax.”<sup>333</sup>

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<sup>330</sup>Email dated 3/27/00, unidentified sender and recipients, “presidio K-1s,” Bates KPMG 0024451.

<sup>331</sup>See, e.g., emails dated 4/1/00-4/3/00 among Mark Ely, David Rivkin and other KPMG tax professionals, “RE: Blips and tax filing issues,” Bates KPMG 0006481-82; emails dated 3/23/00, between Mark Watson, Jeffrey Eischeid, David Rivkin and other KPMG tax professionals, “RE: Blips and tax filing issues,” Bates KPMG 0006480. See also email dated 7/27/99, from Deke Carbo to Randall Bickham, Jeffrey Eischeid, and Shannon Liston, “Grouping BLIPS Investors,” KPMG Bates 0023350 (suggests “grouping” multiple, unrelated BLIPS investors in a single Deutsche Bank account, possibly styled as a joint venture account, which might not qualify as a partnership required to file a K-1 tax return); email response dated 7/27/99, unidentified sender and recipients, “Grouping BLIPS Investors,” KPMG Bates 0023350 (promises followup on suggestion which may “[solve] our grouping problem”).

<sup>332</sup>See email dated 3/11/98 from Gregg Ritchie to multiple KPMG tax professionals, “Potential FLIP Reporting Strategy,” Bates KPMG 0034372-75. See also internal KPMG memorandum dated 3/31/98, by Robin Paule, Los Angeles/Warner Center, “Form 5471 Filing Issues,” Bates KPMG 0011952-53; and internal KPMG memorandum dated 3/6/98, by Bob Simon and Margaret Lukes, “Potential FLIP Reporting Strategy,” Bates KPMG 0050644-45.

<sup>333</sup>“SC2 – Meeting Agenda” and attachments, dated 6/19/00, Bates KPMG 0013375-96, at 13394.

**No Roadmaps.** A Subcommittee hearing held in December 2002, on an abusive tax shelter sold by J.P. Morgan Chase & Co. to Enron presented evidence that the bank and the company explicitly designed that tax shelter to avoid providing a “roadmap” to tax authorities.<sup>334</sup> KPMG appears to have taken similar precautions in FLIP, OPIS, BLIPS, and SC2.

In the case of SC2, in an exchange of emails among senior KPMG tax professionals discussing whether to send clients a letter explicitly identifying SC2 as a high-risk strategy and outlining certain specific risks, the SC2 National Deployment Champion wrote:

“[D]o we need to disclose the risk in the engagement letter? ... Could we have an addendum that discloses the risks? If so, could the Service have access to that? Obviously the last thing we want to do is provide the Service with a road map.”<sup>335</sup>

The DPP head responded:

“... If the risk has been disclosed and the IRS is successful in a challenge, the client can’t maintain he was bushwhacked because he wasn’t informed of the risk. ... We could have a statement in the engagement letter that the client acknowledges receipt of a memorandum concerning risks associated with the strategy, then cover the double taxation risk and penalty risks (and other relevant risks) in that separate memorandum. Depending on how one interprets section 7525(b), such a memorandum arguably qualifies for the federal confidential communications privilege under section 7525(a).”<sup>336</sup>

This was not the only KPMG document that discussed using attorney-client or other legal privileges to limit disclosure of KPMG documents and activities related to its tax products. For example, a 1998 document containing handwritten notes from a KPMG tax professional about a number of issues related to OPIS states, under the heading, “Brown & Wood”: “Privilege[:] B&W can play a big role at providing protection in this area.”<sup>337</sup>

Other parties who participated in the KPMG tax products also discussed using attorney-client privilege to conceal their activities. One was Deutsche Bank, which participated in both OPIS and BLIPS. In an internal email, one Deutsche Bank employee wrote to another regarding BLIPS: “I

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<sup>334</sup>“Fishtail, Bacchus, Sundance, and Slapshot: Four Enron Transactions Funded and Facilitated by U.S. Financial Institutions,” report prepared by the U.S. Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, S. Prt. 107-82 (1/2/03), at 32.

<sup>335</sup>Email dated 3/25/00, from Larry Manth to Larry DeLap, Phillip Galbreath, Mark Springer, and Richard Smith, “RE: S-corp Product,” Bates KPMG 0016986-87.

<sup>336</sup>Email dated 3/27/00, from Larry DeLap to Larry Manth, Phillip Galbreath, Mark Springer and Richard Smith, “RE: S-Corp Product,” Bates KPMG 0016986.

<sup>337</sup>Handwritten notes dated 3/4/98, author not indicated, regarding “Brown & Wood” and “OPIS,” Bates KPMG 0047317.

would have thought you could still ensure that ... the papers are prepared, and all discussion held, in a way which makes them legally privileged. (... you may remember that was one of my original suggestions).”<sup>338</sup> Earlier, when considering whether to participate in BLIPS initially, the bank decided to limit its discussion of BLIPS on paper and not to obtain the approval of the bank committee that normally evaluates the risk that a transaction poses to the reputation of the bank, in order not to leave “an audit trail”:

- “1. STRUCTURE: A diagrammatic representation of the deal may help the Committee’s understanding - we can prepare this.
2. PRIVILEGE [sic]: This is not easy to achieve and therefore a more detailed description of the tax issues is not advisable.
3. REPUTATION RISK: In this transaction, reputation risk is tax related and we have been asked by the Tax Department not to create an audit trail in respect of the Bank’s tax affairs. The Tax department assumes prime responsibility for controlling tax related risks (including reputation risk) and will brief senior management accordingly. We are therefore not asking R&R Committee to approve reputation risk on BLIPS. This will be dealt with directly by the Tax Department and John Ross.”<sup>339</sup>

Another bank that took precautions against placing tax product information on paper was Wachovia Bank’s First Union National Bank. A First Union employee sent the following instructions to a number of his colleagues apparently in connection with the bank’s approving sales of a new KPMG tax product:

“In order to ... lower our profile on this particular strategy, the following points should be noted: The strategy has an KPMG acronym which will not be shared with the general First Union community. ... Our traditional sources of client referrals inside First Union should not be informed of which Big 5 accounting firm we will choose to bring in on a strategy meeting with a client. ... No one-pager will be distributed to our referral sources describing the strategy.”<sup>340</sup>

Other documents obtained by the Subcommittee include instructions by senior KPMG tax professionals to their staff not to keep certain revealing documentation in their files or to clean out their files, again, to avoid or limit detection of firm activity. For example, in the case of BLIPS, a

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<sup>338</sup>Email dated 7/29/99, from Mick Wood to Francesco Piovanetti and other Deutsche Bank professionals, “Re: Risk & Resources Committee Paper - BLIPS,” Bates DB BLIPS 6556.

<sup>339</sup>Email dated 7/30/99, from Ivor Dunbar to multiple Deutsche Bank professionals, “Re: Risk & Resources Committee Paper - BLIPS,” unreadable Bates DB BLIPS number.

<sup>340</sup>Email dated 8/30/99, from Tom Newman to multiple First Union professionals, “next strategy,” Bates SEN-014622.

KPMG tax professional sent an email to multiple colleagues stating: “You may want to remind everyone on Monday NOT to put a copy of Angie’s email on the 988 elections in their BLIPS file. It is a road map for the taxing authorities to all the other listed transactions. I continue to find faxes from Quadra in the files ... in the two 1996 deals here which are under CA audit which reference multiple transactions – not good if we would have to turn them over to California.”<sup>341</sup> In the case of OPIS, a KPMG tax professional wrote: “I have quite a few documents/papers/notes related to the OPIS transaction. ... Purging unnecessary information now pursuant to an established standard is probably ok. If the Service asks for information down the road (and we have it) we’ll have to give it to them I suspect. Input from (gulp) DPP may be appropriate.”<sup>342</sup>

**Marketing Restrictions.** KPMG also took precautions against detection of its activities during the marketing of the four products studied by the Subcommittee. FLIP and OPIS were explained only after potential clients signed a confidentiality agreement promising not to disclose the information to anyone else.<sup>343</sup> In the case of BLIPS, KPMG tax professionals were instructed to obtain “[s]igned nondisclosure agreements ... before any meetings can be scheduled.”<sup>344</sup> KPMG also limited the paperwork used to explain the products to clients. Client presentations were done on chalkboards or erasable whiteboards, and written materials were retrieved from clients before leaving a meeting.<sup>345</sup> KPMG determined as well that “[p]roviding a copy of a draft opinion letter will no

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<sup>341</sup>Email dated 1/3/00, from Dale Baumann to “Jeff,” “988 election memo,” Bates KPMG 0026345.

