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# THE ROLE OF PROFESSIONAL FIRMS IN THE U.S. TAX SHELTER INDUSTRY

REPORT

PREPARED BY THE

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

OF THE

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# CONTENTS


Page

**I. INTRODUCTION** .......... 1
**II. OVERVIEW OF U.S. TAX SHELTER INDUSTRY** .......... 3
**III. FINDINGS AND RECOMMENDATIONS** .......... 5
A. Findings .......... 5
B. Recommendations .......... 7
**IV. EXECUTIVE SUMMARY** .......... 9
**V. ROLE OF ACCOUNTANTS** .......... 11
A. KPMG .......... 11
(1) Developing New Tax Products .......... 13
(2) Mass Marketing Tax Products .......... 33
(3) Implementing Tax Products .......... 48
(4) Avoiding Detection .......... 56
(5) Disregarding Professional Ethics .......... 66
(6) KPMG's Current Status .......... 73
B. ERNST & YOUNG .......... 77
(1) Development of Mass-Marketed Generic Tax Products .......... 77
(2) Ernst & Young's Curent Status .......... 85
C. PRICEWATERSHOUSECOOPERS .......... 87
(1) Mass-Marketed Generic Tax Products .......... 87
(2) PricewaterhouseCoopers' Current Status .......... 93
**VI. ROLE OF LAWYERS** .......... 96
A. SIDLEY AUSTIN BROWN & WOOD .......... 96
B. SUTHERLAND ASBILL & BRENNAN .......... 100
**VII. ROLE OF FINANCIAL INSTITUTIONS** .......... 104
A. DEUTSCHE BANK .......... 105
B. HVB BANK .......... 109
C. UBS BANK .......... 113
D. FIRST UNION NATIONAL BANK .......... 114
**VIII. ROLE OF INVESTMENT ADVISORS** .......... 121
A. PRESIDIO ADVISORY SERVICES .......... 122
B. QUELLOS GROUP .......... 125
**IX. ROLE OF CHARTITABLE ORGANIZATIONS** .......... 126
A. LOS ANGELES DEPARTMENT OF FIRE AND POLICE PENSIONS . 127
B. AUSTIN FIRE FIGHTERS RELIEF AND RETIREMENT FUND .......... 131

# THE ROLE OF PROFESSIONAL FIRMS IN THE U.S. TAX SHELTER INDUSTRY

## I. INTRODUCTION

In October 2002, the U.S. Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, began an investigation into the development, marketing, and implementation of abusive tax shelters by accountants, lawyers, financial advisors, and bankers. The Subcommittee's Minority Staff initiated this investigation, at the direction of Senator Carl Levin, with the concurrence and support of Subcommittee Chairman Norm Coleman. The information in this Report is based upon the ensuing bipartisan investigation by the Subcommittee's Democratic and Republican staffs.

In its broadest sense, the term "tax shelter" is a device used to reduce or eliminate the tax liability of the tax shelter user. This may encompass legitimate or illegitimate endeavors. While there is no one standard to determine the line between legitimate "tax planning" and "abusive tax shelters," the latter can be characterized as transactions in which a significant purpose is the avoidance or evasion of Federal, state or local tax in a manner not intended by the law.

The abusive tax shelters investigated by the Subcommittee were complex transactions used by corporations or individuals to obtain substantial tax benefits in a manner never intended by the Federal tax code. While some of these transactions may have complied with the literal language of specific tax provisions, they produced results that were unwarranted, unintended, or inconsistent with the overall structure or underlying policy of the Internal Revenue Code. These transactions had no economic substance or business purpose other than to reduce taxes. Abusive tax shelters can be custom-designed for a single user or prepared as a generic tax product sold to multiple clients. The Subcommittee investigation focused on generic abusive tax shelters sold to multiple clients as opposed to a custom-tailored tax strategy sold to a single client.

Under present law, generic tax shelters sold to multiple clients are not illegal per se. They are potentially illegal depending on how the purchasers use them and report their tax liability on their tax returns. Certain statutory provisions, judicial doctrines, and IRS administrative guidance define and identify abusive tax shelters that may violate Federal tax law. Over the last 5 years, the IRS and the Treasury Department have begun to publish legal guidance on transactions they consider to be abusive. This guidance warns 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.

After a one-year investigation, the Permanent Subcommittee on Investigations held 2 days of hearings on November 18, 2003, and November 20, 2003, entitled *U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals.*

At the November 18 hearing, the Subcommittee heard testimony from three tax experts: Debra Peterson, Tax Counsel, California Franchise Tax Board; Mark Watson, Former Partner, KPMG LLP; and Calvin Johnson, Professor, The University of Texas at Austin School of Law. The Subcommittee also heard testimony from numerous tax professionals from various accounting firms. Tax professionals from KPMG LLP included: Philip Wiesner, Partner in Charge, Washington National Tax Client Services; Jeffrey Eischeid, Partner, Personal Financial Planning; Lawrence DeLap, retired National Partner in Charge, Department of Professional Practice-Tax; Lawrence Manth, former West Area Partner in Charge, Stratecon; and Richard Smith Jr., Vice Chair, Tax Services. Accounting firm PricewaterhouseCoopers was represented by Richard Berry, Jr., Senior Tax Partner. Accounting firm Ernst & Young LLP was represented by Mark Weinberger, Vice Chair, Tax Services.

At the November 20 hearing, the Subcommittee heard testimony from three lawyers: Raymond Ruble, former Partner, Sidley Austin Brown & Wood LLP; Thomas Smith, Jr., Partner, Sidley Austin Brown & Wood LLP; and N. Jerold Cohen, Partner, Sutherland Asbill & Brennan LLP. The Subcommittee also heard testimony from William Boyle, former Vice President, Structured Finance Group, Deutsche Bank AG; Domenick DeGiorgio, former Vice President, Structured Finance, HVB America, Inc.; John Larson, Managing Director, Presidio Advisory Services; and Jeffrey Greenstein, Chief Executive Officer, Quellos Group LLC, formerly known as Quadra Advisors LLC. Lastly, the Subcommittee heard testimony from three regulatory and oversight agencies: Mark Everson, Commissioner, Internal Revenue Service; William McDonough, Chairman, Public Company Accounting Oversight Board; and Richard Spillenkothen, Director, Division of Banking Supervision and Regulation, The Federal Reserve.

This Report is based upon the information gathered by the Subcommittee during those two hearings and the course of its investigation to date, including a report prepared by Senator Levin and released in connection with the November hearings,[1] review of over 250 boxes of documents and electronic disks, numerous interviews, three depositions, testimony presented by the 20 witnesses at two hearings, and supplemental post-hearing information.

[1] See "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals, Four KPMG Case Studies: FLIP, OPIS, BLIPS, and SC2," Minority Staff Report of the U.S. Senate Permanent Subcommittee on Investigations (11/18/03) (hereinafter "Levin Report"), S. Prt. 108–34, reprinted in "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals," Subcommittee hearings (11/18/03 and 11/20/03) (hereinafter "Subcommittee hearings"), S. Hrg. 108–473, at 145–274. This Subcommittee Report confirms the factual findings of the earlier Levin Report and draws heavily from its text.

## II. OVERVIEW OF U.S. TAX SHELTER INDUSTRY

Under current law, no single standard defines an abusive tax shelter. Abusive tax shelters are governed by statutory provisions, judicial doctrines, and administrative guidance used to identify transactions in which a significant purpose is the avoidance or evasion of income tax in a manner not intended by the law.

Over the past 10 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 [2] or who knowingly aid or abet the filing of tax return information that understates a taxpayer's tax liability.[3] Additional tax code provisions now require taxpayers and promoters to disclose to the IRS information about certain potentially illegal tax shelters.[4]

In 2003, 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.[5] For example, these 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.[6] 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 categories of disclosure 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.[7] 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." [8] The IRS has also stated in court that "the IRS has concluded that taxpayers who engaged in such [listed] transactions have failed or

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[2] 26 U.S.C. § 6700.

[3] 26 U.S.C. § 6701.

[4] 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); and 6112 (promoters must maintain lists of clients who purchase potentially illegal tax shelters and, upon request, disclose such client lists to the IRS).

[5] See, e.g., Treas. Reg. Sec. 301.6112–1 and Sec. 1.6011–4, which took effect on 2/28/03.

[6] 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.

[7] *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; "Challenges Remain in Combating Abusive Tax Shelters," testimony by Michael Brostek, Director, Tax Issues, General Accounting Office (GAO) before the U.S. Senate Committee on Finance, No. GAO–04–104T (10/21/03) (hereinafter "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.

[8] 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.

may fail to comply with the internal revenue laws."[9] As of March 2004, the IRS had published 31 listed transactions.[10]

In addition to 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 shelters, including the economic substance,[11] business purpose,[12] substance-over-form,[13] step transaction,[14] and sham transaction[15] 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.[16]

Bipartisan legislation to clarify and strengthen the economic substance and business purpose doctrines, as well as other aspects of Federal tax shelter law, has long been advocated by the Senate Finance Committee and approved by the Senate on multiple occasions, but not adopted by the House of Representatives. During the 108th Congress, as a result of the Subcommittee investigation, Senators Levin and Coleman introduced S. 2210, the Tax Shelter and Tax Haven Reform Act, to strengthen penalties on tax shelter promoters, prevent abusive tax shelters, deter uncooperative tax havens, and codify the economic and business purpose doctrines. This bill was referred to the Senate Finance Committee which subsequently reported a more comprehensive tax bill, S. 1637. This bill included some of the tax shelter provisions in S. 2210. In May, the Senate considered and adopted S. 1637. During the Senate debate, a Levin-Coleman amendment was accepted to further strengthen Federal penalties on promoters, aiders and abettors of abusive tax shelters. In October 2004, after a House-Senate conference, Congress enacted into law H.R. 4520, the American Jobs Creation Act. This tax legislation included a number of tax shelter reforms supported by the Subcommittee's investigation and the Senate Finance Committee, including stronger penalties on promoters of abusive

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[9] *Id.* at ¶ 16.

[10] In September 2004, the number of listed transactions was modified by the IRS and reduced to 30. See IRS Notice 2004–67 (9/23/04).

[11] 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 (9th 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.").

[12] See, e.g., *Gregory v. Helvering,* 293 U.S. 465 (1935); *Commissioner v. Transport Trading & Terminal Corp.,* 176 F.2d 570, 572 (2nd 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.").

[13] 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.").

[14] 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).

[15] See, e.g., *Gregory v. Helvering,* 293 U.S. 465 (1935); *Rice's Toyota World v. Commissioner,* 752 F.2d 89, 91–92 (4th 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 (11th 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.").

[16] Joint Committee on Taxation report at 7.

tax shelters.[17] Other tax shelter reforms, such as the codification of the economic substance and business purpose doctrines and stronger penalties on aiders and abettors of tax shelters, were not included in the final bill.

In December 2004, the Public Company Accounting Oversight Board (PCAOB) proposed rules to strengthen auditor independence and restrict the tax services that accounting firms may provide to their audit clients.[18] Among other provisions, the proposed rule would require any accounting firm that audits a publicly traded company to maintain strict independence from that company throughout the auditing engagement. The proposed rule would also bar such accounting firms from: (1) entering into a contingent fee arrangement with an audit client for tax services; (2) providing tax services to certain executives of an audit client; and (3) planning, marketing, or opining on aggressive tax positions with respect to an audit client, as further defined by the rule. The proposed rule would also require accounting firms, before providing any tax service to an audit client, to disclose detailed information about the tax service to the company's audit committee and obtain the committee's approval. This proposed rule, like the legislation enacted by Congress, represents a renewed effort to rein in abusive practices within the U.S. tax shelter industry.

## III. FINDINGS AND RECOMMENDATIONS

The Subcommittee's investigation to date has determined that in 2003, the U.S. tax shelter industry no longer focused solely on providing individualized tax advice but had expanded its focus to include generic "tax products" aggressively marketed to multiple clients. The investigation also found that numerous respected members of the American business community were heavily involved in the development, marketing, and implementation of generic tax products whose principal objective was to reduce or eliminate a client's U.S. tax liability. These tax shelters required close collaboration between accounting firms, law firms, investment advisory firms, and banks.

### A. FINDINGS

Based upon its investigation, the Subcommittee makes the following findings:

(1) The sale of potentially abusive and illegal tax shelters is a lucrative business in the United States, and some professional firms such as accounting firms, banks, law firms, and investment advisory firms have been major participants in the development, mass marketing, and implementation of generic tax products sold to multiple clients.

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[17] See Amendment No. 3120 to S. 1637. The Levin-Coleman bill, S. 2210, had advocated a penalty equal to 150% of the gross income derived, or to be derived, by a promoter, aider, or abettor of an abusive tax shelter. S. 1637, in contrast, had proposed a 50% penalty solely on promoters. The Levin-Coleman amendment compromised by increasing S. 1637's penalty to 100% of the gross income derived, or to be derived, by a promoter, aider or abettor of an abusive tax shelter. Unfortunately, the final bill approved by Congress, H.R. 4520, adopted only the lower 50% penalty and confined it to promoters, leaving the penalty for aiders and abettors still in need of reform.

[18] See PCAOB Release 2004–15 (12/14/04).

(2) During the period 1998 to 2003, KPMG devoted substantial resources and maintained an extensive infrastructure to produce a continuing supply of generic tax products to sell to clients, using a process which pressured its tax professionals to generate new ideas, move them quickly through the development process, and approve, at times, illegal or potentially abusive tax shelters.

(3) KPMG used aggressive marketing tactics to sell its generic tax products by turning tax professionals into tax product salespersons, pressuring its tax professionals to meet revenue targets, using telemarketing to find clients, developing an internal tax sales force, using confidential client tax data to find clients, targeting its own audit clients for sales pitches, and using tax opinion letters and insurance policies as marketing tools.

(4) KPMG was actively involved in implementing the tax shelters which it sold 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.

(5) KPMG took steps to conceal its tax shelter activities from tax authorities, including by claiming it was 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.

(6) Since Subcommittee hearings in 2003, KPMG has committed to cultural, structural, and institutional changes to dismantle its abusive tax shelter practice, including by dismantling its tax shelter development, marketing and sale resources, dismantling certain tax practice groups, making leadership changes, and strengthening tax services oversight and regulatory compliance.

(7) During the period 1998 to 2002, Ernst & Young sold generic tax products to multiple clients despite evidence that some, such as CDS and COBRA, were potentially abusive or illegal tax shelters.

(8) Ernst & Young has committed to cultural, structural, and institutional changes to dismantle its tax shelter practice, including by eliminating the tax practice group that promoted its tax shelter sales, making tax leadership changes, and strengthening its tax services oversight and regulatory compliance.

(9) During the period 1997 to 1999, PricewaterhouseCoopers sold generic tax products to multiple clients, despite evidence that some, such as FLIP, CDS, and BOSS, were potentially abusive or illegal tax shelters.

(10) PricewaterhouseCoopers has committed to cultural, structural, and institutional changes intended to dismantle its abusive tax shelter practice, including by establishing a centralized quality and risk management process, and strengthening its tax services oversight and regulatory compliance.

(11) Sidley Austin Brown & Wood, through its predecessor firm Brown & Wood, provided legal services that facilitated the development and sale of potentially abusive or illegal tax shelters, including by providing design assistance, collaboration on allegedly independent tax opinion letters, and hundreds of boilerplate tax opinion letters to clients referred by KPMG and others, in return for substantial fees.

(12) Sutherland Asbill & Brennan provided legal representation to over 100 former KPMG clients in tax shelter matters before the IRS, despite a longstanding business relationship with KPMG and without performing any conflict of interest analysis prior to undertaking these representations.

(13) Deutsche Bank, HVB Bank, and UBS Bank provided billions of dollars in lending critical to transactions which the banks knew were tax motivated, involved little or no credit risk, and facilitated potentially abusive or illegal tax shelters known as FLIP, OPIS, and BLIPS.

(14) First Union National Bank promoted to its clients generic tax products which had been designed by others, including potentially abusive or illegal tax shelters known as FLIP, BLIPS, and BOSS, by introducing and explaining these products to its clients, providing sample opinion letters, and introducing its clients to the promoters of the tax products, in return for substantial fees.

(15) Some investment advisors, including Presidio Advisory Services and the Quellos Group, helped develop, design, market, and execute potentially abusive or illegal tax shelters such as FLIP, OPIS, and BLIPS.

(16) Some charitable organizations, including the Los Angeles Department of Fire and Police Pensions and Austin Fire Fighters Relief and Retirement Fund, participated as counter parties in a highly questionable tax shelter known as SC2, which had been developed and promoted by KPMG, in return for substantial payments in the future.

## B. RECOMMENDATIONS

Based upon its investigation and the above factual findings, the Subcommittee makes the following recommendations:

(1) The Internal Revenue Service and the Department of Justice should continue enforcement efforts aimed at stopping accounting firms and law firms from aiding and abetting tax evasion, promoting potentially abusive or illegal tax shelters, and violating Federal tax shelter regulations, and

should impose substantial penalties on wrongdoers to punish and deter such misconduct.

(2) Congress should enact legislation to increase the civil penalties on aiders and abettors of tax evasion and promoters of potentially abusive or illegal tax shelters, to ensure that they disgorge not only all illicit proceeds from such activities, but also pay a substantial monetary fine to punish and deter such misconduct.

(3) Congress should appropriate additional funds to enable the IRS to hire more enforcement personnel and increase enforcement activities to stop the promotion of potentially abusive and illegal tax shelters by lawyers, accountants, and other financial professionals.