<sup>342</sup>Email dated 9/16/98, from Bob to unknown recipients, “Documentation,” Bates KPMG 0025729. Documents related to other KPMG tax products, such as TEMPEST and OHELLO, contain similar information. See, e.g., message from Bob McCahill and Ken Jones, attached to an email dated 3/1/02, from Walter Duer to multiple KPMG tax professionals, “RE: TCS Review of TEMPEST and OHELLO,” Bates KPMG 0032378-80 (“There is current IRS audit activity with respect to two early TEMPEST engagements. One situation is under fairly intense scrutiny by IRS Financial Institutions and Products specialists .... Although KPMG has yet to receive a subpoena or any other request for documents, client lists, etc. we believe it is likely that such a request(s) is inevitable. Since TEMPEST is a National Stratecon solution for which Bob McCahill and Bill Reilly were the Co-Champions ... it is most efficient to have all file reviews and ‘clean-ups’ (electronic or hard copy) performed in one location, namely the FS NYC office. This effort will be performed by selected NE Stratecon professionals ... with ultimate review and final decision making by Ken Jones. ... [W]e want the same approach to be followed for OHELLO as outlined above for TEMPEST. Senior tax leadership, Jeff Stein and Rick Rosenthal concur with this approach.”)

<sup>343</sup>See, e.g., memorandum dated 8/5/98, from Doug Ammerman to PFP Partners, “OPIS and Other Innovative Strategies,” Bates KPMG 0026141 - 43, at 2-3 (“subject to their signing a confidentiality agreement”); *Jacoboni v. KPMG*, Case No. 6:02-CV-510 (District Court for the Middle District of Florida) Complaint (filed 4/29/02), at paragraph 9 (“KPMG executives told [Mr. Jacoboni] he could not involve any other professionals because the investment ‘strategy’ [FLIP] was ‘confidential.’” Emphasis in original.); Subcommittee interview of Mr. Jacoboni (4/4/03).

<sup>344</sup>Email dated 5/5/99, from Jeffrey Eischeid to multiple KPMG tax professionals, “Marketing BLIPS,” Bates KPMG 0006106.

<sup>345</sup>Subcommittee interview of Wachovia Bank representatives (3/25/03); Subcommittee interview of legal counsel of Theodore C. Swartz (9/16/03).

longer be done to assist clients in their due diligence.”<sup>346</sup> In SC2, the DPP head instructed KPMG tax professionals not to provide any “sample documents” directly to a client.<sup>347</sup>

KPMG also attempted to place marketing restrictions on the number of products sold so that word of them would be restricted to a small circle. In the case of BLIPS, the DPP initially authorized only 50 to be sold.<sup>348</sup> In the case of SC2, a senior tax professional warned against mass marketing the product to prevent the IRS from getting “wind of it”:

“I was copied on the message below, which appears to indicate that the firm is intent on marketing the SC2 strategy to virtually every S corp with a pulse (if S corps had pulses). Going way back to Feb. 2000, when SC2 first reared its head, my recollection is that SC2 was intended to be limited to a relatively small number of large S corps. That plan made sense because, in my opinion, there was (and is) a strong risk of a successful IRS attack on SC2 if the IRS gets wind of it. ...[T]he intimate group of S corps potentially targeted for SC2 marketing has now expanded to 3,184 corporations. Call me paranoid, but I think that such a widespread marketing campaign is likely to bring KPMG and SC2 unwelcome attention from the IRS. ... I realize the fees are attractive, but does the firm’s tax leadership really think that his is an appropriate strategy to mass market?”<sup>349</sup>

The DPP head responded: “We had a verbal agreement following a conference call with Rick Rosenthal earlier this year that SC2 would not be mass marketed. In any case, the time has come to formally cease all marketing of SC2. Please so notify your deployment team and the marketing directors.”<sup>350</sup>

## **(5) Disregarding Professional Ethics**

In addition to all the other problems identified in the Subcommittee investigation, troubling evidence emerged regarding how KPMG handled certain professional ethics issues, including issues related to fees, auditor independence, and conflicts of interest in legal representation.

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<sup>346</sup>Email dated 5/5/99, from Jeffrey Eiseheid to multiple KPMG tax professionals, “Marketing BLIPS,” Bates KPMG 0006106.

<sup>347</sup>Email dated 4/11/00, from Larry DeLap to Tax Professional Practice Partners, “S-Corporation Charitable Contribution Strategy (SC2),” Bates KPMG 0052582.

<sup>348</sup>Email dated 5/5/99, from Jeffrey Eiseheid to multiple KPMG tax professionals, “Marketing BLIPS,” Bates KPMG 0006106.

<sup>349</sup>Email dated 12/20/01, from William Kelliher to WNT head David Brockway, “FW: SC2,” Bates KPMG 0013311.

<sup>350</sup>Email dated 12/29/01, from Larry DeLap to Larry Manth, David Brockway, William Kelliher and others, “FW: SC2,” Bates KPMG 0013311.

**Contingent, Excessive, and Joint Fees.** The fees charged by KPMG in connection with its tax products raise several concerns. It is clear that the lucrative nature of the fees drove the marketing efforts and helped convince other parties to participate.<sup>351</sup> KPMG made more than \$124 million from just the four tax products featured in this Report. Sidley Austin Brown & Wood made millions from issuing concurring legal opinions on the validity of the four tax products. Deutsche Bank made more than \$30 million in fees and other profits from BLIPS.

Traditionally, accounting firms charged flat fees or hourly fees for tax services. In the 1990s, however, accounting firms began charging “value added” fees based on “the value of the services provided, as opposed to the time required to perform the services.”<sup>352</sup> In addition, some firms began charging “contingent fees” that were paid only if a client obtained specified results from the services offered, such as achieving specified tax savings.<sup>353</sup> Many states prohibit accounting firms from charging contingent fees due to the improper incentives they create, and a number of SEC, IRS, state, and AICPA rules allow their use in only limited circumstances.<sup>354</sup>

Within KPMG, the head of DPP-Tax took the position that fees based on projected client tax savings were contingent fees prohibited by AICPA Rule 302.<sup>355</sup> Other KPMG tax professionals disagreed, complained about the DPP interpretation, and pushed hard for fees based on projected tax savings. For example, one memorandum objecting to the DPP interpretation of Rule 302 warned that it “threatens the value to KPMG of a number of product development efforts,” “hampers our ability to price the solution on a value added basis,” and will cost the firm millions of dollars.<sup>356</sup> The memorandum also objected strongly to applying the contingent fee prohibition to, not only the firm’s

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<sup>351</sup>See, e.g., email dated 3/14/98, from Jeff Stein to multiple KPMG tax professionals, “Simon Says,” Bates 638010, filed by the IRS on June 16, 2003, as an attachment to Respondent’s Requests for Admission, Schneider Interests v. Commissioner, U.S. Tax Court, Docket No. 200-02 (addressing a dispute over which of two tax groups, Personal Financial Planning and International, should get credit for revenues generated by OPIS).

<sup>352</sup>KPMG Tax Services Manual, §31.11.1 at 31-6.

<sup>353</sup>See AICPA Code of Professional Conduct, Rule 302 (“[A] contingent fee is a fee established for the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such service.”)

<sup>354</sup>See, e.g., AICPA Rule 302; 17 C.F.R. §210.2-01(c)(5)(SEC contingent fee prohibition: “An accountant is not independent if, any point during the audit and professional engagement period, the accountant provides any service or product to an audit client for a contingent fee.”); KPMG Tax Services Manual, §32.4 on contingent fees in general and §31.10.3 at 31-5 (DPP head determines whether specific KPMG fees comply with various rules on contingent fees.)

<sup>355</sup>Subcommittee interview of Lawrence DeLap (10/30/03); memorandum dated 7/14/98, from Gregg Ritchie to multiple KPMG tax professionals, “Rule 302 and Contingency Fees – CONFIDENTIAL,” Bates KPMG 0026557-58.