(4) Congress should enact legislation to clarify and strengthen the economic substance doctrine and to strengthen civil penalties on transactions with no economic substance or business purpose apart from their alleged tax benefits.

(5) Congress should enact legislation authorizing the IRS to disclose relevant tax shelter information to other Federal agencies, such as the Public Company Accounting Oversight Board, Federal bank regulators, and the Securities and Exchange Commission (SEC), to strengthen their efforts to stop the entities they oversee from aiding or abetting tax evasion or promoting potentially abusive or illegal tax shelters.

(6) The Public Company Accounting Oversight Board should strengthen and finalize proposed rules restricting certain accounting firms from providing aggressive tax services to their audit clients, charging companies a contingent fee for providing tax services, and using aggressive marketing efforts to promote generic tax products to potential clients.

(7) Federal bank regulators, in consultation with the IRS, should review tax shelter activities at major banks, and clarify and strengthen rules preventing banks from aiding or abetting tax evasion by third parties or promoting potentially abusive or illegal tax shelters.

(8) The SEC, in consultation with the IRS, should review tax shelter activities at investment advisory and securities firms it oversees, and clarify and strengthen rules preventing such firms from aiding or abetting tax evasion by third parties or promoting potentially abusive or illegal tax shelters.

(9) The IRS should further strengthen Federal tax practitioner rules issued under Circular 230 regarding the issuance of tax opinion letters to ensure that such practitioners, including law firms and accounting firms, have written procedures for issuing tax opinions, resolving internal disputes over legal issues addressed in such opinions, and preventing practitioners or their firms from aiding or abetting tax evasion by clients or promoting potentially abusive or illegal tax shelters.

(10) The IRS should review tax shelter activities at charitable organizations, and clarify and strengthen rules preventing such organizations from aiding or abetting tax evasion by third parties or promoting potentially abusive or illegal tax shelters.

## IV. EXECUTIVE SUMMARY

This report details the Subcommittee's investigation of the U.S. tax shelter industry. First, this report examines the development of mass-marketed generic tax products sold to multiple clients using prominent accounting firms, banks, lawyers, and investment firms. Second, as a result of the Subcommittee's investigation, this report describes the commitments made by the accounting firms examined during this investigation to end their involvement with abusive tax shelters.

The investigation found that by 2003, the U.S. tax shelter industry was 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 had moved from providing one-on-one tax advice in response to tax inquiries to also initiating, designing, and mass marketing tax shelter products.

Also, the investigation found that numerous respected members of the American business community had been heavily involved in the development, marketing, and implementation of generic tax products whose objective was not to achieve a specific business or economic purpose, but to reduce or eliminate a client's U.S. tax liability. By 2003, dubious tax shelter sales were no longer the province of shady, fly-by-night companies with limited resources. They had become 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.

This report focuses on generic tax products developed and promoted by KPMG, PricewaterhouseCoopers, and Ernst & Young, auditors and tax experts comprising three of the top four accounting firms in the United States. During the 1990's, in response in part to the stock market boom and the proliferation of stock options, these firms and others designed and developed tax products used to generate large paper losses that could be used to offset or shelter gains from taxation. Tax products examined by the Subcommittee include: KPMG's Bond Linked Issue Premium Structure (BLIPS), Foreign Leveraged Investment Program (FLIP), and Offshore Portfolio Investment Strategy (OPIS); PricewaterhouseCooper's Bond and Option Sales Strategy (BOSS); and Ernst & Young's Contingent Deferred Swap (CDS) tax product. Each of these products generated hundreds of millions of dollars in phony paper losses for taxpayers, using a series of complex, orchestrated transactions, structured finance, and investments with little or no profit potential. All of these tax products have been "listed" by the IRS as potentially abusive tax shelters.[19]

Additionally, the Subcommittee examined a fourth tax product, S-Corporation Charitable Contribution Strategy (SC2), developed by KPMG. SC2 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 was 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. Recently, the IRS listed SC2 as a potentially abusive tax shelter.[20]

As a result of the Subcommittee's hearings and investigation, each accounting firm has committed to cultural, structural, and institutional reforms and changes to end the promotion, development, implementation, and offering of mass-marketed abusive tax shelters. KPMG informed the Subcommittee that the firm has dismantled its development, marketing, and sales infrastructure used for offering mass-marketed tax shelters. In addition, KPMG indicated that it has dismantled various tax practice groups, made leadership changes, and strengthened oversight and compliance. KPMG indicated that these changes reflect a firm-wide commitment to attain the highest degree of trust from the firm's clients, regulators, and the public at large. Similarly, Ernst & Young told the Subcommittee that the firm has instituted new oversight and leadership changes, IRS compliance and monitoring systems, and firm-wide policies to ensure the highest standards of professionalism. Lastly, PricewaterhouseCoopers told the Subcommittee that the firm has instituted new leadership positions, and a centralized product development process to monitor all tax services to ensure that mass-marketed abusive tax shelters would not be marketed by the firm in the future.

The investigation also examined a number of professional firms that assisted in the development, marketing, and implementation of tax shelters promoted by the three accounting firms. Leading banks, including Deutsche Bank, HVB, and UBS, provided multi-billion dollar credit lines essential to the orchestrated transactions. Wachovia Bank, acting through First Union National Bank, made client referrals to KPMG and PricewaterhouseCoopers, playing a key role in facilitating the marketing of potentially abusive or illegal tax shelters. Leading law firms, such as Brown & Wood, which later merged with another firm to become Sidley Austin Brown & Wood, provided favorable tax opinions on these tax shelters, advising that they were permissible under the law. The evidence also suggests collaboration between Sidley Austin Brown & Wood and KPMG on the OPIS and BLIPS tax shelters, including the issuance

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[19] 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). PricewaterhouseCooper's BOSS transaction is covered by IRS Notice 1999–59 (1999–52 IRB 761) (12/27/99). Ernst & Young's CDS transaction is covered by IRS Notice 2002–35 (2002–21 IRB 992) (5/28/02).

[20] See IRS Notice 2004–30 (4/1/04).

of allegedly independent opinion letters on BLIPS containing numerous virtually identical paragraphs. Two investment advisory firms, Presidio Advisory Services and Quellos Group, formerly doing business as Quadra Capital Management LLP and QA Investments LLC, assisted in the design, development, marketing, and implementation of tax shelters promoted by KPMG. Additionally, Quellos served as the investment advisor for PricewaterhouseCooper's version of FLIP.

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.

## V. ROLE OF ACCOUNTANTS

The Subcommittee's investigation of the U.S. tax shelter industry found that leading U.S. accounting firms were focused on developing generic "tax products" aggressively marketed to multiple clients from the late 1990's to as late as 2003, despite increasing IRS enforcement efforts to halt the tax shelters they were promoting. Accounting firms were devoting substantial resources to develop, market, and implement tax shelters, costing the Treasury billions of dollars in lost tax revenues.[21] To illustrate the problems, the Subcommittee developed case histories focused on tax shelters promoted by KPMG, PricewaterhouseCoopers, and Ernst & Young. The investigation also uncovered evidence that these firms took steps to conceal their tax shelter activities from tax authorities and the public, including by failing to register potentially abusive tax shelters with the IRS.

### A. KPMG

The Subcommittee conducted its most detailed examination of four potentially abusive or illegal tax shelters that were developed, marketed, and implemented by KPMG. KPMG International is one of the largest public accounting firms in the world, with over 700 offices in 152 countries.[22] In 2002, it employed over 100,000 people and had worldwide revenues of $10.7 billion. KPMG International, 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.

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[21] According to the General Accounting Office, a recent IRS consultant estimated that for the 6-year period, 1993–1999, the IRS lost on average between $11 and $15 billion each year from abusive tax shelters. See GA0–04–104T, at 3 (2003). GAO estimates potential tax losses of about $33 billion from transactions listed by the IRS as potentially abusive, and another $52 billion from non-listed abusive transactions, for a combined total of $85 billion. *Id.* at 10.

[22] 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.) (1/29/03).

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 has generated more than $1.2 billion in annual revenues for the firm. These revenues have been increasing rapidly in recent years, including a 45% cumulative increase over 4 years, from 1998 to 2001.[23] The Tax Services Practice is headquartered in New York, has 122 U.S. offices, and maintains additional offices around the world. The head of the Tax Service during the period of the investigation was Vice Chairman for Tax, Richard Smith, Jr.

The Tax Services Practice has over two dozen subdivisions, offices, "practices," or "groups" which over the years have changed missions and personnel. Many played key roles in developing, marketing, or implementing KPMG's generic tax products, including the four KPMG products featured in this Report. One key group is the Washington National Tax (WNT) Practice which provides technical tax expertise to the entire KPMG firm. During the course of the Subcommittee's investigation, a WNT subgroup, the Tax Innovation Center, led 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 focused on selling "tax-advantaged" products to high net worth individuals and large corporations.[24] Through a subdivision known as the Capital Transaction Services (CaTS) Practice, later renamed the Innovative Strategies Practice, PFP led KPMG's efforts on FLIP, OPIS, and BLIPS.[25] KPMG's Stratecon Practice, which focused on "business based" tax planning and tax products, led the firm's efforts on SC2. Innovative Strategies and Stratecon were later disbanded, and their tax professionals assigned to other groups.[26] The Tax Innovation Center was apparently closed in 2003.

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 1990's, when it made a formal decision to begin devoting substantial resources 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, and, in part, due to new tax leadership that was enthusiastic about increasing tax product sales. One senior KPMG tax professional told the Subcommittee staff that some KPMG part-

[23] 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 4-year period, from 1998 gross revenues of $830 million to 2001 gross revenues of $1.24 billion.

[24] Minutes dated 11/30/00, Monetization Solutions Task Force Teleconference, Bates KPMG 0050624–29, at 50625.

[25] Document dated 5/18/01, "PFP Practice Reorganization Innovative Strategies Business Plan—DRAFT," Bates KPMG 0050620–23, at 50621.

[26] KPMG told the Subcommittee that both groups were disbanded over time in 2002; it is unclear exactly when each ceased to function.

ners considered it "important" for the firm to become an industry leader in producing generic tax products.

### (1) Developing New Tax Products

**Finding: During the period 1998 to 2003, KPMG devoted substantial resources and maintained an extensive infrastructure to produce a continuing supply of generic tax products to sell to clients, using a process which pressured its tax professionals to generate new ideas, move them quickly through the development process, and approve, at times, illegal or potentially abusive tax shelters.**

During the investigation, KPMG preferred to describe itself as a tax advisor that responded to client inquiries seeking tax planning services to structure legitimate business transactions in a tax efficient way. The Subcommittee investigation determined, however, that KPMG had also developed and supported an extensive internal infrastructure of offices, programs, and procedures designed to churn out a continuing supply of new generic tax products, unsolicited by a specific client, for mass marketing to multiple clients.

**Drive to Produce New Tax Products.** In 1997, KPMG established the Tax Innovation Center whose sole mission was to push the development of new KPMG tax products. Located within the Washington National Tax (WNT) Practice, the Center was staffed with about a dozen full-time employees and assisted by others who worked 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."[27]

Essentially, the Tax Innovation Center encouraged KPMG tax professionals to propose new tax product ideas and then provided administrative support to develop the proposals into approved tax products and move them into the marketing stage. As part of this effort, the Center maintained a "Tax Services Idea Bank" which it used to drive and track new tax product ideas. The Center asked 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 product would work and who would be interested in buying it.[28]

In recent years, the Center 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."[29] On May 30, 2001, the Center reported on the Tax Services' progress in meeting this goal as part of a larger Powerpoint 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

[27] "Tax Innovation Center Overview," Solution Development Process Manual (4/7/01), prepared by the KPMG Tax Innovation Center (hereinafter "TIC Manual"), at i.

[28] "TIC Solution Development Process," TIC Manual at 6.

[29] KPMG presentation dated 5/30/01, "Tax Innovation Center Solution and Idea Development—Year-End Results," Bates XX 001755–56, at 1754.

chart showed 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.

**Development and Approval Process.** Once ideas were deposited into the Tax Services Idea Bank, KPMG 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 was described in its Tax Services Manual and Tax Innovation Center Manual.[30] Essentially, the process consisted of three stages, each of which could overlap with another. In the first stage, the new tax idea underwent an initial screening "for technical and revenue potential."[31] This initial analysis was supposed to be provided by a "Tax Lab" which was a formal meeting, arranged by the Tax Innovation Center, of six or more KPMG tax experts specializing in the tax issues or industry affected by the proposed product.[32] Promising proposals were 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 and later succeeded by Andrew Atkin.

If a proposal survived the initial screening, in the second stage it underwent a thorough review by the Washington National Tax Practice ("WNT review"), which was responsible for determining whether the product met the technical requirements of existing tax law.[33] WNT personnel often spent significant time identifying and searching for ways to resolve problems with how the proposed product was structured or was intended to be implemented. The WNT review also included analysis of the product by the WNT Tax Controversy Services group "to address tax shelter regulations issues."[34] WNT was required to "sign-off" on the technical merits of the proposal before it was approved for sale to clients.

In the third and final stage, the product underwent review and approval by the Department of Practice and Professionalism ("DPP review"). The DPP review had to determine that the product not only complied with the law, but also met KPMG's standards for

[30] KPMG Tax Services Manual, § 24.1 to 24.7.

[31] TIC Manual at 5.

[32] 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.

[33] 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).

[34] KPMG Tax Services Manual, § 24.4.1, at 24–2.

"risk management and professional practice."[35] This latter review included 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 were to be structured, whether auditor independence issues needed to be addressed, and the potential impact of a proposed tax product on the firm's reputation.[36]

The KPMG development and approval process was 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 stated 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."[37] KPMG defines "more likely than not" as a "greater than 50 percent probability of success if [a tax product is] challenged by the IRS."[38] 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.[39] In addition, to "launch" the new product within KPMG, the Tax Innovation Center was supposed to prepare a "Tax Solution Alert" which served "as the official notification" that the tax product was available for sale to clients.[40] This Alert was 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. 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.

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[35] *Id.*, § 24.5.2, at 24–3.

[36] Subcommittee interview of Lawrence DeLap (10/30/03). The Subcommittee staff was told that, since 1997, DPP-Tax had very limited resources to conduct its new product reviews. Until 2002, for example, DPP-Tax had a total of less than 10 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, had well over 100 employees.

[37] KPMG Tax Services Manual, § 24.5.2, at 24–3.

[38] *Id.*, § 41.19.1, at 41–10.

[39] *Id.*, § 24.4.2, at 24–2. See also TIC Manual at 10.

[40] TIC Manual at 10.

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.[41] 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."[42] 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 tax products examined by the Subcommittee.

**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 process worked. 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.[43] 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, and Presidio Advisory Services, an investment advisory firm run by two former KPMG tax professionals. Key documents written 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 profes-

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[41] KPMG Tax Services Manual, §41.17.1, at 41–8.

[42] *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.

[43] IRS Notice 2000–44 (2000–36 IRB 255) (9/5/00).

sionals 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,"[44] 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.[45]

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 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."[46]

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.[47] 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."[48] 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 2 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 2 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

[44] Email dated 2/9/99, from Jeffrey Eischeid to John Lanning, Doug Ammerman, Mark Watson, and Larry DeLap, "BLIPS," Bates MTW 0001.

[45] 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.")

[46] Email dated 2/15/99, from Mark Watson to multiple KPMG tax professionals, "BLIPS Progress Report," Bates MTW 0004.

[47] "Meeting Summary" for meeting held on 2/19/99, Bates MTW 0009.

[48] Subcommittee interview of Mark Watson (11/4/03).

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);
> >
> > 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.[49]

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."[50] 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.[51]

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

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[49] Email dated 5/4/99, from Mark Watson to Larry DeLap, Bates KPMG 0011916.

[50] Email dated 5/5/99, from Larry DeLap to Mark Watson, Bates KPMG 0011916.

[51] 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 MTW 0024; email dated 4/26/99, from Steven Rosenthal to Larry DeLap, "RE: BLIPS Analysis," Bates MTW 0026; email dated 5/7/99, from Steven Rosenthal to multiple KPMG professionals, "Who Is the Borrower in the BLIPS transaction," Bates MTW 0028; email dated 8/19/99, from Steven Rosenthal to Mark Watson, Bates SMR 0045.

PFP technical partner in WNT believes it should not be approved."[52]

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 6 months into this process) our chief WNT PFP technical 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???"[53]

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."[54]

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?[55]

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. . . .

[52] Email dated 5/7/99, from Larry DeLap to three 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.

[53] Email dated 5/8/99, from John Lanning to four KPMG tax professionals, Bates KPMG 0011905.

[54] Email exchange dated 5/9/99, between Richard Smith and Steven Rosenthal, Bates SMR 0025 and SMR 0027.

[55] Email dated 5/10/99, from Philip Wiesner to multiple WNT tax professionals, Bates MTW 0031.

> [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 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.[56]

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."[57]

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.[58]

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

[56] Email dated 5/10/99, from Philip Wiesner to John Lanning and eight 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 MTW 0036 ("you've framed the issues well").

[57] Email dated 5/10/99, from Jeffrey Stein to Philip Wiesner and others, Bates KPMG 0011903.

[58] Email dated 5/10/99, from Mark Watson to John Lanning and others, "FW: BLIPS," Bates MTW 0039 (emphasis in original).