<sup>356</sup>Memorandum dated 7/14/98, from Gregg Ritchie to multiple KPMG tax professionals, “Rule 302 and Contingency Fees – CONFIDENTIAL,” Bates KPMG 0026555-59.



audit clients, but also to any individual who “exerts significant influence over “ an audit client, such as a company director or officer, as required by the DPP. The memorandum stated this expansive reading of the prohibition was problematic, because “many, if not most, of our CaTS targets are officers/directors/shareholders of our assurance clients.”<sup>357</sup> The memorandum states: “At the present time, we do not know if DPP’s interpretation of Rule 302 has been adopted with the full awareness of the firm’s leadership .... However, it is our impression that no one other than DPP has fully considered the issue and its impact on the tax practice.”

In the four case studies examined by the Subcommittee, the fees charged by KPMG for BLIPS, OPIS, and FLIP were clearly based upon the client’s projected tax savings.<sup>358</sup> In the case of BLIPS, for example, the BLIPS National Deployment Champion wrote the following description of the tax product and recommended that fees be set at 7% of the generated “tax loss” that clients would achieve on paper from the BLIPS transactions and could use to offset and shelter other income from taxation:

“BLIPS ... [A] key objective is for the tax loss associated with the investment structure to offset/shelter the taxpayer’s other, unrelated, economic profits. ... The all-in cost of the program, assuming a complete loss of investment principal, is 7% of the targeted tax loss (pre-tax). The tax benefit of the investment program, which ranges from 20% to 45% of the targeted tax loss, will depend on the taxpayer’s effective tax rates.

FEE: BLIPS is priced on a fixed fee basis which should approximate 1.25% of the tax loss. Note that this fee is included in the 7% described above.”<sup>359</sup>

Another document, an email sent from Presidio to KPMG, provides additional detail on the 7% fee charged to BLIPS clients, ascribing “basis points” or portions of the 7% fee to be paid to various participants for various expenses. All of these basis points, in turn, depended upon the size of the client’s expected tax loss to determine their amount. The email states:

“The breakout for a typical deal is as follows:

|           |     |
|-----------|-----|
| Bank Fees | 125 |
| Mgmt Fees | 275 |

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<sup>357</sup>“CaTS” stands for KPMG’s Capital Transaction Services Group which was then in existence and charged with selling tax products to high net worth individuals.

<sup>358</sup>If a client objected to the requested fee, KPMG would, on occasion, negotiate a lower, final amount.

<sup>359</sup>Document dated 7/21/99, entitled “Action Required,” authored by Jeff Eischeid, Bates KPMG 0040502. See also, e.g., memorandum dated 8/5/98, from Doug Ammerman to “PFP Partners,” “OPIS and Other Innovative Strategies,” Bates KPMG 0026141-43 at 2 (“In the past KPMG’s fee related to OPIS has been paid by Presidio. According to DPP-Assurance, this fee structure may constitute a contingent fee and, as a result, may be a prohibited arrangement .... KPMG’s fee must be a *fixed* amount and be paid directly by the client/target.” Emphasis in original.)

|                          |                |
|--------------------------|----------------|
| Gu[aran]teed Pymt.       | 8              |
| Net Int. Exp.            | 6              |
| Trading Loss             | 70             |
| KPMG                     | 125            |
| Net return to Class A 91 | <sup>360</sup> |

Virtually all BLIPS clients were charged this 7% fee.

In the case of SC2, which was constructed to shelter certain S corporation income otherwise attributable and taxable to the corporate owner, KPMG described SC2 fees as “fixed” at the beginning of the engagement at an amount that “generally ... approximated 10 percent of the expected average taxable income of the S Corporation for the two years following implementation.”<sup>361</sup> SC2 fees were set at a minimum of \$500,000, and went as high as \$2 million per client.<sup>362</sup>

The documents suggest that, at least in some cases, KPMG deliberately manipulated the way it handled certain tax products to circumvent state prohibitions on contingent fees. For example, a document related to OPIS identifies the states that prohibit contingent fees. Then, rather than prohibit OPIS transactions in those states or require an alternative fee structure, the memorandum directs KPMG tax professionals to make sure the OPIS engagement letter is signed, the engagement is managed, and the bulk of services is performed “in a jurisdiction that does not prohibit contingency fees.”<sup>363</sup>

Another set of fee issues related to the fees paid to the key law firm that issued concurring legal opinions supporting the four KPMG tax products, Sidley Austin Brown & Wood. This law firm was paid \$50,000 for each legal opinion it provided in connection with BLIPS, FLIP, and OPIS. Documents and interview evidence obtained by the Subcommittee indicate that the law firm was paid even more in transactions intended to provide clients with large tax losses, and that the amount paid to the law firm may have been linked directly to the size of the client’s expected tax loss. For example, one email describing the fee amounts to be paid to Sidley Austin Brown & Wood in BLIPS and OPIS deals appears to assign to the law firm “basis points” or percentages of the client’s expected tax loss:

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<sup>360</sup>Email dated 5/24/00, from Kerry Bratton of Presidio to Angie Napier of KPMG, “RE: BLIPS - 7 percent,” Bates KPMG 0002557.

<sup>361</sup>Tax Solution Alert for S-Corporation Charitable Contribution Strategy, FY00-28, revised as of 12/7/01, at 2. See also email dated 12/27/01, from Larry Manth to Andrew Atkin and other KPMG tax professionals, “SC2,” Bates KPMG 0048773 (describing SC2 fees as dependent upon client tax savings).

<sup>362</sup>Id.

<sup>363</sup>Memorandum dated 7/1/98, from Gregg Ritchie and Jeffrey Zysik to “CaTS Team Members,” “OPIS Engagements - Prohibited States,” Bates KPMG 0011954.

“Brown & Wood fees:

Quadra OPIS98 - 30 bpts  
Quadra OPIS99 - 30 bpts

Presidio OPIS98 - 25 bpts  
Presidio OPIS99 - 25 bpts  
BLIPS - 30 bpts<sup>364</sup>

American Bar Association (ABA) Model Rule 1.5 states that “[a] lawyer shall not make an agreement for, charge, or collect an unreasonable fee,” and cites as the factors to consider when setting a fee amount “the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly.” Sidley Austin Brown & Wood charged substantially the same fee for each legal opinion it issued to a FLIPS, OPIS, or BLIPS client, even when opinions drafted after the initial prototype opinion contained no new facts or legal analysis, were virtually identical to the prototype except for client names, and in many cases required no client consultation. As mentioned earlier, in BLIPS, Sidley Austin Brown & Wood was also paid a fee in any sale where a prospective buyer was told that the law firm would provide a favorable tax opinion letter if asked, regardless of whether the opinion was later requested or provided.<sup>365</sup> These fees, with few costs after the prototype opinion was drafted, raise questions about the firm’s compliance with ABA Model Rule 1.5.

Still another issue involves joint fees. In the case of BLIPS, clients were charged a single fee equal to 7% of the tax losses to be generated by the BLIPS transactions. The client typically paid this fee to Presidio, a investment advisory firm, which then apportioned the fee amount among various firms according to certain factors. The fee recipients typically included KPMG, Presidio, participating banks, and Sidley Austin Brown & Wood, and one of the factors determining the fee apportionment was who had brought the client to the table. This fee splitting arrangement may violate restrictions on contingency and client referral fees, as well as an American Bar Association prohibition against law firms sharing legal fees with non-lawyers.<sup>366</sup>

**Auditor Independence.** Another professional ethics issue involves auditor independence. Deutsche Bank, HVB, and Wachovia Bank are all audit clients of KPMG, and at various times all three have played roles in marketing or implementing KPMG tax products. Deutsche Bank and HVB

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<sup>364</sup>Email dated 5/15/00, from Angie Napier to Jeffrey Eischied and others, “B&W fees and generic FLIP rep letter,” Bates KPMG 0036342.

<sup>365</sup>See “Declaration of Richard E. Bosch,” IRS Revenue Agent, In re John Doe Summons to Sidley Austin Brown & Wood (N.D. Ill. 10/16/03) at ¶ 18, citing an email dated 10/1/97, from Gregg Ritchie to Randall Hamilton, “Flip Tax Opinion.”

<sup>366</sup>See ABA Model Rule 5.4, “A lawyer or law firm shall not share legal fees with a non-lawyer.” Reasons provided for this rule include “protect[ing] the lawyer’s professional independence of judgment.”

provided literally billions of dollars in financing to make OPIS and BLIPS transactions possible. Wachovia, through First Union National Bank, referred clients to KPMG and was paid or promised a fee for each client who actually purchased a tax product. For example, one internal First Union email on fees stated: “Fees to First Union will be 50 basis points if the investor is not a KPMG client, and 25 bps if they are a KPMG client.”<sup>367</sup>

KPMG Tax Services Manual states: “Due to independence considerations, the firm does not enter into alliances with SEC audit clients.”<sup>368</sup> KPMG defines an “alliance” as “a business relationship between KPMG and an outside firm in which the parties intend to work together for more than a single transaction.”<sup>369</sup> KPMG policy is that “[a]n oral business relationship that has the effect of creating an alliance should be treated as an alliance.”<sup>370</sup> Another provision in KPMG’s Tax Services Manual states: “The SEC considers independence to be impaired when the firm has a *direct or material indirect* business relationship with an SEC audit client.”<sup>371</sup>

Despite the SEC prohibition and the prohibitions and warnings in its own Tax Services Manual, KPMG worked with audit clients, Deutsche Bank, HVB, and Wachovia, on multiple BLIPS, FLIP, and OPIS transactions. In fact, at Deutsche Bank, the KPMG partner in charge of Deutsche Bank audits in the United States expressly approved the bank’s accounting of the loans for the BLIPS transactions.<sup>372</sup> KPMG tax professionals were aware that doing business with an audit client raised auditor independence concerns.<sup>373</sup> KPMG apparently attempted to resolve the auditor independence

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<sup>367</sup>Email dated 8/30/99, from Tom Newman to multiple First Union employees, “next strategy,” Bates SEN-014622.

<sup>368</sup>KPMG Tax Services Manual, §52.1.3 at 52-1.

<sup>369</sup>Id., §52.1.1 at 52-1.

<sup>370</sup>Minutes dated 9/28/98, of KPMG “Assurance/Tax Professional Practice Meeting” in New York, “Summary of Conclusions and Action Steps,” Bates XX 001369-74, at 1373.

<sup>371</sup>Id., §52.5.2 at 52-6 (Emphasis in original.). The SEC “Business Relationships” regulation states: “An accountant is not independent if, at any point during the audit and professional engagement period, the accounting firm or any covered person in the firm has any direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity, such as an audit client’s officers, directors, or substantial stockholders.” 17 C.F.R. §210.2-01(c)(3).

<sup>372</sup>Undated document prepared by Deutsche Bank in 1999, “New Product Committee Overview Memo: BLIPS Transaction,” Bates DB BLIPS 6906-10, at 6909-10.

<sup>373</sup>See, e.g., memorandum dated 8/5/98, from Doug Ammerman to “PFP Partners,” “OPIS and Other Innovative Strategies,” Bates KPMG 0026141-43 (“Currently, the only institution participating in the transaction is a KPMG audit client .... As a result, DPP-Assurance feels there may be an independence problem associated with our participation in OPIS ....”); email dated 2/11/99, from Larry DeLap to multiple KPMG tax professionals, “RE: BLIPS,” Bates KPMG 0037992 (“The opinion letter refers to transactions with Deutsche Bank. If the transactions will always involve Deutsche Bank, we could have an independence issue.”); email dated 4/20/99, from Larry DeLap to multiple KPMG tax professionals, “BLIPS,” Bates KPMG 0011737-38 (Deutsche Bank, a KPMG audit client, is

issue by giving clients a choice of banks to use in the OPIS and BLIPS transactions, including at least one bank that was not a KPMG audit client.<sup>374</sup> It is unclear, however, whether individuals actually could choose what bank to use. It is also unclear how providing clients with a choice of banks alleviated KPMG's conflict of interest, since it still had a direct or material, indirect business relationship with banks whose financial statements were certified by KPMG auditors.

In 2003, the SEC opened an informal inquiry into whether the client referral arrangements between KPMG and Wachovia violated the SEC's auditor independence rules. In its second quarter filing with the SEC in August 2003, Wachovia provides the following description of the ongoing SEC inquiry:

On June 19, 2003, the Securities and Exchange Commission informally requested Wachovia to produce certain documents concerning any agreements or understandings by which Wachovia referred clients to KPMG LLP during the period January 1, 1997 to the present. Wachovia is cooperating with the SEC in its inquiry. Wachovia believes the SEC's inquiry relates to certain tax services offered to Wachovia customers by KPMG LLP during the period from 1997 to early 2002, and whether these activities might have caused KPMG LLP not to be 'independent' from Wachovia, as defined by applicable accounting and SEC regulations requiring auditors of an SEC-reporting company to be independent of the company. Wachovia and/or KPMG LLP received fees in connection with a small number of personal financial consulting transactions related to these services. During all periods covered by the SEC's inquiry, including the present, KPMG LLP has confirmed to Wachovia that KPMG LLP was and is 'independent' from Wachovia under applicable accounting and SEC regulations."

In its third quarter filing with the SEC, Wachovia stated that, on October 21, 2003, the SEC issued a "formal order of investigation" into this matter, and the bank is continuing to cooperate with the inquiry.

A second set of auditor independence issues involves KPMG's decision to market tax products to its own audit clients. Evidence appears throughout this Report of KPMG's efforts to sell tax products to its audit clients or the officers, directors, or shareholders of its audit clients. This evidence includes instances in which KPMG mined its audit client data to develop a list of potential clients for a particular tax product;<sup>375</sup> tax products that were designed and explicitly called for

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conducting BLIPS transactions); email dated 11/30/01, from Councill Leak to Larry Manth, "FW: First Union Customer Services," Bates KPMG 0050842 (lengthy discussion of auditor independence concerns and First Union).

<sup>374</sup>See, e.g., email dated 4/20/99, from Larry DeLap to multiple KPMG tax professionals, "BLIPS," Bates KPMG 0011737-38 (discussing using Deutsche Bank, a KPMG audit client, in BLIPS transactions).

<sup>375</sup>See, e.g., Presentation dated 7/17/00, "Targeting Parameters: Intellectual Property – Assurance and Tax," with attachment dated September 2000, entitled "Intellectual Property Services," at page 1 of the attachment, Bates XX 001567-94.

“fostering cross-selling among assurance and tax professionals”,<sup>376</sup> and marketing initiatives that explicitly called upon KPMG tax professionals to contact their audit partner counterparts and work with them to identify appropriate clients and pitch KPMG tax products to those audit clients.<sup>377</sup> A KPMG memorandum cited earlier in this Report observed that “many, if not most, of our CaTS targets are officers/directors/shareholders of our assurance clients.”<sup>378</sup>

By using its audit partners to identify potential clients and targeting its audit clients for tax product sales pitches, KPMG not only took advantage of its auditor-client relationship, but also created a conflict of interest in those cases where it successfully sold a tax product to an audit client. This conflict of interest arises when the KPMG auditor reviewing the client’s financial statements is required, as part of that review, to examine the client’s tax return and its use of the tax product to reduce its tax liability and increase its income. In such situations, KPMG is, in effect, auditing its own work.

The inherent conflict of interest is apparent in the minutes of a 1998 meeting held in New York between KPMG top tax and assurance professionals to address topics of concern to both divisions of KPMG.<sup>379</sup> A written summary of this meeting includes as its first topic: “Accounting Considerations of New Tax Products.” The section makes a single point: “Some tax products have pre-tax accounting implications. DPP-Assurance’s role should be to review the accounting treatment, not to determine it.”<sup>380</sup> This characterization of the issue implies not only a tension between KPMG’s top auditing and tax professionals, but also an effort to diminish the authority of the top assurance professionals and make it clear that they may not “determine” the accounting treatment for new tax products.