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 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." [59]

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." [60]

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.[61]

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.[62] 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 prod-

[59] Email dated 5/10/99, from Philip Wiesner to multiple KPMG tax professionals, Bates KPMG 0009344.

[60] Email dated 5/11/99, from Mark Watson, WNT, to Lawrence DeLap, Bates KPMG 0011911.

[61] Subcommittee interview of Lawrence DeLap (10/30/03).

[62] *Id.*

uct contradicted the DPP head's normal practice of requiring written product approvals.[63]

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 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, 2 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 7-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."[64] His superiors indicated that they were.

[63] Subcommittee interview of Mark Watson (11/4/03).

[64] Email dated 7/22/99, from Mark Watson to Richard Smith and Phil Wiesner, Bates MTW 0078.

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.
>
> 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.[65]

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.[66]

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

About 6 months after BLIPS tax products had begun to be sold to clients, an effort was begun within KPMG to design a modified "BLIPS 2000."[67] 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.[68]

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[65] Email dated 8/4/99, from Mark Watson to David Brockway, Mark Springer and Douglas Ammerman, Bates SMR 0039.

[66] *Id.*

[67] 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 urging the analysis of the new product "so we can take this to market. Your attention over the next few days would be most appreciated.").

[68] 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

Continued

When asked by Subcommittee staff whether he had ever personally concluded that BLIPS met 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.[69] A BLIPS Powerpoint 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." [70] In response to an email on BLIPS stating that the firm would provide a more likely than not opinion, indicating a greater than 50 percent chance of success on the merits, one KPMG tax professional who refused to sell BLIPS to his clients wrote "[j]ust so we are clear, I personally view it no greater than 15%." [71]

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." [72] The IRS' disallowance of BLIPS has not yet been tested in court. Rather than defend BLIPS in court, however, 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, [73] 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.[74] 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

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Brockway, "Talking points on significant tax issues for BLIPS 2000," Bates SMR 0117–21 (identifying numerous problems with BLIPS).

[69] Subcommittee interview of Lawrence DeLap (10/30/03).

[70] Powerpoint 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.

[71] Email dated 5/5/99, from William Goldberg to Paul Kearns, "RE: BLIPs," Bates KPMG 0028162.

[72] IRS Notice 2000–44 (2000–36 IRB 255) (9/5/00) at 255.

[73] See document dated 5/18/01, "PFP Practice Reorganization Innovative Strategies Business Plan—DRAFT," Bates KPMG 0050620–23, at 50621.

[74] Memorandum dated 2/23/98, from Robert Simon to Gregg Ritchie, Randy Bickham, and John Harris, concerning OPIS, Bates KPMG 0010729.

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 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 3rd 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.[75] 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 6 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

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[75] 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.

warrant." The email states: "In kicking the 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 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[ed] 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.[76] The IRS has since audited and penalized numerous taxpayers for using these illegal tax shelters.[77]

**SC2 Development and Approval Process.** The Subcommittee investigation also obtained documentation establishing KPMG's awareness of flaws in the technical merits of SC2.

Documents preceding 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, 1 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 white-paper as soon as possible. . . ." [78]

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 strategy. . . . It is essential that such risk discussion memorandum (attached) be provided to each client contemplating entering into an SC2 engagement.[79]

The referenced memorandum, required to be given to all SC2 clients, identifies a number of risks associated with the tax product,

[76] IRS Notice 2001–45 (2001–33 IRB 129) (8/13/01).

[77] See "Settlement Initiative for Section 302/318 Basis-Shifting Transactions," IRS Announcement 2002–97 (2002–43 IRB 757) (10/28/02).

[78] Email dated 3/13/00, from Phillip Galbreath to Richard Bailine, "FW: S-CAEPS," Bates KPMG 0046889.

[79] 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.

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.[80]

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.[81] 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.[82] KPMG tax professionals identified other technical problems as well involving assignment of income, reliance on tax indifferent parties, and valuation issues.[83]

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

[80] Undated KPMG document entitled, "S Corporation Charitable Contribution Strategy[:] Summary of Certain Risks," marked "*PRIVATE AND CONFIDENTIAL*," Bates KPMG 0049987–88.

[81] See, e.g., email dated 3/13/00, from Richard Bailene to Phillip Galbreath, "S-CAEPS," Bates KPMG 0015744.

[82] 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.

[83] 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).

> 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.[84]

At the Subcommittee hearings in November 2003, Lawrence E. Manth, KPMG's designated National Product Champion for SC2 and the tax professional primarily responsible for its creation and development, read a statement defending the tax product and claiming that SC2 was "consistent with the law."[85] Certain statements made by Mr. Manth under oath, however, regarding two critical elements of SC2 are directly contradicted by KPMG documents, information from SC2 participants, and the actual implementation history of some SC2 transactions.

The first element involves distributions of income by an S Corporation during the period in which most of its stock is being held by a tax exempt organization. This issue is important, because it provides evidence relevant to determining the true nature of the SC2 transaction. If distributions of income were limited or suspended while a tax exempt entity held most of the S Corporation stock (and was therefore entitled to most of the distributions), questions necessarily arise as to whether the stock "donation" was a genuine transfer of ownership to the tax exempt entity or a mere ploy to defer taxation on retained corporate income until the original owner of the stock redeems the shares a few years later.

As part of his testimony before the Subcommittee, Mr. Manth made the following statement regarding the limitation or suspension of distributions by S Corporations implementing an SC2 transaction:

> Some articles reported that S Corporations that implemented SC2 passed resolutions to limit or suspend dividends or other distributions to shareholders, basically to keep the charity from getting any share of earnings. So far as I know, a resolution limiting or suspending distributions was not an element of SC2. In fact, KPMG recommended that S Corporations make distributions during the period tax-exempts held their stock.[86]

Yet, in March 2000, when a KPMG colleague characterized the SC2 transaction as "nothing more that a[n] old give stock to charity and then redeem it play," Mr. Manth responded:

> Yes, very similar, but during the time the tax exempt owns the stock it will be allocated 90% of the income, be paid no distributions, and be redeemed for a small value.[87]

In an e-mail written on April 11, 2000, Larry DeLap, head of KPMG's Department of Professional Practice for Tax, provided the following description of the SC2 transaction:

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[84] Email dated 12/20/01, from William Kelliher to David Brockway, "FW: SC2," Bates, KPMG 0012723.

[85] See Manth testimony at the Subcommittee Hearings (11/18/03), at 34–35.

[86] *Id.*, at 35.

[87] Email dated 3/13/00, between Mr. Manth, Richard Baline, and other KPMG tax personnel, "RE: S-CAEPS," Bates KPMG 0015738–0015747, reprinted in the Subcommittee Hearings as Hearing Exhibit 49, at 574–83.

> The strategy involves the transfer of a substantial portion of S Corporation stock to a section 401(a) governmental pension plan, with the intention that such stock be redeemed from the pension plan after about 2 years. The intent is that most of the earnings of the S Corporation would be allocated to the pension plan during the period it owns the S Corporation stock, but relatively little of the earnings would be distributed during that period.[88]

On February 22, 2001, James Councill Leak, a tax professional at KPMG who worked on the sale of the SC2 tax product, sent an email to a large number of KPMG employees and included this description of the SC2 product.

> SC2 is designed to allow an S Corp shareholder to obtain a charitable deduction for a gift of non-voting stock to a qualified tax exempt entity. After the gift, the tax exempt will be allocated a significant portion of the S Corp taxable income. The S Corp will curtail cash distributions that would otherwise have been made to fund quarterly tax obligations. The cash will build up inside the S Corp and can be used for any corporate purpose. After 2 or 3 years, the tax exempt has the right to "put" the stock back to the S Corp for redemption. After redeeming the shares, the S Corp can resume making cash distributions. The end result is a deferral of income tax and the ultimate conversion from ordinary to capital gain tax rates on S Corp income.

Mr. Manth sent the following response to Mr. Leak's memo:

> Great e-mail, Councill!! Andrew [Atkin], you may consider sending this to other regions.[89]

In the spring of 2000, KPMG produced a packet of information describing the SC2 product, its implementation, and how to address questions raised by potential customers. Mr. Leak advised the Subcommittee that this was the packet of information used to train KPMG tax professionals who were going to sell the SC2 product, and that Mr. Manth and other KPMG employees conducted the training session. Mr. Manth informed the Subcommittee that he had a role in the development of the information packet. The packet includes a Powerpoint presentation on how the SC2 transaction works, and one of the pages in this presentation states: "For valid business purposes, the S-corporation will decrease its cash distributions during the tax-exempt shareholder's stock ownership."[90]

Also included in the packet is a section entitled: *"SC2 IMPLEMENTATION PROCESS,"* which states the following:

> c. Corporate issues—we need to review copies of Articles of Incorporation, By Laws and any shareholder agreements. Make sure that there are no provisions in any corporate documents:

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[88] Email dated 4/11/00, from Larry DeLap to KPMG's Tax Professional Practice partners, "S-Corporation Charitable Contribution Strategy (SC2)," Bates KPMG 0015631, reprinted in the Subcommittee Hearings as Hearing Exhibit 50 at 584.

[89] Series of emails dated 3/05/2001, between Mr. Manth, Mr. Leak, and others, "RE: SC2 Solution—New Development," Bates KPMG 0048251–54, reprinted in the Subcommittee Hearings as Hearing Exhibit 96 x.

[90] "SC2—Meeting Agenda June 19th, 2000," Bates KPMG 0013375–96, at KPMG 0013383, reprinted in the Subcommittee Hearings as Hearing Exhibit 21.

> i. requiring the Corporation to make dividends (e.g. to pay taxes);
>
> ii. allowing the corporation or other shareholders to redeem stock; or
>
> iii. giving shareholders indemnification for any actions;
>
> If any of these provisions exist, we will probably need to delete or alter them before the contribution.[91]

An addendum to the KPMG "White Paper" description and analysis of the SC2 product contains similar passages:

> (1) Distribution requirements. Are there any provisions in the by-laws, articles of incorporation, shareholders' agreements or elsewhere that mandates that the company make a distribution to pay the shareholders' taxes? If so, these provisions should be deleted prior to implementation. . . .
>
> (3) The issuance of notes may also be beneficial where the shareholders are dependent on distributions for their primary source of income. During the transaction period, distributions normally are not made. Therefore, if the shareholders will need cash from the corporation during the transaction period, a note should be distributed prior to the transaction.[92]

KPMG prepared packets containing boilerplate legal documents that could be provided to S Corporations planning to implement the SC2 transaction. One such packet included sample Board and Shareholder resolutions supporting the amendment of the shareholders agreement to provide that the S Corporation was not obligated to make distributions to shareholders for the payment of income tax due with respect to their S Corporation shares.[93]

Finally, as explained later in this Report, most of the SC2 transactions reviewed by the Subcommittee did not, in fact, include any distributions of income to the tax exempt entity holding the S Corporation stock.[94] For example, the Los Angeles Department of Fire and Police Pensions, which engaged in 28 SC2 transactions, told the Subcommittee that only nine, or less than one-third of the S Corporations in which it held stock, actually paid any distributions of income while it held the stock. Two-thirds of the S Corporations made no distributions to the pension fund at all.

In short, KPMG documents and communications, some of which were authored by or included Mr. Manth, as well as the actual SC2 transactions examined by the Subcommittee, contradict Mr. Manth's testimony that a resolution limiting or suspending dis-

[91] *Id.*, at KPMG 0013385.

[92] "*SC2 Outline*" and "SC2 White Paper," Bates 0013397–447, at KPMG 0013430 and 38, reprinted in the Subcommittee Hearings as Hearing Exhibit 96 b. The addendum also states:

> "WNT [Washington National Tax, the KPMG group that reviewed the technical aspects of SC2] thinks payment of dividends would reduce the taxpayers' level of risk by making it more difficult for the IRS to successfully argue that the taxpayer has retained beneficial ownership of the stock contributed to the exempt pension fund. WNT thinks it would also bolster the taxpayers' 'economic substance' argument. Although the payment of dividends to the exempt pension fund would be an additional cost to the taxpayer, that cost would provide a corresponding benefit in the event of an examination challenge."

*Id.*, at KPMG 0013444. This advice was not, however, followed in most of the SC2 transactions reviewed by the Subcommittee.

[93] See sample documents, Bates KPMG 0015569–89, at KPMG 0015572–74, reprinted in the Subcommittee Hearings as Hearing Exhibit 96 l.

[94] For more information, see Section IX(A) of this Report.

tributions was not an element of SC2. Given his active involvement in the development, sale, and implementation of the SC2 product, Mr. Manth should have known that his testimony on this matter was not accurate.

A second issue of concern involves Mr. Manth's testimony at the Subcommittee hearings in November 2003, regarding the role of warrants in the SC2 transactions. In every SC2 transaction examined by the Subcommittee, the transfer of S Corporation shares to a tax exempt entity was preceded by the creation and distribution to the existing S Corporation shareholders of thousands of warrants, enabling these shareholders to purchase additional S Corporation shares. If exercised, these warrants would give the holders additional shares representing 85% to 90% of the S Corporation's entire stock, and significantly dilute the percentage and value of the shares held by the tax exempt, as well as the percentage of distributions to which the tax exempt entity would have been entitled. If these warrants were used as a means to ensure that the tax exempt entity would re-sell the S Corporation shares to the original owner, as planned in the SC2 transaction, this tactic would provide evidence that the original owner had no real intent to donate the S Corporation shares to the tax exempt entity, but only to temporarily shift the shares to a tax exempt entity, thereby deferring and mitigating the tax liability of the original, and subsequent, owner of the shares.

Regarding the intended use of warrants in the SC2 transactions, Mr. Manth testified at the Subcommittee hearings as follows:

> I have also read descriptions that say that should the charity decide not to sell its stock, other S Corporation shareholders can exercise warrants for additional shares of stock, thereby making the charity's share much less valuable. Actually, just the opposite would happen. An S Corporation shareholder who wanted to exercise the warrants would have to come up with a substantial amount of money to pay for the new stock. That money would be paid into the S Corporation and raise its market value. This would reduce the charity's percentage ownership share, but the charity would end up owning a smaller percentage of a much more valuable company. In other words, owning 10 percent of $1 million is a lot better than owning 90 percent of $100,000.[95]

Again, internal KPMG documents and communications contradict this statement. For example, the SC2 information packet produced by KPMG in the spring of 2000, which was used to train KPMG tax professionals planning to sell the SC2 product, contained a section entitled: "*SC*[2]*—Appropriate Answers for Frequently Asked Shareholder Questions.*" Question 1 reads as follows:

> Q1: What happens if the tax-exempt ("TE") does not want to redeem the stock to the S-corp?
>
> A1: First, the longer the TE owns the stock, the more benefit the company will receive (assuming the company continues to make money). Secondly, the TE would have no reason not to sell the stock back, since the company is really its only source

[95] Manth testimony at the Subcommittee Hearings (11/18/03), at 34–35.

> of liquidity (nobody will want the stock). Third, the only reason for the TE to accept the stock is to get cash. Also, the TE knows the deal prior to accepting the stock. It signs a redemption agreement that discloses the warrants as well as the fact that no distributions are required to be made.
>
> However, if we assume the TE gets a new board, and the board wants to hold the company "hostage," the shareholders can exercise their warrants that can dilute the TE to less than 10%.[96]

A similar message is contained in an addendum to the KPMG White Paper on SC2. One part of this addendum addresses a number of implementation issues. A section entitled "Frequently Asked Questions" contains the following:

> (ii) What if the tax-exempt won't redeem?
>
> (1) The tax-exempt has no reason to hold onto the stock after the redemption period. First, it has no vote to authorize a distribution. Secondly, the market for it to sell the stock is severely limited because most holders of this stock would incur more tax liability than the stock is worth. In addition, the stock has limited appreciation potential. Therefore, the tax-exempt has nothing to gain by holding the stock beyond the redemption period.
>
> (2) Still, if tax-exempt won't redeem, exercising the warrants will immediately dilute the tax-exempt's interest."[97]

These documents show that the warrants were characterized internally at KPMG and to potential clients as a tool which could be used, if necessary, to dilute a tax exempt entity's interest in, and corresponding claim on, distributions from the S Corporation. The documents also show that KPMG viewed the possibility of the warrants being exercised to dilute the tax exempt's holdings as a way, not only to ensure that the tax exempt entity would resell its shares to the S Corporation shareholders, but also prevent the tax exempt from threatening to retain the stock in order to extract large payments or a greater buyout price from the S-corporation shareholders. These documents present a very different picture from the one provided by Mr. Manth at the Subcommittee hearings. Given his active involvement in the development, sale, and implementation of the SC2 product, Mr. Manth should have known that his testimony on this matter was not accurate.

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 were approved for sale and made their way to market.

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[96] "SC2—Meeting Agenda June 19th, 2000," Bates KPMG 0013375–96, at KPMG 0013389, reprinted in the Subcommittee Hearings as Hearing Exhibit 21.

[97] *"SC2 Outline"* and SC2 White Paper, Bates KPMG 0013446–47, reprinted in the Subcommittee Hearings as Hearing Exhibit 96 b.