The next topic in the meeting summary is: “Financial Statement Treatment of Aggressive Tax Positions.”<sup>381</sup> Again, the section discloses an ongoing tension between KPMG’s top auditing and tax professionals on how to account for aggressive tax products in an audit client’s financial statements. The section notes that discussions had taken place and further discussions were planned “to determine

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<sup>376</sup>Presentation dated 3/6/00, “Post-Transaction Integration Service (PTIS) – Tax,” by Stan Wiseberg and Michele Zinn of Washington, D.C., Bates XX 001597-1611.

<sup>377</sup>Email dated 8/14/01, from Jeff Stein and Walter Duer to “KPMG LLP Partners, Managers and Staff,” “Stratecon Middle Market Initiative,” Bates KPMG 0050369.

<sup>378</sup>Memorandum dated 7/14/98, from Gregg Ritchie to multiple KPMG tax professionals, “Rule 302 and Contingency Fees – CONFIDENTIAL,” Bates KPMG 0026555-59. CaTS stands for the Capital Transaction Services Group which was then in existence and charged with selling tax products to high net worth individuals.

<sup>379</sup>Minutes dated 9/28/98, of KPMG “Assurance/Tax Professional Practice Meeting” in New York, “Summary of Conclusions and Action Steps,” Bates XX 001369-74. (Capitalization in original omitted.)

<sup>380</sup>Id. at Bates XX 001369.

<sup>381</sup>Minutes dated 9/28/98, of KPMG “Assurance/Tax Professional Practice Meeting” in New York, “Summary of Conclusions and Action Steps,” Bates XX 001369-74.

whether modifications may be made” to KPMG’s policies on how “aggressive tax positions” should be treated in an audit client’s financial statements. An accompanying issue list implies that the focus of the discussions will be on weakening rather than strengthening the existing policies. For example, among the policies to be re-examined were KPMG’s policies that, “[n]o financial statement tax benefit should be provided unless it is probable the position will be allowed,”<sup>382</sup> and that the “probable of allowance” test had to be based solely on technical merits and could not consider the “probability” that a client might win a negotiated settlement with the IRS. The list also asked, in effect, whether the standard for including a financial statement tax benefit in a financial statement could be lowered to include, not only tax products that “should” survive an IRS challenge, which KPMG interprets as having a 70% or higher probability, but also tax products that are “more-likely-than-not” to withstand an IRS challenge, meaning a better than 50% probability.

**Conflicts of Interest in Legal Representation.** A third set of professional ethics issues involves legal representation of clients who, after purchasing a tax product from KPMG, have come under the scrutiny of the IRS for buying an illegal tax shelter and understating their tax liability on their tax returns. The mass marketing of tax products has led to mass enforcement efforts by the IRS after a tax product has been found to be abusive and the IRS obtains the lists of clients who purchased the product. In response, certain law firms have begun representing multiple clients undergoing IRS audit for purchasing similar tax shelters.

One key issue involves KPMG’s role in referring its tax shelter clients to specific law firms. In 2002, KPMG assembled a list of “friendly” attorneys and began steering its clients to them for legal representation. For example, an internal KPMG email providing guidance on “FLIPS/OPIS/BLIPS Attorney Referrals” states: “This is a list that our group put together. All of the attorneys are part of the coalition and friendly to the firm. Feel free to forward to a client if they would like a referral.”<sup>383</sup> The “coalition” referred to in the email is a group of attorneys who had begun working together to address IRS enforcement actions taken against taxpayers who had used the FLIP, OPIS or BLIPS tax products.

One concern with the KPMG referral list is that at least some of the clients being steered to “friendly” law firms might want to sue KPMG itself for selling them an illegal tax shelter. In one instance examined by the Subcommittee, for example, a KPMG client under audit by the IRS for using BLIPS was referred by KPMG to a law firm, Sutherland, Asbill & Brennan, with which KPMG had a longstanding relationship but with which the client had no prior contact. In this particular instance, the law firm did not even have offices in the client’s state. The client was also one of more

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<sup>382</sup>*Id.* at Bates XX 001370. (Emphasis in original.)

<sup>383</sup>Email dated 4/9/02, from Erin Collins to multiple KPMG tax professionals, “FLIPS/OPIS/BLIPS Attorney Referrals,” Bates KPMG 0050113. See also email dated 11/4/02, from Ken Jones to multiple KPMG tax professionals, “RE: Script,” Bates KPMG 0050130 (“Attached is a list of law firms that are handling FLIP/OPIS cases. Note that there are easily another 15 or so law firms ... but these are firms that we have dealt with in the past. Note that we are not making a recommendation, although if someone wants to talk about the various strengths/weaknesses of one firm vs. another ... we can do that.”).

than two dozen clients that KPMG had steered to this law firm. While KPMG did not obtain a fee for making those client referrals, the firm likely gained favorable attention from the law firm for sending it multiple clients with similar cases. These facts suggest that Sutherland Asbill would owe a duty of loyalty to KPMG, not only as a longstanding and important client, but also as a welcome source of client referrals.

The engagement letter signed by the KPMG client, in which he agreed to pay Sutherland Asbill to represent him before the IRS in connection with BLIPS, contained this disclosure:

“In the event you desire to pursue claims against the parties who advised you to enter into the transaction, we would not be able to represent you in any such claims because of the broad malpractice defense practice of our litigation team (representing all of the Big Five accounting firms, for example).”<sup>384</sup>

The KPMG client told the Subcommittee that he had not understood at the time that this disclosure meant that Sutherland Asbill was already representing KPMG in other “malpractice defense” matters and therefore could not represent him if he decided to sue KPMG for selling him an illegal shelter. The client signed the engagement letter on July 24, 2002.

On September 8, 2002, Sutherland Asbill “engaged KPMG” itself to assist the law firm in its representation of KPMG’s former client, including with respect to “investigation of facts, review of tax issues, and other such matters as Counsel may direct.” This engagement meant that KPMG, as Sutherland Asbill’s agent, would have access to confidential information related to its client’s legal representation, and that KPMG itself would be providing key information and analysis in the case. It also meant that the KPMG client would be paying for the services provided by the same accounting firm that had sold him the tax shelter. When a short while later, the client asked Sutherland about the merits of suing KPMG, he was told that the firm could not represent him in such a legal action, and he switched to new legal counsel.

The conflict of interest issues here involve, not only whether KPMG should be referring its clients to a “friendly” law firm, but also whether the law firm itself should be accepting these clients, in light of the firm’s longstanding and close relationship with KPMG. While both KPMG and the client have an immediate joint interest in defending the validity of the tax product that KPMG sold and the client purchased, their interests could quickly diverge if the suspect tax product is found to be in violation of federal tax law. This divergence in interests has been demonstrated repeatedly since 2002, as growing numbers of KPMG clients have filed suit against KPMG seeking a refund of past fees paid to the firm and additional damages for KPMG’s selling them an illegal tax shelter.

The preamble to the American Bar Association (ABA) Model Rules states that “a lawyer, as a member of the legal profession, is a representative of clients, an officer of the legal system and a

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<sup>384</sup>Engagement letter between Sutherland Asbill & Brennon LLP and the client, dated 7/23/02, at 1, Bates SA 001964.



public citizen having special responsibility for the quality of justice. ... As (an) advocate, a lawyer zealously asserts the client's position under the rules of the adversary system." The problem here is the conflict of interest that arises when a law firm attempts to represent an accounting firm's client at the same time it is representing the accounting firm itself, and the issue in controversy is a tax product that the accounting firm sold and the client purchased. In such a case, the attorney cannot zealously represent the interests of both clients due to conflicting loyalties. A related issue is whether the law firm can ethically use the accounting firm as the tax expert in the client's case, given the accounting firm's self interest in the case outcome.

At the request of the Subcommittee, the Congressional Research Service's American Law Division analyzed the possible conflict of interest issues.<sup>385</sup> The CRS analysis concluded that, under American Bar Association Model Rule 1.7, a law firm should decline to represent an accounting firm client in a tax shelter case if the law firm already represents the accounting firm itself on other matters. The CRS analysis identified "two possible, and interconnected, conflicts of interest" that should lead the law firm to decline the engagement. The first is a "current conflict of interest" at the time of engagement, which arises from "a 'substantial risk' that the attorney ... would be 'materially limited' by his responsibilities to another client" in "pursuing certain relevant and proper courses of action on behalf of the new client" such as filing suit against the firm's existing client, the accounting firm. The second is a "potential conflict of interest whereby the attorney may not represent the new client in litigation ... against an existing, current client. That particular, potential conflict of interest could not be waived."