### (2) Mass Marketing Tax Products

**Finding: KPMG used aggressive marketing tactics to sell its generic tax products by turning tax professionals into tax product salespersons, pressuring its tax professionals to meet revenue targets, using telemarketing to find clients, developing an internal tax sales force, using confidential client tax data to find clients, targeting its own audit clients for sales pitches, and using tax opinion letters and insurance policies as marketing tools.**

One of the more striking aspects of the Subcommittee investigation was its discovery of the substantial efforts KPMG had expended to market its tax products, including extensive efforts to target clients and, at times, use high-pressure sales tactics. Evidence 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 was launched within the firm, the "Tax Solution Alert" was 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 designated one or more persons to lead the marketing effort for a new tax product. These persons were referred to as the product's "National Deployment Champions," "National Product Champions," or "Deployment Leaders." With regard to the tax products 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 were given significant institutional support to market their assigned tax product. For example, KPMG maintained a national marketing office that included marketing professionals and resources "dedicated to tax." [98] Champions could 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.[99] These indi-

[98] KPMG Tax Services Manual, § 2.21.1, at 2–14.
[99] *Id.*

viduals became members of the product's official "deployment team."

Champions could also draw on a Tax Services group skilled in marketing research to identify prospective clients and develop target client lists. This group was known as the Tax Services Marketing and Research Support group. Champions could also make use of a KPMG "cold call center" in Indiana. This center was 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 products offered by the firm. These telemarketers could and, at times did, make cold calls to sell specific tax shelters such as SC2.[100]

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. . . .
>
> 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.[101]

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[100] 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.

[101] Email dated 8/6/00 from Jeffrey Stein to 15 National Deployment Champions, Bates KPMG 050016. The Opportunity Management System (OMS) is a software system that KPMG tax professionals have used to monitor with precision who has been contacted about a particular tax

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.[102]

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

Documentation obtained by the Subcommittee shows that National Deployment Champions and senior KPMG tax officials expended significant effort to convince KPMG personnel to devote time and resources to selling new products. Senior tax professionals used general exhortations as well as 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 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!! [103]

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

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.

[102] Email dated 3/14/02, from Rick Rosenthal and other KPMG professionals, to "US Management Group," Bates XX 001730–32 (emphasis in original).

[103] Email dated 2/18/00, from Richard Rosenthal to multiple KPMG tax professionals, Bates KPMG 0049236. 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. See email dated 4/21/00, from Michael Terracina, KPMG office in Houston, to Gary Choate, KPMG office in Dallas, Bates KPMG 0048191.

pressured their colleagues to increase SC2 sales.[104] 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.[105] For example, a member of the SC2 deployment team, who also worked for Stratecon, sent an email to a 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:

> 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.[106]

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.[107] 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 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.[108] KPMG's Tax Innovation Center conducted a specific campaign requiring KPMG tax professionals to

[104] 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.

[105] See e.g., email dated 12/2/00, from Lawrence Manth to multiple tax professionals, Bates XX 000021.

[106] Email dated 2/22/01, from Councill Leak to multiple tax professionals, Bates KPMG 0050822–23.

[107] Email dated 2/3/00, from Philip Wiesner to US-WNT Tax Partners, Bates KPMG 0050888–90.

[108] Presentation entitled, "KMatch Push Feature Campaign," undated, prepared by Marsha Peters of the Tax Innovation Center, Bates XX 001511.

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.[109] 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.[110]

The evidence indicates that KPMG also used 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 are those requiring the combined participation of both KPMG tax and assurance professionals to market specified tax products.

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.[111] 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."[112] Internal KPMG documentation states that the purpose of the new product was "[t]o increase KPMG's market penetration of key clients and targets by enhancing the linkage between Assurance and Tax professionals."[113] Another KPMG document states: "Teaming with Assurance expands tax team's knowledge of client and industry[.] Demonstrates unified team approach that separates KPMG from competitors."[114] 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.[115]

[109] 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).

[110] *Id.*

[111] 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.

[112] Presentation dated 10/30/00, "Intellectual Property Services (IPS)," by Dut LeBlanc of Shreveport and Joe Zier of Silicon Valley, Bates XX 001580–94.

[113] 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.

[114] Presentation dated 10/30/00, "Intellectual Property Services (IPS)," by Dut LeBlanc of Shreveport and Joe Zier of Silicon Valley, Bates XX 001580–94.

[115] 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.

Additional tax products which relied in part on KPMG audit partners followed. In 2002, for example, KPMG launched a "New Enterprises Tax Suite" product[116] 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."[117]

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 champions will coordinate with and involve assurance partners and managers in their respective areas."[118]

In addition to electronic searches, National Deployment Champions regularly exhorted KPMG field personnel to review KPMG client lists personally to identify clients 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?[119]

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 an arrangement KPMG entered into with First Union National Bank,

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[116] 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.

[117] 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").

[118] 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.

[119] Email dated 2/9/01, from Ty Jordan to multiple KPMG tax professionals, "SC2 revisit of stale leads," Bates KPMG 0050814.

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.[120] 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.[121] In the case of SC2, KPMG also worked with a variety of other outside parties, such as mid-sized accounting firms and automobile dealers, to locate and refer potential clients.[122] 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."[123]

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.[124] It obtained these lists from either state governments, 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.[125] Some of the lists had large blocks of S Corporations associated with automobile or truck dealers, real estate firms, home builders, or architects.[126] In some instances, KPMG tax professionals instructed KPMG telemarketers to contact the corporations to gauge interest

[120] Subcommittee interview of Wachovia Bank representatives (3/25/03).

[121] See, e.g., Memorandum dated 9/3/99, from Karen Chovan, Financial Advisory Services to CMG Risk Review Oversight Committee, "Meeting Minutes of September 1 . . .," Bates SEN–008629–31 ("Senior PFC Advisor and CMG Risk Review Subcommittee ('subcommittee or SC') member Tom Newman presented an overview of an enhanced investment strategy for OC vote to be able to present it to selected First Union clients. KPMG brought the BLIPS strategy (referred hereafter as the 'Alpha' strategy) to First Union. . . ."); 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 V(A)(5) of this Report for more information on the auditor independence issue.

[122] 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).

[123] Memorandum dated 2/16/01, from Andrew Atkin to SC2 Marketing Group, "Agenda from Feb 16th call and goals for next two weeks," Bates KPMG 0051135.

[124] 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 16th 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).

[125] 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).

[126] Email dated 11/17/00, from Jonathan Pullano to US-Southwest Tax Services Partners and others, "FW: SW SC2 Channel Conflict," Bates KPMG 0048309.

in SC2.[127] 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,[128] but almost as soon as the no-call policy was 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.[129] 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."[130]

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.[131] 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.[132]

**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.

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[127] 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.

[128] See email dated 4/22/01, from John Schrier to Thomas Crawford, "RE: SC2 target list," Bates KPMG 0050029.

[129] See email dated 4/23/01, from John Schrier to Thomas Crawford, "RE: SC2 target list," Bates KPMG 0050029.

[130] 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."

[131] Subcommittee briefing by Jeffrey Eischeid and Timothy Speiss (9/12/03).

[132] Subcommittee interview of Councill Leak (10/22/03). See also KPMG/Peat Marwick memorandum dated 11/24/98, from Jeffrey Stein to KPMG Tax Partners, "Tax Sales Organization and Telemarketing," at 5 ("The Tax practice has also made a significant investment in building our marketing capabilities and has expanded our telemarketing resources to support our national services and initiatives. . . . The telemarketers already have an impressive track record; they have played a critical role in our SALT practice and most recently helped drive the COLI and Export Tax Minimization product 'blitzes.' ")

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." [133] 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:
>
> 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. . . .

This document was hardly the work product of a disinterested tax adviser. In fact, it went 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

[133] "SC2—Meeting Agenda" and attachments, dated 6/19/00, Bates KPMG 0013375–96.

limited number of people or that it is no longer being sold at all in order to "elicit an immediate response from the client." 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.

**Tax Shelter Sales Force.** In addition to exhorting its tax professionals to spend more time selling KPMG tax products, beginning in 1997, KPMG established a dedicated sales position, known as a Business Development Manager (BDM), to market its tax shelters, as well as other KPMG products and services. The Subcommittee interviewed former BDMs and obtained documentation related to BDM involvement in KPMG's tax shelter activities.

A key KPMG document describing the newly established "National BDM Tax Sales Initiative" states that one of its goals was to "[h]elp create an aggressive sales culture" at KPMG.[134] A document establishing the terms and conditions for BDM compensation states that the primary duty of a BDM selling tax products was to maximize revenue to KPMG through aggressive sales:

> The duty of each Tax Business Development Manager is to produce the Maximum revenue for the Firm. The Tax Business Development Manager's contribution to maximum revenue will be primarily via the sale of Tax Services to new and existing Clients.[135]

A 1998 memorandum to KPMG tax partners urging greater use of BDMs declared that "a solid sales team dedicated to Tax is critical to our marketplace success."[136]

KPMG established an initial sales force of 6 to 10 BDMs in 1997, and increased the number of BDMs over the following 5 years to a maximum of 125 individuals. KPMG provided the Subcommittee with these total, annual BDM employment figures: FY1998: 34; FY1999: 84; FY2000: 88; FY2001: 98; FY2002: 125; and FY2003: 89.[137]

The BDM sales force was organized by region, using six geographic areas: Northeast, Mid-Atlantic, Southeast, Midwest, Southwest, and West.[138] The BDMs within a region reported to an Area Sales Director (ASD), who in turn reported to a National Partner in Charge of the Business Development Managers. Each ASD was responsible for recruiting and training BDMs, ensuring the BDMs met specified sales quotas, leading sales effort on at least five major accounts within their markets, coordinating with the KPMG Area Managing Partner for Tax, and developing national sales

[134] "'The Blueprint' National BDM Tax Sales Initiative: Objectives, Roles & Responsibilities" (undated) at 14.

[135] KPMG document, "Tax Business Development Stub Fiscal Year 2001 and Full Fiscal Year 2002 (15 Months Beginning July 1, 2001 and Ending September 30, 2003) Compensation Plan Terms & Conditions," (date uncertain) (hereinafter "Tax BDM 2001–2002 Compensation Plan") at 2.

[136] KPMG/Peat Marwick memorandum dated 11/24/98, from Jeffrey Stein to KPMG Tax Partners, "Tax Sales Organization and Telemarketing" (hereinafter "Stein Memorandum") at 1.

[137] See letter dated 1/15/04, from KPMG to the Subcommittee, at 7. See also written responses to Subcommittee questions dated 4/25/04, from a former KPMG BDM, who estimated that, in FY2000, 65 to 70 of KPMG's BDMs sold tax products and services ("Tax BDMs"), while 15 to 20 sold assurance products and services ("Audit BDMs").

[138] KPMG presentation dated 12/9/98, "Tax Sales Organization." See also ANational Tax BDM Roster," dated 2/1/01. The documents indicate that no ASD was appointed for the Mid-Atlantic region.

strategies with other ASDs.[139] The BDM training program consisted of a new hire orientation, two sessions of sales "Boot Camp," a course in "Selling with Confidence," mock sales calls, self training videos, and weekly national conference calls launching new products.[140] The program also included "intense training in several of the innovative Tax Products that KPMG was marketing."[141]

In a 1998 memorandum, the head of KPMG Tax Practice operations instructed KPMG's tax partners to integrate BDMs into their sales operations.[142] The memorandum explained that each member of the BDM sales force had been designated as either a "Product" or "Area" BDM. Product BDMs, the memorandum explained, Awill be dedicated to and responsible for a select number of national tax products—that are perceived to yield the greatest return and represent our highest opportunities."[143] With respect to Area BDMs, the memorandum stated that Atheir primary focus will be to team with the Tax Services Partners (TSPs) to promote a specific portfolio of tax products including select new tax initiatives as they are developed by the Tax Innovation Center (TIC)."[144]

To promote tax product sales, KPMG set individual sales quotas for each BDM[145] and stated that it was Aexpected that each Tax Business Development Manager shall achieve 100% of their sales quotas."[146] These individual BDM sales quotas were apparently based upon area and national BDM revenue targets that were also established by KPMG. For example, a KPMG presentation entitled "The Blueprint" set national revenue goals for BDMs of $50 million in FY1999, $100 million in FY2000, and $150 million in FY2001.[147] A later KPMG document cites actual BDM tax sales revenue of about $33 million in FY1999 and $109 million in FY2000, with projected FY2001 sales revenue of $125 million.[148]

BDM compensation routinely included sales commissions and, at times, also included bonuses or awards for meeting or exceeding sales revenue targets. In general, the evidence indicates that each BDM received a base salary and commission based on booked fees, billed accountancy income, and collected accountancy income.[149] In FY 1999, for example, BDMs received a base salary of $75,000 plus a 3% commission on sales revenue. In FY 2000, BDMs received a base salary of $90,000 plus a 3% commission on sales to existing clients, a 4% commission for new sales to "idle" accounts, and a 6% commission on sales to new clients. In FY 2001, the evidence indicates that the 4% commission level was eliminated, and some expe-

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139 Stein Memorandum at 2.

140 KPMG presentation, "BDM Training Program Components" (undated).

141 Written responses to Subcommittee questions, dated 4/25/04, by a former KPMG BDM.

142 Stein Memorandum at 1.

143 *Id.* at 4. The list of tax products available for sale by BDMs included tax products under the jurisdiction of Capital Transaction Strategies, the KPMG tax practice that led the efforts on FLIP, OPIS, and BLIPS. *Id.* at 3. Internal KPMG emails also indicate that at least one BDM was engaged in selling BLIPS. See email dated 2/22/00, from KPMG BDM Tobin Gilman to Ian Harrison and Robert Wells, "FW: Multi-Year Engagements, Contingent Engagements, Etc."

144 Stein Memorandum at 2.

145 See, e.g., Tax BDM 2001–2002 Compensation Plan at 2.

146 *Id.* at 5.

147 "'The Blueprint' National BDM Tax Sales Initiative: Objectives, Roles & Responsibilities" (undated) at 3.

148 KPMG presentation dated 2001, "BDM Tax Sales Organization Financial Trends."

149 KPMG document dated 4/20/99, "Fiscal Year 1999 Tax Business Development Manager Compensation Plan," at 4.

rienced new hires received base salaries of between $200,000 and $300,000.[150]

According to a June 2000 compensation plan analysis, the levels of compensation promised meant that a BDM with a base salary of $90,000 and who met a $3 million sales target would earn an annual income of up to $243,360. If the same BDM were to sell $4 million worth of tax products, he or she would earn up to $324,000.[151] Top-selling BDMs were also offered, at times, rewards for their sales, such as an opportunity to attend a luxurious "Performance Club 1999" retreat in Carmel, California.[152]

The BDMs were heavily involved in the marketing of tax shelter products. A lengthy Tax Sales Organization area analysis of 2001 sales trends, for example, demonstrates the level of BDM involvement with KPMG tax shelter sales. It states that "BDMs are pushing heavily on SC2," one of the tax shelters featured in this Report.[153] It describes the sales efforts of a top-selling BDM based in Dallas by referring to his sales of several tax shelter products and to his working relationship with Stratecon, a KPMG group involved in developing and marketing tax shelter products to KPMG clients: "Significant portion (90%) of pipeline is Stratecon, with CLAS, SC2, and Gain Mitigation. Works extremely close with Stratecon Partner—and is widely known as a strong prospector."[154] The analysis also states that a Seattle-based BDM sold $5.4 million worth of tax products in FY 2000, focusing on SALT, TAS and SC2; while a Silicon Valley-based BDM had pending FY 2001 fees related to SC2 totaling $2 million.[155]

This sales analysis suggests that KPMG encouraged its BDMs to engage in aggressive sales of its tax products. It describes a Dallas-based BDM as Aa strong prospector, who has already garnered strong praise from several Partners for his aggressive marketing stance."[156] It commends a Stamford-based BDM projected to achieve $6 million in FY 2001 sales for being Aextremely aggressive, as he easily averages 1 to 2 new relationship meetings each week."[157] It also singles out BDMs with the ability to make "cold" sales. An Atlanta-based BDM, for example, is cited for success with Aaccounts where KPMG has no acquaintances, the 'coldest' of category 1 gain accounts. Several have become KPMG solution buyers."[158] The analysis notes that a number of BDMs had been deployed exclusively against cold accounts.[159]

In response to a Subcommittee inquiry about the current status of KPMG's sales force, KPMG informed the Subcommittee that it was refocusing the BDM position by eliminating sales commissions and training BDMs as relationship managers.[160] In September 2004, KPMG held a national conference call in which it was announced that many BDMs would be terminated. Those remaining

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[150] Written responses to Subcommittee questions, dated 4/25/04, by a former KPMG BDM, at 2.

[151] KPMG document dated 6/30/00, "BDM Comp. Plan Analysis," at 1.

[152] Letter dated 9/29/99, from KPMG's Ian Harrison to a BDM.

[153] KPMG presentation dated 2001, "BDM Tax Sales Organization Financial Trends," at 4.

[154] *Id.* at 9.

[155] *Id.* at 13.

[156] *Id.* at 9.

[157] *Id.* at 19.

[158] *Id.* at 25.

[159] *Id.*

[160] See letter dated 1/15/04, from KPMG to the Subcommittee, at 7.

with the firm would have their job titles changed to "Account Relationship Managers." However, it appears as if their primary job responsibility continued to be sales, albeit primarily in audit and tax services."

**Using Tax Opinions and Insurance as Marketing Tools.** Documents obtained during the Subcommittee's 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 an earlier 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 five KPMG tax specialty groups and by specialists who were former employees of the IRS.[161]

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."[162] In another SC2 document, KPMG advised 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 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.[163]

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. 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

[161] "SC2—Meeting Agenda" and attachments, dated 6/19/00, at Bates KPMG 0013394.

[162] "SC2—Meeting Agenda" and attachments, dated 6/19/00, 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 16th 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.")

[163] "SC2—Appropriate Answers for Frequently Asked Shareholder Questions," included in an SC2 information packet dated 7/19/00, Bates KPMG 0013393.

have decided as a firm that B&W opinion should be given in all deals."[164]

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."[165]

According to KPMG tax professionals interviewed by Subcommittee staff, the insurance companies offering this insurance included AIG and Hartford.[166] In response to posthearing questions, KPMG produced copies of a redacted insurance policy from Lexington Insurance Company and a sample "fiscal event" insurance policy prepared by AIG, both of which related to SC2.[167] The AIG policy, for example, promises to reimburse the policy holder for a range of payments made to a Federal or state taxing authority related to SC2, including any payment made for an assessment of unpaid taxes, interest, a fine or penalty. Once these policies became available, KPMG tax professionals were asked to re-visit potential clients who had declined the tax product and try again.[168] 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.[169] However, evidence gathered by the Subcommittee indicates that KPMG could and did obtain specific revenue tracking information.

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, included 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 FY2001 revenues broken down by each of six regions in the United States:[170]

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
*Mid-Atlantic $550,000

[164] "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.)

[165] "SC2—Meeting Agenda" and attachments, dated 6/19/00, Bates KPMG 0013375–96.

[166] See, e.g., Subcommittee interview of Lawrence Manth (11/6/03).

[167] See insurance policies reprinted in Subcommittee hearing record at 2911–29.

[168] Email dated 2/9/01, from Ty Jordan to multiple KPMG tax professionals, "SC2 revisit of stale leads," Bates KPMG 0050814.

[169] Subcommittee briefing by Jeffrey Eischeid (9/12/03); Subcommittee interview of Jeffrey Stein (10/31/03).

[170] Internal KPMG presentation, dated 6/18/01, by Andrew Atkin and Bob Huber, entitled "S-Corporation Charitable Contribution Strategy (SC2) Update," Bates XX 001553.

*Midwest $425,000
*Northeast $300,000

KPMG never produced this document to the Subcommittee.[171]

Another document obtained by the Subcommittee from a party other than KPMG is a 1998 memorandum sent by a senior KPMG tax official to all U.S. KPMG tax partners directing them to begin using a special database to track all KPMG tax sales activity.[172] The memorandum states:

> The Opportunity Management System (OMS) will serve as the Tax practice's central Database for all sales activity. It is essential that we have one system that captures the activity of the [Business Development Managers,] Telemarketers and our professionals. This will ensure that we leverage our relationships and coordinate our sales efforts for increased success. The BDMs, Telemarketers and Marketing already use OMS as their repository for all information. And plans are to make OMS available to all Tax partners on a read only basis by the beginning of December. . . . You must be sure to report your individual sales activity to your Area Marketing Leader-Tax for input into the system. Reports are generated from OMS are the tool the Tax Leadership Team will be using to measure individual partner activity.

A later email sent in August 2000, which KPMG did produce to the Subcommittee, indicates that by the year 2000, 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.[173]

Moreover, KPMG's Tax Innovation Center reported in 2001 that it had developed new software that "captured solution development costs and revenue" and had begun "[p]repar[ing] quarterly Solution Profitability reports."[174] 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. These documents, as well as other information, contradict KPMG's statement that "the firm does not main-

[171] 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 4-year period, with $829 million in FY1998, $1.001 million in FY1999, $1.184 million in FY2000, and $1.239 million in FY2001. 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.

[172] KPMG/Peat Marwick memorandum by Jeffrey Stein to KPMG Tax Partners, "Tax Sales Organization and Telemarketing" (11/24/98), reprinted in Subcommittee Hearings as Hearing Exhibit 97 kk.

[173] Email dated 8/6/00 from Jeffrey Stein to 15 National Deployment Champions, Bates KPMG 050016. See also KPMG 2001 presentation, "Tax Sales Organization Financial Trends," indicating that KPMG carefully tracked the sales revenues generated by its Business Development Managers, not only to calculate their sales commissions, but also to develop BDM revenue targets and sales quotas.

[174] 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.

tain any systematic, reliable method of recording revenues by tax product on a national basis."[175]

### (3) Implementing Tax Products

**Finding: KPMG was actively involved in implementing the tax shelters which it sold 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 did not end with the sale itself. Many KPMG tax products, including the four examined by the Subcommittee, required the purchaser to carry out complex financial and investment activities in order to realize promised tax benefits. KPMG typically provided 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 also, at times, caused KPMG to adjust how a tax product was structured and even spurred development of new products.

**Executing FLIP, OPIS, and BLIPS.** FLIP, OPIS, and BLIPS each 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 Group to design the complex series of financial transactions called for by the product.[176] Using contacts it had established in other business dealings, Quellos 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, where the bank referred bank clients who might be interested in the FLIP tax product to KPMG tax professionals.[177] In some cases, the bank permitted KPMG and Quellos Group to make FLIP pres-

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[175] Letter from KPMG to Subcommittee, dated 4/22/03, attached one-page chart entitled, "Good Faith Estimate of Top Revenue-Generating Strategies," n.1.

[176] Quellos Group was then known and doing business as Quadra Capital Management LLP or QA Investments, LLC.

[177] KPMG actually did business with First Union National Bank, which subsequently merged with Wachovia Bank.

entations to its clients in the bank's offices.[178] KPMG also enlisted Sidley Austin Brown & Wood to issue a favorable legal opinion letter on the FLIP tax product.[179]

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 Group, KPMG obtained investment advice from Presidio Advisory Services. Presidio was formed in 1997 by two former KPMG tax professionals, one of whom was a key participant in the development and marketing of FLIP.[180] These two tax professionals left the accounting firm, because they wanted to focus on the investment side of the generic tax products being developed by KPMG.[181] Unlike Quellos Group, which had substantial investment projects aside from FLIP, virtually all of Presidio's work over the following 5 years derived from KPMG tax products. Presidio's principals 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 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.[182] Other KPMG employees were assigned to Presidio to assist in expediting BLIPS transactions and paperwork. KPMG also worked with Quellos Group, Presidio, and the relevant banks to ensure that the banks established large enough credit lines, at times in the billions 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.[183] 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

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[178] Subcommittee interview of First Union National Bank representatives (3/25/03).

[179] KPMG actually worked with Brown & Wood, a large New York law firm which subsequently merged with Sidley & Austin.

[180] The two former KPMG tax professionals are John Larson and Robert Pfaff. They 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").

[181] 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."

[182] Credit Request dated 9/26/99, Bates HVB 001166; Subcommittee interview of HVB representatives (10/29/03).

[183] Subcommittee interview of Jeffrey Eischeid (10/8/03).

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.[184]

**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 donations. . . . We need to be able to go to the tax-exempt with what we are going to give them to get them interested."[185]

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.[186]

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."[187] 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 exam-

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[184] 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.

[185] Attachment entitled, "Tax Exempt Organizations," included in an SC2 information packet dated 7/19/00, "SC2—Meeting Agenda," Bates KPMG 0013387.

[186] Subcommittee interviews with Los Angeles Department of Fire and Police Pensions (10/22/03) and the Austin Fire Relief and Retirement Fund (10/14/03).

[187] *Id.*

ple, 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 stock donation.[188]

Both charities said that KPMG often acted as a go-between for the charity and the stock 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.[189] 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.[190]

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 re-took control of the S Corporation and distributed some or all of the income that had built up within the company while the charity was a shareholder. The SC2 National Deployment Champion wrote the following to more than 20 of his colleagues working on SC2:

> 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.[191]

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[188] "SC2 Implementation Process," included in an SC2 information packet dated 7/19/00, Bates KPMG 0013385–86.

[189] Subcommittee interview of Lawrence Manth (11/6/03).

[190] Subcommittee interview of William Stefka, Austin Fire Relief and Retirement Fund (10/14/03).

[191] 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.

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.

**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 tax shelters 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 instance, 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. 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.[192]

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 fol-

[192] Treas. Reg. § 1.6664–4(c)(1)(ii).

lowing description of the facts and representations associated with the investment transactions undertaken by Investor."[193] The Subcommittee was told that Sidley Austin Brown & Wood relied on the same factual representations to compose the legal opinion letters that it drafted.

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.[194] 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.

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."[195] 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 under-

[193] Prototype BLIPS tax opinion letter prepared by KPMG, (12/31/99), Bates KPMG 0000405–417, at 1.

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

[195] Prototype BLIPS tax opinion letter prepared by KPMG, (12/31/99), Bates KPMG 0000405–417, at 9.

standing 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.[196] 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.[197]

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 7 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 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." [198]

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

[196] 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, a KPMG tax expert states: "the probability of actually making a profit from this transaction is remote (possible, but remote).").

[197] 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.

[198] Email dated 4/14/99, from Larry DeLap to multiple KPMG tax professionals, "RE: BLIPS," Bates KPMG 0017578–79.

> 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.[199]

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.[200] 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 involved decisions by KPMG to stop selling particular tax products. In all four of the tax products examined by the Subcommittee, KPMG stopped marketing the tax product within 1 or 2 years of its first sale.[201] 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.[202] 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.[203] 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.[204]

Evidence 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

[199] Email dated 2/24/00, from Philip Wiesner to multiple KPMG tax professionals, "RE: BLIPS/OPIS," Bates KPMG 0011789.

[200] 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").

[201] 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).

[202] Subcommittee interview of Lawrence DeLap (10/30/03).

[203] *Id.*

[204] See next section of this Report on "Avoiding Detection."

the marketing ban was announced.[205] These purchasers were referred to internally at KPMG as "grandfathered BLIPS" clients.[206] 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.[207] Also in 2000, some KPMG tax professionals attempted to restart BLIPS sales by developing a modified BLIPS product that would be sold to only extremely wealthy individuals.[208] 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.[209] 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.[210] 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.[211] 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.

### (4) Avoiding Detection

**Finding: KPMG took steps to conceal its tax shelter activities from tax authorities, including by claiming it was 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 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 with regard to FLIP, OPIS, BLIPS, and SC2 indicate that KPMG took a number of precautions in the way it designed, mar-

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205 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. . . .").

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

207 Subcommittee interview of Lawrence DeLap (10/30/03).

208 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).").

209 See Section V(A)(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.

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

211 Subcommittee interview of Lawrence DeLap (10/30/03).

keted, and implemented these tax products to avoid or minimize detection of its activities.

**No Tax Shelter Disclosure.** KPMG's public position has been it does not develop, sell or promote tax shelters. As a consequence, as of the time of the Subcommittee hearings in 2003, KPMG had not voluntarily registered, and thereby disclosed to the IRS, a single one of its tax products, even after being advised by a senior tax professionals that a particular tax product should be registered.

One glaring example of this flawed approach involves a 1998 memorandum sent by a KPMG tax professional to the second most senior KPMG tax official at KPMG advising the firm not to register the OPIS tax product with the IRS, even if OPIS qualified as a tax shelter under the law.[212] The memorandum stated in part:

> 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. . . .
>
> **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. . . .
>
> **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.
>
> 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. . . .

[212] 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.

> 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.

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 learned that some KPMG tax professionals agreed with this analysis,[213] while other senior KPMG tax professionals provided the opposite advice to the firm.[214] The head of KPMG's Tax Services Practice, the Vice Chairman for Tax, ultimately determined not to register the tax product as a tax shelter. 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 Vice Chairman for Tax.[215]

Other documents show that consideration of tax shelter registration issues was 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."[216] For example, one internal document analyzing tax shelter registration issues discusses the "policy argument" that KPMG's tax "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 reg-

[213] 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).

[214] 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). See also handwritten notes dated 3/4/98, author not indicated, regarding "Brown & Wood" and "OPIS," Bates KPMG 0047317 ("*Must* register the product. B&W concerns—risk is too high. Confirm w/ Presidio that they will register." Emphasis in original.) ("B&W" refers to Brown & Wood, the law firm that worked with KPMG on OPIS; Presidio is the investment firm that worked with KPMG on OPIS.).

[215] Subcommittee interview of Lawrence DeLap (10/30/03).

[216] KPMG Tax Services Manual, § 24.4.1, at 24–2.

> istration 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.[217]

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.[218] 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, BLIPS, and SC2 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.[219]

At the November 18 hearing before this Subcommittee, KPMG was asked directly whether its tax professionals promoted the sale of its tax products to potential clients. Then head of KPMG's Tax Practice avoided answering the question in sparring that lasted more than ten minutes, before finally admitting that KPMG did.[220]

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 whether the promoters happen to be accountants or lawyers, the issue continues to be the subject of vigorous litigation."[221] 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 charac-

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[217] 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.").

[218] Document dated 5/18/01, "PFP Practice Reorganization Innovative Strategies Business Plan—DRAFT," Bates KPMG 0050620–23, at 2.

[219] See *United States v. KPMG,* Case No. 1: 02MS00295 (D.D.C. 9/6/02).

[220] See Subcommittee Hearings (11/18/03), at 65–67.

[221] 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.

terized 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.” [222]

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.” [223] 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 15th 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.[224]

**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.

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.

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[222] 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.

[223] 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.

[224] Email dated 4/9/02, from Deke Carbo to Jeffrey Eischeid, “Larry’s Message,” Bates KPMG 0024467.

This netting approach, advocated in an internally-distributed KPMG memorandum,[225] 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 4 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."[226]
>
> 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.[227]

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.[228]

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."[229]

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 judgment 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

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[225] "Grantor Trust Reporting Requirements for Capital Transactions," KPMG WNT internal memorandum (2/98).

[226] 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).

[227] Email dated 1/21/99, from Mark Watson to multiple KPMG tax professionals, "RE: Grantor trust reporting," Bates KPMG 0010066.

[228] Email dated 1/21/99, from Carl Hasting to Jeffrey Eischeid, "FW: Grantor trust reporting," Bates KPMG 0010066.

[229] 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.

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.[230]

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. . . .[231]

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.[232]

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.[233]

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[230] Subcommittee interview of Mark Watson (11/4/03).

[231] IRS Notice 2000–44 (2000–36 IRB 255) (9/5/00) at 256.

[232] 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 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.")

[233] Email dated 2/15/00, from Robert Jordan to Jeffrey Eischeid, "Tax reporting for BLIPS," Bates KPMG 0006537.

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–1's 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–1's.
>
> David was wondering what the rationale was since the instructions and PPC say that single member LLCs are disregarded entities so 1099s, K–1's should use the EIN of the single member.[234]

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–1's. . . . Tracey indicated that Mark did not like the idea of having us prepare partnership returns this year because then the IRS would be looking for them in future years.[235]

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.[236]

In the case of FLIP, KPMG tax professionals devised a different approach to avoiding IRS detection.[237] 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 indi-

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[234] 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.

[235] Email dated 3/27/00, unidentified sender and recipients, "presidio K–1s," Bates KPMG 0024451.

[236] 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").

[237] 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.

vidual 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.[238]

**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.[239] 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.[240]

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).[241]

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 contained handwritten notes from a KPMG tax professional about a number of issues related to OPIS states under

[238] "SC2—Meeting Agenda" and attachments, dated 6/19/00, Bates KPMG 0013375–96, at 13394.

[239] "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.

[240] 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.

[241] 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.

the heading, "Brown & Wood": "Privilege[:] B&W can play a big role at providing protection in this area."[242]

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 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."[243] 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."[244]

**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.[245] With OPIS, KPMG tax professionals were instructed "you should NOT leave this [marketing] material with clients or targets under any circumstances. Not only will this unduely [sic] harm our ability to keep the product confidential, it will DESTROY any chance the client may have to avoid the step transaction doctrine."[246] In the case of BLIPS, KMPG tax professionals were instructed to obtain "[s]igned nondisclosure agreements . . . before any meetings can

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[242] Handwritten notes dated 3/4/98, author not indicated, regarding "Brown & Wood" and "OPIS," Bates KPMG 0047317.

[243] Email dated 1/3/00, from Dale Baumann to "Jeff," "988 election memo," Bates KPMG 0026345.

[244] 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 OTHELLO, 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 OTHELLO," 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 OTHELLO as outlined above for TEMPEST. Senior tax leadership, Jeff Stein and Rick Rosenthal concur with this approach.")

[245] 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).

[246] Email dated 6/8/98, from Gregg W. Ritchie to multiple KPMG tax professionals, "RE[2]: OPIS," Bates XX 001932 (emphasis in original).

be scheduled."[247] 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.[248] KPMG determined as well that "[p]roviding a copy of a draft opinion letter will no longer be done to assist clients in their due diligence."[249] In SC2, the DPP head instructed KPMG tax professionals not to provide any "sample documents" directly to a client.[250]

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.[251] 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 this is an appropriate strategy to mass market?[252]

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."[253]

### (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.

[247] Email dated 5/5/99, from Jeffrey Eischeid to multiple KPMG tax professionals, "Marketing BLIPS," Bates KPMG 0006106.

[248] Subcommittee interview of Wachovia Bank representatives (3/25/03); Subcommittee interview of legal counsel of Theodore C. Swartz (9/16/03).

[249] Email dated 5/5/99, from Jeffrey Eischeid to multiple KPMG tax professionals, "Marketing BLIPS," Bates KPMG 0006106.

[250] Email dated 4/11/00, from Larry DeLap to Tax Professional Practice Partners, "S-Corporation Charitable Contribution Strategy (SC2)," Bates KPMG 0052582.