The CRS analysis also recommends that the law firm fully inform a potential client about the two conflicts of interest prior to any engagement, so that the client can make a meaningful decision on whether he or she is willing to be represented by a law firm that already represents the accounting firm that sold the client the tax product at issue. According to ABA Model Rule 1.7, informed consent must be in writing, but "[t]he requirement of a writing does not supplant the need in most cases for the lawyer to talk with the client, to explain the risks and advantages, if any, of representation burdened with a conflict of interest, as well as reasonably available alternatives, and to afford the client a reasonable opportunity to consider the risks and alternatives and to raise questions and concerns." The CRS analysis opines that a "blanket disclosure" provided by a law firm in an engagement letter is insufficient, without additional information, to ensure the client fully understands and consents to the conflicts of interest inherent in the law firm's dual representation of the client and the accounting firm.

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<sup>385</sup>Memorandum dated 11/14/03, by Jack Maskell, Legislative Attorney, American Law Division, Congressional Research Service, "Attorneys and Potential Conflicts of Interest Between New Clients and Existing Clients."

## APPENDICES

### APPENDIX A **CASE STUDY OF BOND LINKED ISSUE PREMIUM STRUCTURE (BLIPS)**

KPMG approved the Bond Linked Issue Premium Structure (BLIPS) for sale to multiple clients in 1999. KPMG marketed BLIPS for about one year, from about October 1999 to about October 2000. KPMG sold BLIPS to 186 individuals, in 186 transactions, and obtained more than \$53 million in revenues, making BLIPS one of KPMG's top revenue producers in the years it was sold and the highest revenue-producer of the four case studies examined by the Subcommittee.

BLIPS was developed by KPMG primarily as a replacement for earlier KPMG tax products, FLIP and OPIS, each of which KPMG has characterized as a "loss generator" or "gain mitigation strategy."<sup>386</sup> In 2000, the IRS issued a notice declaring transactions like BLIPS to be potentially abusive tax shelters.<sup>387</sup>

BLIPS is so complex that a full explanation of it would take more space than this Report allows, but it can be summarized as follows.

- 1) **The Gain.** Individual has ordinary or capital gains income (e.g., \$20 million).
- 2) **The Sales Pitch.** Individual is approached with a "tax advantaged investment strategy" by KPMG and Presidio, an investment firm, to generate an artificial "loss" sufficient to offset the income and shelter it from taxation. Individual is told that, for a fee, Presidio will arrange the required investments and bank financing, and KPMG and a law firm will provide separate opinion letters stating it is "more likely than not" the tax loss generated by the investments will withstand an IRS challenge.
- 3) **The Shell Corporation.** Pursuant to the strategy, Individual forms a single-member limited liability corporation ("LLC") and contributes cash equal to 7% (\$1.4 million) of the tax loss (\$20 million) to be generated by the strategy.
- 4) **The "Loan."** LLC obtains from a bank, for a fee, a non-recourse "loan" (e.g., \$50 million) with an ostensible 7-year term at an above-market interest rate, such as 16%. Because of the above-market interest rate, LLC also obtains from the bank a large cash amount up-front (e.g., \$20 million) referred

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<sup>386</sup>See, e.g., document dated 5/18/01, "PFP Practice Reorganization Innovative Strategies Business Plan – DRAFT," authored by Jeffrey Eischeid, Bates KPMG 0050620-23, at 1.

<sup>387</sup>BLIPS is covered by IRS Notice 2000-44 (2000-36 IRB 255)(9/5/00). FLIP and OPIS are covered by IRS Notice 2001-45 (2001-33 IRB 129)(7/26/01).

to as a “loan premium.” The “premium” equals the net present value of the portion of the “loan” interest payments that exceed the market rate and that LLC is required to pay during the full 7-year “loan.” The “loan premium” also equals the tax loss to be generated by the strategy. LLC thus receives two cash amounts from the bank (\$50 million plus \$20 million totaling \$70 million).

5) **The “Loan” Restrictions.** LLC agrees to severe restrictions on the “loan” to make it a very low credit risk. Most importantly, LLC agrees to maintain “collateral” in cash or liquid securities equal to 101% of the “loan” amount, including the “loan premium” (e.g., \$70.8 million). LLC also agrees to severe limits on how the “loan proceeds” may be invested and gives the bank unilateral authority to terminate the “loan” if the “collateral” amount drops below 101% of the “loan” amount.

6) **The Partnership.** LLC and two Presidio affiliates form a partnership called a Strategic Investment Fund (“Fund”) in which LLC has a 90% partnership interest, one Presidio affiliate holds a 9% interest, and the second Presidio affiliate has a 1% interest. The 1% Presidio affiliate is the managing partner.

7) **The Assets.** The Fund is capitalized with the following assets. The LLC contributes all of its assets, consisting of the “loan” (\$50 million), “loan premium” (\$20 million), and the individual’s cash contribution (\$1.4 million). Presidio’s two affiliates contribute cash equal to 10% of the LLC’s total assets (\$155,000). The Fund’s capital is a total of these contributions (\$71.6 million).

8) **The Loan Transfer.** LLC assigns the “loan” to the Fund which assumes LLC’s obligation to repay it. This obligation includes repayment of the “loan” and “loan premium,” since the “premium” consists of a portion of the interest payments owed on the “loan” principal.

9) **The Swap.** At the same time, the Fund enters into a swap transaction with the bank on the “loan” interest rate. In effect, the Fund agrees to pay a floating market rate on an amount equal to the “loan” and “loan premium” (about 8% on \$70 million), while the bank agrees to pay the 16% fixed rate on the face amount of the “loan” (16% on \$50 million). The effect of this swap is to reduce the “loan” interest rate to a market-based rate.

10) **The Foreign Currency Investment “Program.”** The Fund converts most of its U.S. dollars into euros with a contract to convert the funds back into U.S. dollars in 30-60 days. This amount includes most or all of the loan and loan premium amount. Any funds not converted into euros remain in the Fund account. The euros are then placed in an account at the bank. The Fund engages in limited transactions which involve the “shorting” of certain low-risk foreign currencies and which are monitored by the bank to ensure that only a limited amount of funds are ever placed at risk and that the funds deemed as 101% “collateral” for the bank “loan” are protected.

11) **The Unwind.** After 60 to 180 days, LLC withdraws from the partnership. The partnership unwinds, converts all cash into U.S. dollars, and uses that cash to repay the “loan” plus a “prepayment penalty” equal to the unamortized amount of the “loan premium,” so that the “loan” is paid in full.

Any remaining partnership assets are apportioned and distributed to the LLC and Presidio partners, either in cash or securities. LLC sells any securities at fair market value.

12) **Tax Claim for Cost Basis.** For tax purposes, the LLC's income or loss passes to its owner, the individual. According to the opinion letters, the individual can attempt to claim, for tax purposes, that he or she retained a cost basis in the partnership equal to the LLC's contributions of cash (\$1.4 million) and the "loan premium" (\$20 million), even though the partnership later assumed the LLC's "loan" obligation and re paid the "loan" in full, including the "premium amount." According to the opinion letters, the individual can attempt to claim a tax loss equal to the cost basis (\$21.4 million), adjusted for any gain or loss from the currency trades, and use that tax loss to offset ordinary or capital gains income.

13) **IRS Action.** In 2000, the IRS issued a notice declaring that the "purported losses" arising from these types of transactions, which use an "artificially high basis," "do not represent bona fide losses reflecting actual economic consequences" and "are not allowable as deductions for federal income tax purposes." IRS Notice 2000-44 listed this transaction as a potentially abusive tax shelter.

**APPENDIX B**  
**CASE STUDY OF S-CORPORATION CHARITABLE CONTRIBUTION  
STRATEGY (SC2)**

KPMG approved the S-Corporation Charitable Contribution Strategy (SC2) for sale to multiple clients in 2000. KPMG marketed SC2 for about 18 months, from about March 2000 to about September 2001. KPMG sold SC2 to 58 S corporations, in 58 transactions, and obtained more than \$26 million in revenues, making SC2 one of KPMG's top ten revenue producers in 2000 and 2001. SC2 is not covered by a "listed transaction" issued by the IRS, but is currently under IRS review.