[251] Email dated 5/5/99, from Jeffrey Eischeid to multiple KPMG tax professionals, "Marketing BLIPS," Bates KPMG 0006106.

[252] Email dated 12/20/01, from William Kelliher to WNT head David Brockway, "FW: SC2," Bates KPMG 0013311.

[253] Email dated 12/29/01, from Larry DeLap to Larry Manth, David Brockway, William Kelliher and others, "FW: SC2," Bates KPMG 0013311.

**Contingent 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.[254] For example, KPMG made more than $124 million from just the four tax products featured in this Report. Sidley Austin Brown & Wood obtained fees for issuing concurring legal opinions on these three tax products, FLIP, OPIS and BLIPS, totaling more than $23 million.[255]

Traditionally, accounting firms charged flat fees or hourly fees for tax services. In the 1990's, 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."[256] 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.[257] 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.[258]

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.[259] 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.[260] The memorandum also objected strongly to applying the contingent fee prohibition to, not only the firm's 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."[261] The

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[254] 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).

[255] Letter dated 1/16/04, from Sidley Austin Brown & Wood to the Subcommittee, at 2.

[256] KPMG Tax Services Manual, § 31.11.1 at 31–6.

[257] 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.")

[258] 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.). In December 2004, the Public Company Accounting Oversight Board proposed rules which would, among other provisions, bar any accounting firm that audits a publicly traded company from entering into a contingent fee arrangement with an audit client for tax services.

[259] 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.

[260] Memorandum dated 7/14/98, from Gregg Ritchie to multiple KPMG tax professionals, "Rule 302 and Contingency Fees—CONFIDENTIAL," Bates KPMG 0026555–59.

[261] "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.

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 tax products examined by the Subcommittee, the fees charged by KPMG for BLIPS, OPIS, and FLIP were clearly based upon the client's projected tax savings.[262] 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.[263]

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 |
| Gu[aran]teed Pymt. | 8 |
| Net Int. Exp. | 6 |
| Trading Loss | 70 |
| KPMG | 125 |
| Net return to Class A | 91[264] |

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 Cor-

[262] If a client objected to the requested fee, KPMG would, on occasion, negotiate a lower final amount.

[263] 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).

[264] Email dated 5/24/00, from Kerry Bratton of Presidio to Angie Napier of KPMG, "RE: BLIPS–7 percent," Bates KPMG 0002557.

poration for the 2 years following implementation."[265] SC2 fees were set at a minimum of $500,000, and went as high as $2 million per client.[266]

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."[267]

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, an 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.[268]

**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 played roles in marketing or implementing KPMG tax products. Deutsche Bank and HVB 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 a fee for each client who actually purchased a tax product.

KPMG Tax Services Manual states: "Due to independence considerations, the firm does not enter into alliances with SEC audit clients."[269] 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."[270] KPMG policy is that "[a]n oral business relationship that has the effect of creating an alliance should be treated as an alliance."[271] Another provision in KPMG's Tax Services Manual states: "The SEC considers

[265] 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).

[266] *Id.*

[267] Memorandum dated 7/1/98, from Gregg Ritchie and Jeffrey Zysik to "CaTS Team Members," "OPIS Engagements—Prohibited States," Bates KPMG 0011954.

[268] 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."

[269] KPMG Tax Services Manual, § 52.1.3 at 52–1.

[270] *Id.*, § 52.1.1 at 52–1.

[271] 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.

independence to be impaired when the firm has a *direct* or *material indirect* business relationship with an SEC audit client."[272]

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.[273] KPMG tax professionals were aware that doing business with an audit client raised auditor independence concerns.[274] KPMG apparently attempted to resolve the auditor independence 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.[275] 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.

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;[276] tax products that were designed and explicitly called for "fostering cross-selling among assurance and tax professionals";[277] 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.[278] A KPMG memorandum cited earlier in this Report observed that "many, if

[272] *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).

[273] Undated document prepared by Deutsche Bank in 1999, "New Product Committee Overview Memo: BLIPS Transaction," Bates DB BLIPS 6906–10, at 6909–10.

[274] 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 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).

[275] 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).

[276] 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.

[277] 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.

[278] See e.g. 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.

not most, of our CaTS targets are officers/directors/shareholders of our assurance clients."[279]

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.[280] 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."[281] 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."[282] 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 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,"[283] 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

[279] 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.

[280] 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.)

[281] *Id.* at Bates XX 001369.

[282] 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.

[283] *Id.* at Bates XX 001370 (emphasis in original).

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.** Another 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." [284] 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. 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. In fact, although Sutherland, Asbill & Brennan represented 39 "matters," involving 113 separate clients, in connection with a KPMG tax product or service, 17, or nearly half of these "matters" were directly attributable to referrals from KPMG.[285] The conflict of interest issue here involves, 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.

[284] 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.").

[285] Letter dated 12/19/03, from Sutherland Asbill & Brennan to the Subcommittee. See also Section VI(B) of this Report.

### (6) KPMG's Current Status

**Finding: Since Subcommittee hearings in 2003, KPMG has committed to cultural, structural, and institutional changes to dismantle its abusive tax shelter practice, including by dismantling its tax shelter development, marketing and sale resources, dismantling certain tax practice groups, making leadership changes, and strengthening its tax services oversight and regulatory compliance.**

At the Subcommittee hearing on November 18, 2003, the head of KPMG's Tax Practice testified that "[i]t is no longer enough to say that a strategy complies with the law or meets technical standards. Today, the standard by which we judge our conduct is whether any action could in any way risk the reputations of KPMG or our clients."[286] KPMG also told the Subcommittee that the firm "recognizes that certain tax strategies previously offered, and the manner in which they were offered, were inconsistent with the role expected of a professional organization to which public trust and confidence is indispensable."[287]

**Dismantling its Tax Shelter Development, Marketing and Sales Infrastructure.** As part of KPMG's commitment not to engage in tax services that "could in any way risk the reputations of KPMG or [its] clients," the firm announced a number of changes in its Tax Practice. KPMG informed the Subcommittee that it had refocused its tax services to emphasize advice tailored to a client's specific facts and circumstances, rather than continue mass marketing generic tax products to multiple clients.[288] KPMG also told the Subcommittee that it no longer offers, implements, or endorses aggressive strategies such as FLIP, OPIS, BLIPS, or SC2.[289]

In addition, KPMG has indicated that it has dismantled much of the development, marketing, and sales infrastructure it had used to mass market its tax products to multiple clients. For example, KPMG has eliminated the Tax Innovation Center, which was responsible for coordinating the development and deployment of new generic tax strategies. It has closed the telemarketing center in Fort Wayne, Indiana, which KPMG had used to market tax products through cold calls and sales appointments.[290] KPMG also in-

[286] Prepared statement of Richard Smith, Jr., Vice Chair, Tax Services, KPMG, Subcommittee Hearings (11/18/03).

[287] Letter dated 5/10/04 from KPMG to the Subcommittee, at 2.

[288] See id., at 2. See also KPMG testimony at the Subcommittee hearing: "[W]e have shifted our approach from one focused on taking solutions to clients to one that works with clients to address their individual situations." Testimony of Jeffrey Eischeid at Subcommittee Hearings (11/18/03).

[289] See testimony of Jeffrey Eischeid, Subcommittee Hearings (11/18/03) ("None of these strategies—nor anything like these strategies—is currently being presented to clients by KPMG. . . . Today, KPMG does not present any aggressive tax strategies specifically designed to be sold to multiple clients, like FLIP, OPIS, BLIPS, and SC2.") KPMG also stated at the hearing: "[T]he strategies presented to our clients in the past were complex and technical, but were also consistent with the laws in place at the time, which were also extremely complicated." *Id.*

[290] Letter dated 1/15/04, from Richard Smith, Jr., to the Subcommittee, at 8. In apparent contradiction to its action closing its own telemarketing center, KPMG disclosed that it had also contracted with MarketSource Corporation to perform centralized business development telemarketing for KPMG for the purpose of scheduling face-to-face or conference call appointments between KPMG professionals and prospective clients. *Id.* at 8–9. When asked about this telemarketing contract, KPMG subsequently informed the Subcommittee that the firm had also terminated all contracts with Marketsource for telemarketing services. KPMG meeting with the Subcommittee (5/12/04).

formed the Subcommittee that it was in the process of "disbanding our network of business development managers," although the current status of these employees is unclear.[291] KPMG told the Subcommittee that it was also re-evaluating its personnel requirements for market research and account management.[292] KPMG further announced that it had "abolished positions such as national deployment champions and area deployment champions," which had been used to facilitate nationwide sales of its tax products to multiple clients.[293]

**Dismantling of Stratecon and Innovative Strategies Practice Groups.** At the November 18, 2003, Subcommittee hearing, the head of KPMG's Tax Practice testified that two of the key practice groups responsible for the FLIP, OPIS, BLIPS, and SC2 tax products, known as Stratecon and Innovative Solutions, had been disbanded. Under questioning by Senator Levin, the Tax Practice head testified that both groups had been eliminated in April 2002, when he first assumed his position as head of the Practice. When asked at the hearing about KPMG's FY2003 organizational chart which listed Stratecon as a functioning office and a November 2002 document listing tax products then being sold by Stratecon, KPMG's Tax Practice head testified that the documents reflect "the fact that the systems that we had had not yet been changed at the particular point in time when this document was produced."

In a letter dated January 15, 2004, to the Subcommittee, KPMG clarified that the Stratecon and Innovative Strategies practice groups had actually been disbanded over a period of time, although the decision to terminate these groups had been made in April 2002.[294] In response to a request from the Subcommittee for contemporaneous documentation, KPMG provided a number of documents demonstrating the process undertaken to dismantle the Stratecon practice group. KPMG also stated, however, that it had "not been able to locate any specific documentation relating to the closure or the decision to close Innovative Strategies."[295]

The absence of any Innovative Strategies documentation is particularly troubling in light of a draft Innovative Strategies Business Plan for 2002, which suggests that this group was continuing to work on abusive tax shelters. The 2002 draft business plan stated, for example, that after the IRS listed the BLIPS transaction as potentially abusive, KPMG had made the business decision to stay out of the loss generator business "for an appropriate period of time."[296] Nevertheless, Innovative Strategies reported that it had continued to work on developing a new tax shelter product known as POPS, in which "[t]he last significant hurdle in aggressively taking the solution to market [SIC] will likely be obtaining a commitment from tax leadership to re-enter the individual 'loss-generator' business."[297] In addition, the draft business plan identified six tax

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[291] Letter dated 5/10/04, from KPMG to the Subcommittee, at 2 and 5; KPMG meeting with the Subcommittee (5/12/04).
[292] Letter dated 5/10/04, from KPMG to the Subcommittee, at 3.
[293] *Id.*, at 2.
[294] Letter dated 1/15/04, from Richard Smith, Jr., to the Subcommittee, at 2.
[295] *Id.* at 3.
[296] PFP Practice Reorganization (5/18/01), "Innovative Strategies Business Plan—DRAFT," Bates KPMG 0050620–23.
[297] *Id.* As recently as last year KPMG seemed committed to maintaining or expanding tax services. For example, KPMG had provided the Subcommittee a 2003 list of more than 500 ac-

products which had been approved for sale or were awaiting approval, and which were "expected to generate $27 million of revenue in fiscal '02." 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.

On May 10, 2004, KPMG assured the Subcommittee that Stratecon and Innovative Strategies had been disbanded, because the firm "realized that these practices were not consistent with our commitment to upholding the trust placed in us by our clients, or with meeting the responsibilities incumbent upon us from our regulators and the public at large."[298] KPMG indicated that of the 13 partners and professionals assigned to Innovative Strategies, five have left the firm, two had been transferred to the Federal Tax practice and six had been transferred to the Personal Financial Planning practice. KPMG stated that of the approximately 115 Stratecon professionals, 57 partners and professionals had left the firm, and the remaining 58 had been reassigned to other practice groups within the firm. KPMG told the Subcommittee that the individuals transferred from Stratecon and Innovative Strategies to other KPMG practices were "not involved with the development or deployment of aggressive look-alike strategies like FLIP, OPIS, BLIPS or SC2."[299]

**Leadership Changes, Strengthening Oversight and Regulatory Compliance.** In addition to dismantling various practice groups and tax development and marketing units, KPMG has reported taking steps to strengthen oversight and regulatory compliance within the firm. In May 2002, to strengthen the independence and objectivity of its regulatory compliance functions, for example, KPMG established a new senior position of Vice Chair for Risk and Regulatory Matters. This senior officer is authorized to report directly to the chief executive officer of KPMG rather than to any business unit.[300] Another change is the establishment of a new position of a Partner in Charge of Risk and Regulatory Matters for Tax. This position is supposed to work independently of tax operations, report directly to the Vice Chair for Risk and Regulatory Matters, and wield ultimate authority to define the parameters for acceptable tax services.[301]

In addition, KPMG announced that it had strengthened the independence of its Department of Practice and Professionalism for Tax (DPP), which provides final approval of new KPMG tax products, helps draft KPMG tax analysis, helps determine which tax products should be registered with the IRS, and can take existing KPMG tax products off the market, among other tasks. KPMG told the Subcommittee that the head of DPP now reports directly to the Partner in Charge of Tax Risk and Regulatory Matters rather than to the business leaders of the Tax Practice.[302] In light of the instances described in this Report in which the KPMG Tax Practice

tive tax products for various tax practice groups, which were intended to be offered to multiple clients for a fee.

[298] Letter dated 5/10/04 from KPMG to the Subcommittee, at 3.

[299] *Id.*

[300] *Id.*; KPMG meeting with the Subcommittee (5/12/04).

[301] Letter dated 5/10/04 from KPMG to the Subcommittee, at 3.

[302] *Id.*

head overruled or pressured the DPP head on matters related to tax shelters, this institutional change appears necessary and should help ensure that tax issues raising questions of reputational risk or legal or ethical concerns receive scrutiny from senior KPMG officers outside of the Tax Practice.

In addition, KPMG told the Subcommittee that it has instituted a more rigorous and formal procedure to review its tax services, requiring three levels of approval. Approval is required from the Partner in Charge of Risk and Regulatory Matters for Tax, the Washington National Tax Practice, and the Department of Professional Practice for Tax. If any of these three withhold approval, the Partner in Charge of Risk and Regulatory Matters for Tax and the DPP-Tax make the ultimate joint determination on whether a proposed tax service is acceptable.[303] In another change, KPMG said that it was requiring audit clients with tax services resulting in material financial statement benefits to obtain a "should" level tax opinion from a third party before KPMG would accept the financial statement benefits.[304]

KPMG also told the Subcommittee that it had instituted firm-wide enhanced training programs to strengthen regulatory compliance.[305] KPMG reported that this effort included intensive training on compliance with Treasury and IRS tax shelter regulations, compliance with Treasury and SEC auditor independence rules, and ethics matters. KPMG also indicated to the Subcommittee that the firm had registered a tax transaction with the IRS last year, which the Subcommittee understands is the first time it has done so.[306]

**Tax Leadership Changes.** On January 12, 2004, KPMG announced changes in its tax leadership. Jeffrey Stein, Deputy Chair of KPMG and former Vice Chair of Tax Services, was required to retire at the end of January, 2004. Richard Smith, Jr., then head of the Tax Services Practice, was removed from office and assigned to other duties within the firm. Jeff Eischeid, Partner in Charge of KPMG's Personal Financial Planning Practice, was placed on administrative leave and later left the firm.

KPMG indicated to the Subcommittee that these cultural, structural, and leadership changes reflect a firm-wide commitment to restoring KPMG's reputation for professional excellence and integrity. The Subcommittee was told that the mandate to attain the highest degree of professional trust from the firm's clients, regulators, and the public at large came directly from Eugene O'Kelly, KPMG's Chairman and Chief Executive Officer. KPMG told the Subcommittee, "we are embarrassed, and we are committed to ensuring that the past will never happen again."[307]

**Current Legal Proceedings.** KPMG continues to be the subject of numerous legal proceedings related to its tax shelter activities. In February 2004, the media reported that the U.S. Attorney for the Southern District of New York had initiated a Federal grand jury investigation of KPMG regarding its participation in the sale of tax shelters to corporations and wealthy individuals used to es-

[303] Letter dated 5/10/04 from KPMG to the Subcommittee, at 3–4.
[304] *Id.*, at 4.
[305] *Id.*
[306] KPMG meeting with the Subcommittee (5/12/04).
[307] *Id.*

cape at least $1.4 billion in Federal taxes.[308] KPMG responded in a statement that "it is our understanding that the investigation is related to tax strategies that are no longer offered by the firm."[309] KPMG also stated that "KPMG has taken strong actions as part of our ongoing consideration of the firm's tax practices and procedures, including leadership changes announced last month and numerous changes in our risk management and review processes."[310]

The IRS and Department of Justice are continuing to investigate KPMG's compliance with Federal tax shelter laws and regulations. At the Subcommittee hearing in 2003, IRS Commissioner Mark Everson testified that:

> As you have learned some organizations have decided to turn away from the promotion of abusive tax shelters, have reached agreements with the IRS, and are moving on. That is good news. I believe it reflects a reassessment by these firms and an improvement in their professional ethics. Others, such as KPMG and Jenkins and Gilchrist, remain in litigation with the IRS and have not yet complied with our legitimate documents requests.[311]

As of the date of this report, KPMG remains in civil litigation with the IRS and Department of Justice over its tax shelter activities. In addition, KPMG remains the subject of civil suits filed by a number of its former clients who claim that KPMG improperly sold them illegal tax shelters.

## B. ERNST & YOUNG

### (1) Development of Mass-Marketed Generic Tax Products

**Finding: During the period 1998 to 2002, Ernst & Young sold generic tax products to multiple clients despite evidence that some, such as CDS and COBRA, were potentially abusive or illegal tax shelters.**

Ernst & Young (hereinafter "E&Y") was created after the 1989 merger of the two firms Ernst & Ernst and Arthur Young & Company.[312] A global firm with 670 locations in 140 different countries, E&Y currently employs about 100,000 individuals, including 20,000 tax professionals worldwide. In 2002, it reported over $10 billion in revenues. It is managed by a 6-member Global Executive Board, and its current Chairman and Chief Executive Officer is James S. Turley. The current head of E&Y's global tax practice is Vice Chair for Tax Services, Mark A. Weinberger.

E&Y is organized into nine geographic areas, including the Americas Area which encompasses the United States. Like KPMG and PwC, E&Y is one of the four largest accounting firms operating

[308] See, e.g., David Cay Johnson, "Grand Jury is Investigating KPMG's Sale of Tax Shelters," *New York Times,* Feb. 20, 2004, at C5.

[309] *Id.*

[310] *Id.*

[311] See Testimony of Mark Everson, Commissioner, Internal Revenue Service, Subcommittee Hearings (11/20/03). The law firm Jenkens & Gilchrist allegedly collaborated with The Diversified Group to create the COBRA tax shelter and allegedly participated in the sale of at least 600 COBRA tax shelters, bringing the law firm substantial fees for issuing legal opinions letters. Paul Braverman, Helter Shelter, American Lawyer, December 2003, at 65–66.

[312] General information about E&Y is taken from information provided by E&Y in response to the Subcommittee's investigation and from Internet websites maintained by E&Y.

in the United States, and provides both audit and tax services to its clients. E&Y employs more than 23,000 individuals in the United States, including over 6,000 tax professionals. The current Chair of the Americas Area is James S. Turley.

E&Y participated in the U.S. tax shelter industry during the periods relevant to the Subcommittee's investigation. During that time, E&Y marketed a number of questionable tax products to multiple clients, including products known as the Contingent Deferred Swap (CDS), Currency Options Bring Reward Alternatives (COBRA), SOAP, and PICANTE.[313] E&Y marketed these tax products through a group of five to seven tax professionals initially called "VIPER" and later renamed the "more benign" and "less sinister sounding" Strategic Individual Solutions Group (SISG).[314]

E&Y told the Subcommittee that the tax products it sold to multiple clients generally were not developed in-house but originated with an outside source. E&Y explained that it examined each such tax product to "determine whether it was something that SISG would offer to its clients and, if it was, would usually take steps to restructure the strategy to enhance the likelihood that it would be sustained on the merits."[315] E&Y also acknowledged that, during the years in question, the SISG review and approval process for new tax products was an "ad hoc, decentralized, and informal process."[316]

The documents show that E&Y engaged in an aggressive effort to develop and market generic tax products to multiple clients. For example, an internal E&Y email from October 1999, recites seven tax products then under development and closes with the statement: "As you can see, we have a great inventory of ideas. Let's keep up the R&D to stay ahead of legislation and IRS movements."[317] An E&Y email from September 1999, promises the imminent completion of a particular tax product and states: "We will have until 10/31 to market the strategy. . . . Once we roll this product out, I will travel to each area to help you present this strategy to your clients. . . . Let's have fun with this new strategy and kick some KPMG, PWC and AA???"[318] Still another E&Y email, from May 2000, sets a nationwide sales goal for one of the firm's tax products, asking its tax professionals to work to generate "$1 billion of loss."[319]

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[313] See, e.g., email dated 10/26/99, from Brian L. Vaughn of E&Y to multiple E&Y tax professionals, Bates 2003EY011 (describing current status of seven E&Y tax products, including CDS, COBRA, SOAP, and PICANTE). For more information about COBRA, please see "Tax Shelters: Who's Buying, Who's Selling, and What's the Government Doing About It?" before the Senate Committee on Finance, S. Hrg. 108–371 (10/21/03) (including prepared statement of Henry Camferdam).

[314] See 1/17/00 email from Robert Coplan to numerous recipients re: "CDS Lives!," Bates 2003EY011613–14.

[315] Letter dated 5/3/04, from Ernst & Young to the Subcommittee, at 1.

[316] E&Y meeting with the Subcommittee (5/4/04).

[317] Email dated 10/26/99, from Brian L. Vaughn of E&Y to multiple tax professionals, Bates 2003EY011.

[318] Email dated 9/8/99, from Brian L. Vaughn of E&Y to multiple E&Y tax professionals, "Capital Loss/Ordinary Loss Technique," Bates 2003EY011349.

[319] Email dated 5/10/00, from Brian L. Vaughn of E&Y to multiple E&Y tax professionals, "CDS Update," Bates 2003 EY022850 (This email also states: "With your help we can make this goal. As of today, I have the following list of leads that have been given to me. Please send me your leads and the amount of potential loss. I want to help each of you obtain your own CDS goals. Please let me know how I can help. Also, please provide me with updates to this list. Thanks and good luck!!!").

**Contigent Deferred Swap.** E&Y's Contingent Deferred Swap or CDS was a particularly lucrative tax shelter for the firm and illustrates the firm's flawed process for developing, marketing, and implementing potentially abusive or illegal tax shelters.

E&Y first learned of CDS when, in 1998, it was approached by The Private Capital Management Group (TPCMG) which was then handling CDS transactions for PricewaterhouseCoopers.[320] The tax shelter involved a transfer to a partnership that generates a level of trading activity designed to enable the partnership to achieve trading partnership status that, in turn, allegedly allows swap payments and other first year expenses of the partnership to be treated as ordinary losses that can offset the client's ordinary income in that year.[321] Upon termination of the transaction the following year, the taxpayer allegedly received the additional benefit of capital gains tax treatment generated by termination of the swap.[322] Essentially, CDS was a conversion strategy, converting ordinary income to capital gains income, with the additional benefit of deferral.

E&Y enlisted a number of professional firms to help carry out CDS transactions, including two investment firms TPCMG and Bolton Capital Planning. TPCMG acted as the general partner in each trading partnership involved in a CDS transaction and directed the activities of each partnership through Bolton Capital Planning.[323] UBS was retained for the bank loans and swap agreements. [324] Locke, Liddell & Sapp provided clients with a legal opinion indicating that, if challenged by the IRS, CDS "should" be upheld in court.[325]

According to E&Y, in a typical CDS $20 million loss transaction, E&Y would receive $250,000, Bolton Capital Planning would receive $250,000, and Locke, Liddell & Sapp would receive $50,000.[326] In its CDS engagement letters, E&Y expressed its fee as a flat dollar amount to avoid contingent fee issues; however, internal documents show that this fee was, in fact, calculated as 1.25% of the tax loss to be generated through the CDS trans-

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[320] Subcommittee interview of Robert Coplan (5/4/04). The Subcommittee was told that David Lippman-Smith of TPCMG made the initial contact with Richard Shapiro of E&Y.

[321] Email dated 9/15/99, from Robert Coplan to Robert Garner, "Subject: VIPER PRODUCTS—IRS Representation, etc.," Bates 2003EY011387–88.

[322] See email dated 6/4/00, from Robert Coplan to multiple recipients, "SISG Solution Update—CDS Add-On," Bates 2003EY011874–75; Contigent Deferred Strategy Powerpoint Slide (indicating that the $20 million swap payment offsets ordinary income in year paid and that termination of the swap produces a $20 million capital gain tax benefit in the following year).

[323] Email dated 1/14/00 from Sixbelle@aol.com to Melinda Merk, "Subject: Re: Quick Question re: CDS," (describing that David Smith "is the Managing Director of TPCMG (which of course is the general partner of the partnership). TPCMG has an office in California. David Smith is the only person in it. David directed the activities of the trading partnership through BOLTON. Bolton is located in Memphis, Tennessee.") Bates 2003EY011612. In 2000, TPCMG ceased its activities with the CDS transaction, and Bolton Capital Planning took over as the general partner of the trading partnerships. Subcommittee interview of Robert Coplan (5/4/04).

[324] CDS was apparently approved by UBS's internal tax, legal, and regulatory functions. However, the bank created some "bottlenecks" with executing transactions as each particular transaction was required to be submitted to the bank's Chief Credit Officer, Marco Suter, to determine whether any specific transaction gave rise to unacceptable reputation risk for the bank. See email dated 9/28/99, names withheld, "Subject: Re: Fwd: CDS trades for TPCMG," Bates 2003EY011416. In 2000, UBS ceased its activities with CDS. In 2000–2001, Bear Sterns and Refco Bank participated as the counter-parties for the swaps and provided the loans. Letter dated 5/3/04, from Ernst & Young to the Subcommittee, at 6.

[325] Email dated 2/29/00, from Robert Garner to Robert Coplan, "Subject: VIPER Communication," Bates 2003EY011660–61.

[326] *Id.*

action.[327] In fact, E&Y's sample CDS engagement letter stated explicitly: "Our fee for providing the professional services referred to above will be **$[Insert amount at 1.25% of losses to be generated. If size of transaction is not certain at the time this letter is signed, add 'based on your investing $ million in the Partnership']** and it will be paid by the Partnership." [328]

The Subcommittee investigation found that the internal process used by E&Y to review and approve CDS was marked by dissention and dissatisfaction within the firm. E&Y indicated that SISG tax partners had conducted their own analysis of the technical merits of the CDS transaction in 1999, after consulting with other E&Y tax professionals and an outside law firm, and determined that CDS met the requirements of Federal tax law and could be sold by the firm.[329] E&Y also acknowledged, however, that the firm never issued an opinion letter supporting the CDS tax product, either as one that "should" survive a legal challenge or as one that would "more likely than not" survive such a challenge. E&Y told the Subcommittee that it never issued a CDS opinion letter because, as a promoter of the product, E&Y was unable to provide a letter upon which its clients could reasonably rely to protect them from possible IRS penalties if CDS was challenged. E&Y said that it had, instead, arranged for an outside law firm, Lock, Liddell & Sapp, to provide clients with a CDS opinion letter.[330]

This explanation fails to acknowledge or disclose, however, the divergence of opinion within the firm regarding CDS' technical merits. Internal documents show that some E&Y tax professionals outside of SISG raised serious concerns not only about the tax product's technical validity, but also about the firm's failure to disclose the risks associated with the product when marketing CDS to clients. On September 8, 1999, for example, one E&Y tax professional sent this email complaining how the firm had presented CDS to one of her clients:

> It has come to my attention that our firm is not at the "should" level opinion with respect to this transaction. I clearly was under the impression from your references with my client that our firm, in particular, David Garlock, was behind this transaction. You indicated that we were not issuing an opinion because we would be considered a promoter—not because we would not issue a "should" opinion. . . .
>
> I left the meeting, as did Meloni Hallock, with the impression that our firm, including David Garlock was at a "should" level of opinion on this transaction. It has come to my attention that the above statement is not entirely true. In fact, I think if you

[327] Email dated 9/15/99, from Robert Coplan to Robert Garner, "Subject: VIPER PRODUCTS—IRS Representation, etc.," Bates 2003EY011387–88.

[328] See Sample Engagement Letter, Bates 2003EY011138 (emphasis in original).

[329] E&Y meeting with the Subcommittee (5/4/04). CDS was approved for sale in 1999. Subsequently, in 2000, E&Y required new tax products to undergo an independent review by firm tax professionals outside SISG.

[330] An email from Robert B. Coplan of E&Y to Dickensg@aol.com, Bates 2003EY01139, states: "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."

> speak with David directly, as I have done, he isn't even at "more likely than not" let alone "should." . . .[331]

The SISG representative who had made the client presentation, responded:

> David Garlock did review [Locke, Liddell & Sapp's] opinion on our firm's behalf. David may disagree with [the law firm's] level of comfort, but his opinion was never needed in this situation. I represented to your client, our firm will not issue an opinion because the client could not rely on the opinion. This came from a discussion between Robert Coplan and Ron Friedman. Our firm will be considered a promoter in their view, and therefore, our clients cannot rely upon an EY opinion. . . .[332]

The E&Y tax professional replied:

> [D]on't you think if you were the client it would be an important fact for you to know if E&Y could not get to a "should" level on this transaction? Don't you think that my client went away with the impression that not only the law firm was at a "should" level, but so must be E&Y since we said nothing to the contrary? Care to take any bets?[333]

These emails demonstrate that at least two E&Y tax professionals lacked confidence in the CDS product; one was uncertain whether the product reached even a "more likely than not" standard. While SISG claimed that the firm did not issue an opinion supporting CDS because of its position as a promoter of the product, that argument appears to be inconsistent with E&Y's actions with respect to other tax products, such as SOAP and PICANTE, in which E&Y acted as both promoter and a writer of favorable opinion letters.[334]

Locke Liddell and Sapp LLP did, however, issue legal opinions for CDS.[335] According to one potential investor, however, the law firm's opinion letter was deficient in many respects. The client's legal advisor sent the following email to E&Y criticizing the opinion's weak legal analysis:

> I have reviewed the materials you provided to me and from all indications, the transaction appears to be a classic "sham" tax shelter that would be successfully challenged on audit by IRS. The transaction apparently has little, or any, economic significance outside the tremendous tax breaks promised to the investors and is apparently highly tax motivated, as opposed to

[331] Email exchange dated 9/8/99, between Mary Sigler of E&Y and Brian Vaughn of SISG, "Re: CDS Transaction," Bates 2003EY011351–52.

[332] *Id.*

[333] *Id.*

[334] Interview with E&Y representative (5/4/04). While E&Y wrote opinion letters supporting its SOAP and PICANTE tax products, it apparently did not write opinion letters for its CDS or COBRA products. According to E&Y, the firm issued opinions for SOAP and PICANTE because these products were less likely to give rise to a challenge by the IRS. However, E&Y told the Subcommittee that no investors who purchased a SOAP or PICANTE tax product were told that E&Y would be considered a promoter and therefore they could not rely on an E&Y opinion if challenged by the IRS.

[335] See, e.g., letter dated 10/1/99, from Brent Clifton, Locke Liddell & Sapp LLP, to Wolfgang Stolz, UBS, Bates 2003EY011434 (disclosing that the law firm had "undertaken a review of the proposed contingent deferred swap strategy ("CDS") offered by the Private Capital Management Group ("PCMG") and is prepared to issue a tax opinion in connection with each such transaction executed by a PCMG partnership following our engagement by each such partnership and our review of all relevant documentation.").

> being a bona fide transaction that people would invest in regardless of the tax breaks. The concept of a packaged tax shelter sold to investors who need specific tax breaks is under attack by the IRS and courts. My understanding is that IRS has a huge project underway to ferret out these types of tax shelters and will aggressively litigate them (expect penalties to be asserted, in addition to taxes and interest owed).
>
> The opinion provided to me did not discuss the relevant facts, as I understand them. There was little discussion of the hedging within the transaction that will protect the investors against risk of loss or the high level of tax motivation behind the concept. The analysis of the downside to the transaction was weak and often irrelevant. Apparently, there is a dubious loan interest deduction for funds that will be parked in Treasuries. I understand that a very small portion of the investment will involve trading.
>
> The largest problem with the structure and the opinion, however, is that the partnership is not engaged in a trade or business as a "trader;" but will have the status of an investor. Trader status is critical to claim the deductions discussed in the opinion. The opinion states that the general partner will delegate the actual trading to a Fund Manager. The opinion then wrongly states that the Fund Manager's activities will be attributed to the partnership, thus making the partnership a trader. The opinion relies on Adda v CM (10 TC 273), 1458, a 50-year-old case that has nothing to do with trader vs. investor status.
>
> The opinion fails to address the relevant case law, which includes Mayer v CM, 94 USTC Para 50, 509 (1994), a case when [SIC] expressly states that the trading activities of others are not attributed to the taxpayer (citing the U.S. Supreme Court case of Higgins, 312 US 214) in support of its conclusion. Mayer unequivocally states that the taxpayer must personally made [SIC] the trading decisions and cannot delegate this task to others.
>
> Based on what I have provided, my recommendation would be not to invest in this transaction until the issues raised in the email are satisfactorily addressed.[336]

This September 1999 email provides additional evidence that E&Y knew CDS had technical problems and could qualify as an abusive tax shelter. Despite this knowledge, E&Y made the decision to continue selling CDS in 1999 and 2000.

E&Y apparently marketed CDS aggressively. From 1999 until 2001, E&Y sold 70 CDS transactions involving 132 taxpayers, obtaining fees of more than $27.8 millions.[337] The SISG group set an explicit goal in 2000, of using CDS to shelter $1 billion of losses.[338] In April 2000, a key E&Y tax professional in SISG reported: "I just

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[336] Email dated 9/7/99, forwarded to Patricia Klitzke, "FW: CDS Transaction at Risk," Bates 2003EY011345–50.

[337] Letter dated 5/3/04, from Ernst & Young to the Subcommittee, at 8.

[338] Email dated 5/10/00, from Brian Vaughn to multiple E&Y tax professionals, "CDS Update," Bates 2003EY011850–51.

wanted to update you on the success we are having with the CDS transaction in 2000. With the new UDS/Yen model as an option, the sales activity has drastically increased. . . . [W]e are well on our way to meeting the $1 billion loss goal we set at the beginning of this year." [339] E&Y continued to market CDS and other tax products at the same time the IRS increased its efforts to stop abusive tax shelters.