SC2 can be summarized as follows.

- 1) **The Income.** Individual owns 100% of S-corporation which earns net income (e.g., \$3 million annually).
- 2) **The Sales Pitch.** Individual is approached by KPMG with a "charitable donation strategy" to shelter a significant portion (often 90%) of the S-corporation's income from taxation by "allocating," with little or no distribution, the income to a charitable organization. Individual is told that, for a fee, KPMG will arrange a temporary "donation" of corporate non-voting stock to the charity and will provide an opinion letter stating it is "more likely than not" that nonpayment of tax on the income "allocated" to the charity while it "owns" the stock will withstand an IRS challenge, even if the allocated income is not actually distributed to the charity and the individual regains control of the income. The individual is told he can also take a personal tax deduction for the "donation."
- 3) **Setting Up The Transaction.** The S-corporation issues non-voting shares of stock that, typically, equal 9 times the total number of outstanding shares (e.g., corporation with 100 voting shares issues 900 nonvoting shares). Corporation gives the non-voting shares to the existing individual-shareholder. Corporation also issues to the individual-shareholder warrants to purchase a substantial number of company shares (e.g., 7,000 warrants). Corporation issues a resolution limiting or suspending income distributions to all shareholders for a specified period of time (e.g., generally the period of time in which the charity is intended to be a shareholder, typically 2 or 3 years). Prior to issuing this resolution, corporation may distribute cash to the existing individual-shareholder.
- 4) **The Charity.** A "qualifying" charity (one which is exempt from federal tax on unrelated business income) agrees to accept S-corporation stock donation. KPMG actively seeks out qualified charities and identifies them for the individual.
- 5) **The "Donation."** S-corporation employs an independent valuation firm to analyze and provide a valuation of non-voting shares. Due to the non-voting character of the shares and the existence of a large number of warrants, the non-voting shares have a very low fair market value (e.g., \$100,000). Individual "donates" non-voting shares to the selected charity, making the charity the temporary owner of 90% of the corporation's shares. Individual claims a charitable deduction for this

“donation.” At the same time, the corporation and charity enter into a redemption agreement allowing the charity, after a specified period of time (generally 2-3 years), to require the corporation to buy back the shares at fair market value. The individual also pledges to donate an additional amount to the charity to ensure it obtains the shares’ original fair market value in the event that the shares’ value decreases. The charity does not receive any cash payment at this time.

6) **The “Allocation.”** During the period in which the charity owns the non-voting shares, the S-corporation “allocates” its annual net income to the charity and original individual-shareholder in proportion to the percentage of overall shares each holds (e.g., 90:10 ratio). However, pursuant to the corporate resolution adopted before the non-voting shares were issued and donated to the charity, little or no income “allocated” to the charity is actually distributed. The corporation retains or reinvests the non-distributed income.

7) **The Redemption.** After the specified period in the redemption agreement, the charity sells back the non-voting shares to the S-corporation for fair market value (e.g., \$100,000). The charity obtains a cash payment from the corporation for the shares at this time. Should the charity not resell the stock, the individual-shareholder can exercise the warrants, obtain additional corporate shares, and substantially dilute the value of the charity’s shares. Once the non-voting shares are repurchased by the corporation, the corporation distributes to the individual-shareholder, who now owns 100% of the corporation’s outstanding shares, all of the undistributed cash from previously earned income.

8) **Taxpayer’s Claim.** Due to its tax exempt status, the charity pays no tax on the corporate income “allocated” or distributed to it. According to the KPMG opinion letter, for tax purposes, the individual can claim a charitable deduction for the “donated” shares in the year in which the “donation” took place. During the years in which the charity “owned” most of the corporate shares, individual will pay taxes on only that portion of the corporate income that was “allocated” to him or her. KPMG also advised that all income “allocated” to the charity is then treated as previously taxed, even after the corporation buys back the non-voting stock and the individual regains control of the corporation. KPMG also advised the individual that, when the previously “allocated” income was later distributed to the individual, the individual could treat it as long-term capital gains rather than ordinary income, taxable at the lower capital gains rate. The end result is that the individual owner of the S-corporation was told by KPMG that he or she could defer and reduce the rate of the taxes paid on income earned by the S-corporation.

9) **IRS Action.** This transaction is under review by the IRS.

**APPENDIX C**  
**OTHER KPMG INVESTIGATIONS**  
**OR ENFORCEMENT ACTIONS**

In recent years, KPMG has become the subject of IRS, SEC, and state investigations and enforcement actions in the areas of tax, accounting fraud, and auditor independence. These enforcement actions include ongoing litigation by the IRS to enforce tax shelter related document requests and a tax promoter audit of the firm, which are described in the text of the Report. They also include SEC, California, and New York investigations examining a potentially abusive tax shelter involving at least 10 banks that are allegedly using sham mutual funds established on KPMG's advice; SEC and Missouri enforcement actions related to alleged KPMG involvement in accounting fraud at Xerox and General American Mutual Holding Co.; an SEC censure of KPMG for violating auditor independence restrictions by investing in AIM mutual funds while AIM was a KPMG audit client; and a bankruptcy examiner report on misleading accounting at Polaroid and KPMG.

**SHAM MUTUAL FUND INVESTIGATION**

KPMG is currently under investigation by the SEC and tax authorities in California and New York for advising at least ten banks to shift as much as \$17 billion of bank assets into shell regulated investment companies, allegedly to shelter more than \$750 million in income from taxation.

A regulated investment company (RIC), popularly known as a mutual fund, is designed to pool funds from at least 100 investors to purchase securities. RIC investors, also known as mutual fund shareholders, are normally taxed on the income they receive as dividends from their shares, while the RIC itself is tax exempt. In this instance, KPMG allegedly advised each bank to set up one or more RICs as a bank subsidiary, to transfer some portfolio of bank assets to the RIC, and then to declare any income as dividends payable to the bank. Citing KPMG tax advice, the banks allegedly claimed that they did not have to pay taxes on the dividend income due to state laws exempting from taxation money transferred between a subsidiary and its corporate parent. Zions Bancorp., for example, has stated to the press: "These registered investment companies were established upon our receiving tax and accounting guidance from KPMG and the securities law counsel from the Washington, D.C., firm of Ropes & Grey."<sup>388</sup>

The RICs established by the banks are allegedly sham mutual funds whose primary purpose was not to establish an investment pool, but to shelter bank income from taxation. The evidence allegedly suggests that the funds really had one investor – the parent bank – rather than 100 investors as required by the SEC. Press reports state, for example, that some of the RICs had apparently sold all 100 shares to the employees of the parent bank. Also according to press reports, the existence of this tax avoidance scheme was discovered after a bank was approached by KPMG, declined to participate,

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<sup>388</sup>“Zions Among Banks Accused of Scheme,” Desert News (8/8/03).

and asked its legal counsel to alert California officials to what the bank saw as an improper tax shelter. When asked about this matter, California Controller Steve Westly has been quoted as saying, "We do not believe this is appropriate."<sup>389</sup> RICs established by the ten banks participating in this tax shelter have since been voluntarily de-registered, according to press reports, with the last removed from SEC records in 2002.

## **KPMG ACCOUNTING FRAUD AT XEROX**

On January 29, 2003, the SEC filed suit in federal district court charging KPMG and four KPMG partners with accounting fraud for knowingly allowing Xerox to file four years of false financial statements which distorted Xerox's filings by billions of dollars.<sup>390</sup> The prior year, in 2002, without admitting or denying guilt, Xerox paid the SEC a \$10 million civil penalty, then the highest penalty ever paid to the SEC for accounting fraud, and agreed to restate its financial results for the years 1997 through 2000. In July 2003, six former Xerox senior executives paid the SEC civil penalties totaling over \$22 million in connection with the false financial statements.

KPMG is contesting the SEC civil suit and denies any liability for the accounting fraud. Two of the named KPMG partners remain employed by the firm. The SEC complaint includes the following statements:

"KPMG and certain KPMG partners permitted Xerox to manipulate its accounting practices and fill a \$3 billion "gap" between actual operating results and results reported to the investing public from 1997 through 2000. The fraudulent scheme allowed Xerox to claim it met performance expectations of Wall Street analysts, to mislead investors and, consequently, to boost the company's stock price. The KPMG defendants were not the watch dogs on behalf of shareholders and the public that the securities laws and the rules of the auditing profession required them to be. Instead of putting a stop to Xerox's fraudulent conduct, the KPMG defendants themselves engaged in fraud by falsely representing to the public that they had applied professional auditing standards to their review of Xerox's accounting, that Xerox's financial reporting was consistent with Generally Accepted Accounting Principles and that Xerox's reported results fairly represented the financial condition of the company. ...

In the course of auditing Xerox for the years 1997 through 2000, defendants KPMG [and the four KPMG partners] knew, or were reckless in not knowing, for each year in which they were responsible for the Xerox audit, that Xerox was preparing and filing quarterly and annual financial statements and other reports which likely contained material misrepresentations and omissions in violation of the antifraud provisions of the federal securities laws. ...

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<sup>389</sup>"Banks Shifted Billions Into Funds Sheltering Income From Taxes," Wall Street Journal (8/7/03).

<sup>390</sup>SEC v. KPMG, Case No. 03-CV-0671 (S.D.N.Y. 1/29/03).



In the summer or early fall of 1999, Xerox complained to KPMG's chairman, Stephen Butler, about the performance of [one of the defendant KPMG audit partners], who questioned Xerox management about several of the topside accounting devices that formed the fraudulent scheme. Although KPMG policy was to review assignments of an engagement partner after five years, and [the KPMG partner] had been assigned to Xerox less than two years, Butler responded to Xerox's complaints by offering [the KPMG partner] a new assignment in Finland. After [the KPMG partner] declined the new assignment, KPMG replaced [him] as the worldwide lead engagement partner with [another of the defendant KPMG partners] for the 2000 audit. This was the second time in six years in which KPMG removed the senior engagement partner early in his tenure at Xerox's request.”

KPMG was Xerox's auditor for approximately 40 years, through the 2000 audit. KPMG was paid \$26 million for auditing Xerox's financial results for fiscal years 1997 through 2000. It was paid \$56 million for non-audit services during that period. When Xerox finally restated its financial results for 1997-2000, it restated \$6.1 billion in equipment revenues and \$1.9 billion in pre-tax earnings — the largest restatement in U.S. history to that time.

#### **MISSOURI DEPARTMENT OF INSURANCE v. KPMG**

On December 10, 2002, the Missouri Department of Insurance, acting as the liquidator for an insurance firm, General American Mutual Holding Company (“General American”), sued KPMG alleging that: (1) KPMG, acting in conflicting roles as consultant and auditor, misrepresented the financial statements of its client, General American, and (2) KPMG failed to disclose substantial risks associated with an investment product called Stable Value, which KPMG had designed and General American sold during the 1990s.<sup>391</sup>

Stable Value was an investment product that, in essence, allowed General American to borrow money from investors and reinvest it in high-risk securities to obtain a greater return. In the event General American was downgraded by a ratings agency, however, the terms of the Stable Value product allowed investors to withdraw their funds. In 1999, General American, in fact, suffered a ratings downgrade, and hundreds of Stable Value holders redeemed their shares, forcing General American to go into receivership and subjecting its investors to huge losses. KPMG is alleged to have never disclosed the risks of the Stable Value product to General American and, according to the Missouri Department of Insurance, actively attempted to conceal this risk.

The following excerpts are taken from a complaint filed by the Missouri Department of Insurance against KPMG in the Jackson County Circuit Court:

“In the 1990s, with KPMG knowledge, and assistance, General American management developed and grew to obscene proportions a high-risk product known as Stable Value. In essence, certain

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<sup>391</sup>Lakin v. KPMG, (MO Cir. 12/10/02).

General American management, with KPMG's help, bet the very existence of General American on its Stable Value business segment and lost. ... With KPMG's knowledge, General American management forced an otherwise conservative company to engage in an ever-increasing extremely volatile product. When this scheme failed, it was General American's innocent members who were harmed. ...

KPMG consciously chose to: (a) misrepresent General American's financial position; (b) not require the mandated disclosures regarding the magnitude and risks associated with the Stable Value product; and (c) conceal from and misrepresent to the Missouri Department of Insurance and General American's members and outside Board of Directors, the true nature of the Stable Value product. And during this same time, when KPMG was setting up General American's innocent members for huge financial losses, KPMG kept scooping up as much money in fees as possible. ... KPMG abandoned and breached its professional obligations owed to General American, General American's members and the Missouri Department of Insurance. KPMG's failures include a lack of independence, conflicts of interest, breaches of ethical standards, and other gross departures from the most basic of auditing and other professional obligations. ...

To further the cover-up of its wrongful acts, KPMG engaged in a continued pattern of deceit during the Missouri Department of Insurance's investigation into General American's liquidity crisis. The record is replete with KPMG witnesses giving false testimony, evasive answers and just "playing dumb" in an apparent hope to avoid State of Missouri regulatory scrutiny and the filing of this Petition. What KPMG wanted to hide from the regulators was its misrepresentations, gross breaches of its professional obligations and numerous failures regarding full and fair financial reporting for General American."

## **SEC CENSURES KPMG**

On January 14, 2002, the SEC censured KPMG for engaging in improper professional conduct in violation of the SEC's rules on auditor independence and in violation of Generally Accepted Auditing Standards. KPMG consented to the SEC's order but did not admit or deny the SEC's findings.

The following is taken from the SEC's press release announcing the censure of KPMG:<sup>392</sup>

"The SEC found that, from May through December 2000, KPMG held a substantial investment in the Short-Term Investments Trust (STIT), a money market fund within the AIM family of funds. According to the SEC's order, KPMG opened the money market account with an initial deposit of \$25 million on May 5, 2000, and at one point the account balance constituted approximately 15% of the fund's net assets. In the order, the SEC found that KPMG audited the financial statements

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<sup>392</sup>Press Release by the SEC, "SEC Censures KPMG for Auditor Independence Violation," (No. 2002-4/14/02), available at [www.sec.gov/news/press/2002-4.txt](http://www.sec.gov/news/press/2002-4.txt).

of STIT at a time when the firm's independence was impaired, and that STIT included KPMG's audit report in 16 separate filings it made with the SEC on November 9, 2000. The SEC further found that KPMG repeatedly confirmed its putative independence from the AIM funds it audited, including STIT, during the period in which KPMG was invested in STIT.

'This case illustrates the dangers that flow from a failure to implement adequate policies and procedures designed to detect and prevent auditor independence violations,' said Paul R. Berger, Associate Director of Enforcement."

In addition to censuring the firm, the SEC ordered KPMG to undertake certain remedies designed to prevent and detect future independence violations caused by financial relationships with, and investments in, the firm's audit clients.

## **POLAROID AND KPMG**

Polaroid Corporation filed for bankruptcy protection in October 2001. In February 2003, a federal bankruptcy court named Perry Mandarino, a tax expert, as an independent examiner for Polaroid. In August 2003, the bankruptcy examiner issued a report stating that Polaroid and its accounting firm, KPMG, had engaged in improper accounting procedures and failed to warn investors of Polaroid's impending bankruptcy. KPMG attempted to keep the report sealed, but the court made the report available to the public. Since the issuance of the examiner's report, shareholders have filed a class action lawsuit against Polaroid and KPMG alleging violations of the Securities and Exchange Act for filing false financial statements.

Both the report and the lawsuit allege that KPMG and Polaroid engaged in a series of fraudulent accounting transactions, including overstating the value of assets and issuing financial statements that made the company appear healthier than it was. The examiner determined that KPMG should have provided a qualified opinion on the corporation's financial statements and included a warning about its status as a "going concern." The examiner found that KPMG had been considering such a warning, but decided against issuing it after a telephone call was made by Polaroid's chief executive to KPMG's chairman.<sup>393</sup> KPMG has charged that the report is "unfounded" and "incorrect."<sup>394</sup>

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<sup>393</sup>See, e.g., "KPMG Defends Audit Work for Polaroid," Wall Street Journal (8/25/03).

<sup>394</sup>"Polaroid Hit with Lawsuit After Report," Boston Globe (8/27/03).