In early 2000, PricewaterhouseCoopers announced that, because the IRS had listed one of its tax products, the Bond and Options Sales Strategy (BOSS), as an abusive tax shelter, it would refund all BOSS fees to its clients. When a potential client asked whether E&Y would refund fees if the CDS transaction was subsequently determined to be abusive, the firm answered "an unequivocal no." One E&Y tax professional wrote:

> They are a client of mine . . . I suggested CDS (with the option add-on) as an alternative. They would like to move forward. However, there are two issues. One, the amount of income they wish to offset is $10 to $12 million rather than the $20 million. Second, against my advice they did the BOSS transaction last year. . . . They got most of their money back since PWC could not issue the opinion. They want a similar [deal] right here. If the opinion can't be issued because of a change in the law they get a refund of the fee (or most of it, e.g. trading costs would not be refunded).[340]

In response, the SISG head wrote:

> Finally, on the big issue of promising to give back the fee or some part of it if the deal doesn't work, the answer is an unequivocal no. We are not able to do that, and I doubt PWC had that built into their engagement letter. WE have a dispute resolution procedure in our engagement letters that protects the client if he doesn't receive the value he has paid for. Obviously, a big 5 firm would not retain a fee if the client was never put in a position to obtain the tax benefits on the transaction. But that doesn't mean we could insert such a provision up front that would clearly make our fee contingent on the tax outcome of the transaction. That is nonnegotiable. We have been down this road many times before.[341]

It is ironic that E&Y rejected a client's request for a refundable fee, in part, because it would be a non-permissible contingent fee dependent upon "the tax outcome of the transaction," when, at the same time it was charging clients a CDS fee equal to a percentage of the client's expected tax loss.[342]

In late 2000, CDS itself began attracting IRS attention, but even IRS inquiries did not deter E&Y from continuing to market the tax product to new clients. Bolton Capital Planning, the investment firm involved in carrying out CDS transactions, for example, in-

[339] Email dated 4/26/00, from Brian Vaughn of E&Y to Robert B. Coplan of E&Y, "CDS Update," Bates 2003EY011830.

[340] Email dated 7/18/00, from Robert Coplan, "Re: family-potential CDS deal," Bates 2003EY011938–39.

[341] *Id.*

[342] E&Y contended to the Subcommittee that its CDS fee was not dependent on the actual tax benefits received by the client and, thus, was not a contingent fee.

formed E&Y that it had received an IRS letter inquiring about CDS. An SISG tax professional responded in an email to his supervisor as follows:

> With regard to CDS, we all knew one day we would receive a letter. We told our clients to expect the letter. What we don't know at this point is whether the IRS will pursue an IRS exam of the strategy. You ask me this afternoon would I buy the strategy assuming the IRS was aware of the trade. The answer is definitely "YES." Remember, the IRS knew about COBRA, but our clients still made the purchase. In fact, the clients continued to buy the "add-on" trade even though we knew the IRS was extremely familiar with the issues. If the IRS pursues and audit and we successfully defend the strategy, then why wouldn't our clients want to buy the trade. It would be premature at this point to assume our clients would not buy a strategy that the IRS has knowledge of. Why don't we let the clients decide? Therefore, I would like to propose that CDS is not "stopped" at this point. Brian Upchurch and I have a client that is considering CDS and I would be happy to let him know that the IRS has issued a notice to Bolton requesting information on the trade. My belief is he would say "so what."
>
> That is my two cents worth. As I told you, I am a fighter. I don't enjoy giving up before I get my chance to fight. Remember our opinion on CDS is a should. Let them bring their guns!!!! I believe they will turn their tales and run the other direction. CDS has economic substance and has the best promoter in the business associated with the trade. I think we owe it to Belle and ourselves not to give up and stop the sales process at this point. Let the clients decide.[343]

E&Y ultimately decided to continue selling CDS in 2001, with some revisions designed so that the "transaction would not have to be registered with the IRS."[344] In fact, E&Y never registered CDS with the IRS at any time during the 3 years it sold the product. Instead, according to E&Y, it had an oral arrangement with TPCMG in 1999, and with Bolton Capital Planning in 2000, that the general partner of the CDS partnerships was responsible for registering specific CDS transactions with the IRS.

In May 2002, the IRS listed the CDS transaction.[345] In March 2002 and June 2003, the IRS commenced two different investigations of E&Y's tax shelter activities occurring between January 1, 1995 and June 30, 2003. These investigations looked not only at CDS, but a variety of other tax products, including COBRA, SOAP, and PICANTE. On July 2, 2003, E&Y settled with the IRS. Along with a $15 million settlement payment, E&Y was required to institute systemic reforms of its tax strategies practice.

At the time of the E&Y settlement, IRS Commissioner Mark Everson commented:

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[343] Email dated 12/12/00, from Brian Vaughn to Robert Coplan, "Subject: New LLC strategy," Bates 2003EY012125.

[344] Email dated 1/5/01, from Robert Coplan to Quickstrike Team, "Subject: SISG Update, 1/8 Conference Call," Bates 2003EY012139–41.

[345] Ernst & Young's CDS transaction is covered by IRS Notice 2002–35 (2002–21 IRB 992) (5/28/02).

> This represents a real breakthrough and is a good working model for agreements with practitioners. . . . [W]e are trying to differentiate between those who cooperate with the IRS, who try to remedy past mistakes and who seek transparency in their dealings with the Service, and those others who simply refuse and continue to peddle abusive transactions. Our intention is to differ in our approach to them based on their behavior.[346]

At the November 18, 2003 Subcommittee hearing, Mark Weinberger, Vice Chair Tax Services, Ernst & Young, testified that the firm has "taken, and are taking, numerous steps to ensure that quality and professionalism are touchstones for everything that we do."[347]

**(2) Ernst & Young's Current Status**

**Finding: Ernst & Young has committed to cultural, structural, and institutional changes to dismantle its tax shelter practice, including by eliminating the tax practice group that promoted its tax shelter sales, making leadership changes, and strengthening its tax oversight and regulatory compliance.**

E&Y, along with their settlement with the IRS, committed to a number of cultural, structural, and institutional changes to dismantle its tax shelter practice, including by eliminating the tax practice group that promoted its tax shelter sales, establishing a new tax product review and approval process, and strengthening its tax services oversight and regulatory compliance. As a first step, E&Y disbanded the VIPER/SISG group that had taken the lead within the firm in selling CDS, COBRA, and other tax products to multiple clients.

**New IRS Registration and Compliance Monitoring Procedures.** E&Y, as part of their settlement with the IRS, proposed the development and implementation of a Quality and Integrity Program (QIP) to strengthen its compliance with specific Federal requirements for tax shelter registration, client list maintenance, and disclosure of reportable transactions. This program, which E&Y said became operational on October 1, 2003, is staffed by four E&Y personnel who provide centralized national oversight to ensure compliance by E&Y tax professionals with compliance with Federal tax shelter regulations.[348]

E&Y told the Subcommittee that the QIP process requires that any tax transaction resulting in a fee in excess of $10,000 be recorded in a centralized database, so that the firm is aware of and can track all such transactions. The QIP database is also tied to the firm's financial system so that, for example, if a client billing is in excess of $10,000 and does not have a corresponding QIP record, E&Y is able to identify this discrepancy and correct it. E&Y said that, for all transactions generating fees of $100,000 or more, QIP requires a tax shelter registration analysis. A QIP review board performs this registration analysis and, in cases where the

[346] See Discussion of the Ernst & Young Agreement with the Internal Revenue Service.
[347] Testimony at Subcommittee Hearings (11/18/03).
[348] Subcommittee meeting with Ernst & Young (5/4/04).

review board cannot reach agreement on the firm's obligations, solicits guidance from the IRS.[349]

As part of the QIP implementation, 3,100 tax professionals were required to participate in a comprehensive review of the requirements related to registration and list maintenance as well as training on the QIP process. [350] E&Y requires annual certification of compliance with QIP by all partners, principals, senior managers, and tax compliance engagement managers.[351]

**Institutional Changes.** Aside from the settlement, Ernst & Young has instituted firm-wide policies and actions to improve E&Y professionalism. For example, E&Y established the position of Americas Vice Chair of Quality and Risk Management, charged with enhancing quality and compliance across all E&Y product lines in the United States, including tax services. The current Vice-Chair, Susan Friedman who, with a twenty person staff, reports directly to the E&Y Chairman.[352]

E&Y also established a new position, Americas Director for Tax Quality, charged with ensuring that all new tax products sold by E&Y in the United States meet high standards for professionalism and do not run afoul of Federal tax shelter prohibitions.[353] To correct problems identified with E&Y's past procedures for approving new tax products, which E&Y told the Subcommittee had been ad hoc, decentralized, and informal, this new position was created to ensure a centralized review processes and high standards.[354] E&Y told the Subcommittee that, to assist in this effort, the Director for Tax Quality had recently created Tax Technical Review Committees for each of E&Y's tax product functional areas, such as International Tax, Partnerships, and Mergers and Acquisitions. E&Y explained that these committees were charged with reviewing and approving technical tax issues in their areas of expertise.[355] In cases where a Tax Technical Review Committee cannot reach consensus on a product or issue, E&Y said that the committee is required to notify the Director for Tax Quality to resolve the matter at issue. The current Americas Director for Tax Quality is Joseph Knott who reports directly to both the Vice Chair of Tax Services and the Vice Chair of Quality and Risk Management.[356]

In addition, in 2003, E&Y established a senior advisory Tax Review Board, whose members include senior executives from outside the firm's Tax Practice to review the firm's tax policies and procedures for current or proposed services and products. The Tax Review Board is supposed to conduct an annual review of all E&Y tax practice offerings in conjunction with the firm's tax leadership; it may also discuss any matter warranting review on an interim basis. The Board is advisory to the Americas Vice Chair of Tax Services.[357]

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[349] Subcommittee meeting with Ernst & Young (5/4/04). According to E&Y, the firm recently solicited guidance from the IRS with respect to a transaction where the QIP review board was unable to determine if a potential transaction triggered registration requirements.

[350] These tax professionals consist of partners, principals, and senior managers, whose responsibilities include the engagement of clients for tax services.

[351] Letter dated 5/3/04, from Ernst & Young to the Subcommittee, at 5.

[352] *Id.*, at 1.

[353] *Id.*

[354] Subcommittee meeting with Ernst & Young (5/4/04).

[355] Letter dated 5/3/04, from Ernst & Young to the Subcommittee, at 8–9.

[356] Subcommittee meeting with Ernst & Young (5/4/04).

[357] Letter dated 5/3/04, from Ernst & Young to the Subcommittee, at 1, 8.

Still another step taken by E&Y is the establishment of a Tax Quality Review program to review compliance by individual E&Y tax professionals with firm policies. E&Y told the Subcommittee that this review is supposed to be supervised by its National Tax Quality and Standards Group and that the review itself is to be performed by tax professionals from a practice unit other than the one of the individual being reviewed.[358] E&Y indicated that every E&Y tax partner, principal, and senior manager providing tax advice will be reviewed at least once every 3 years by this program, separate and apart from E&Y's annual performance evaluation process.

E&Y indicated to the Subcommittee that all of E&Y's cultural, structural, and institutional changes reflect a firm-wide commitment to quality and professionalism with the "mandate coming directly from James S. Turley, Chairman and Chief Executive Officer."[359] E&Y communicated that these changes are part of an on-going process designed to ensure the highest professional standards.[360]

**Current Legal Proceedings.** Although E&Y has settled with the IRS with respect to its tax shelter registration and client list maintenance obligations, it remains the subject of other litigation over its tax shelter activities. In May 2004, the U.S. Attorney for the Southern District of New York apparently initiated a Federal grand jury investigation of E&Y regarding its sale of tax shelters to corporations and wealthy individuals to escape or reduce Federal taxes. That criminal inquiry is on-going. In addition, several former E&Y clients have sued the firm for improperly selling them illegal tax shelters.[361]

## C. PRICEWATERHOUSECOOPERS

### (1) Mass-Marketed Generic Tax Products

**Finding: During the period 1997 to 1999, PricewaterhouseCoopers sold general tax products to multiple clients, despite evidence that some, such as FLIP, CDS, and BOSS, were abusive or potentially illegal tax shelters.**

PricewaterhouseCoopers International Ltd., was created in 1998 from the merger of two firms, Pricewaterhouse and Coopers & Lybrand.[362] PricewaterhouseCoopers International Ltd. encompasses an international network of member firms using the PricewaterhouseCoopers name. It operates in over 140 countries with more than 750 offices worldwide. As of June 2004, it employed more than 120,000 individuals and reported global net revenues totaling about $16.3 billion. The company is managed by a 19-member "Global Board." The current chief executive officer of Price-

[358] Letter dated 5/3/04, from Ernst & Young to the Subcommittee, at 8–9.
[359] Subcommittee meeting with Ernst & Young (5/4/04).
[360] *Id.*
[361] See, e.g., *Camferdam v. Ernst & Young,* (USDC SDNY) Case No. 02 Civ. 10100 (BSJ) (alleging breach of fiduciary duty, fraud, negligence, and other misconduct by E&Y for selling COBRA to the plaintiff).
[362] General information about PwC is drawn from documents produced to the Subcommittee and Internet websites maintained by PwC.

waterhouseCoopers International Ltd. is Samuel A. DiPiazza, Jr., who is based in New York.

PricewaterhouseCoopers LLP (hereinafter "PwC") is a U.S. limited liability partnerhip and a member of PricewaterhouseCoopers International Ltd. Like KPMG and Ernst &Young, PwC is one of the four largest accounting firms operating in the United States, and provides both audit and tax services to its clients. PwC is managed by a U.S. Executive Board. The current Chairman and Senior Partner heading PwC's U.S. operations is Dennis M. Nally. The current head of PwC's U.S. Tax Practice is Richard J. Berry who oversees more than 6,500 tax professionals.

PwC participated in the U.S. tax shelter industry during the period relevant to the Subcommittee's investigation. With respect to generic tax products marketed to multiple clients, PwC was involved in selling its version of the Foreign Leveraged Investment Program (FLIP), Contingent Deferred Swap (CDS), and the Bond and Options Sales Strategy (BOSS). PwC sold about 50 FLIP transactions to clients in 1997 and 1998, sold 26 CDS transactions in 1998 and 1999, and was in the process of selling about 120 BOSS transactions in 1999, when the firm halted product sales and later refunded all BOSS fees.[363] Each of these tax products has been identified by the IRS as an abusive tax shelter.[364]

PwC told the Subcommittee:

> In the 1990's there was increasing pressure in the marketplace for firms to develop aggressive tax shelters that could be marketed to large numbers of taxpayers. This had not been a traditional part of our tax practice, but regrettably our firm became involved in three types of these transactions.—Although the total number of transactions that were done was limited to 76 over a 3-year period, we acknowledge that we should not have done any. Since late 1999, we have taken strong action to prevent our involvement in transactions like these again.[365]

**Review and Approval Process in General.** According to PwC, the firm's development and sale of abusive tax products such as FLIP, CDS, and BOSS occurred due to a lack of a centralized review process with proper authority, accountability, and oversight.[366]

PwC told the Subcommittee, that during the 1997–1999 time frame, its review and approval process for new tax ideas, including FLIP, CDS, and BOSS, occurred on a decentralized and ad hoc basis.[367] PwC indicated that, at that time, to analyze and develop a new tax product, individual business units within the firm typically established an internal, ad hoc review committee whose members were typically senior tax partners selected by the tax partners advocating the new tax idea.[368] PwC explained that this committee then conducted a technical review of the proposed tax product to

[363] PwC prepared statement for Subcommittee Hearings (11/18/03).
[364] FLIP is covered by IRS Notice 2001–45 (2001–33 IRB 129). CDS transaction is covered by IRS Notice 2002–35 (2002–21 IRB 992) (5/28/02). BOSS is covered by IRS Notice 1999–59 (1999–52 IRB 761).
[365] PwC prepared statement for Subcommittee Hearings (11/18/03).
[366] Subcommittee meeting with PricewaterhouseCoopers (5/27/04).
[367] *Id.*
[368] *Id.*

determine whether it complied with Federal tax law, but did not consider such factors as reputational risk or ethics considerations.[369] PwC indicated that it now recognizes that this process lacked independence from the business unit which stood to profit if the product was approved.

PwC explained that the review committee was supposed to reach a consensus on whether "it was more likely than not" that the proposed tax idea would be upheld in court, if challenged by the IRS. PwC explained further, however, that individual committee members were not required personally to determine that the tax product met the requirements of the law; the standard was whether each member could reasonably see that others could reach a "more likely than not" conclusion on the technical merits.[370] PwC told the Subcommittee that once a review committee approved a new tax product, the individual business unit that established the committee was then free to market it, without obtaining the approval of any other PwC authority, including PwC's tax leadership or senior PwC partners outside of the tax practice.

PwC told the Subcommittee that the review committee typically did not consider any issues related to the firm's compliance with the IRS tax shelter registration or client list maintenance obligations and that, during the 1997–1999 period, these issues had, at times, received little or no attention in connection with the approval of a new tax product.[371] PwC explained that while it had assigned these issues to its Practice and Procedures group, that group was focused primarily on handling audit controversies, obtaining private letter rulings from the IRS, and assisting clients resolve accounting issues.[372] PwC also indicated that the Practice and Procedures group had been subject to little oversight, and the firm then lacked a centralized process for reviewing decisions regarding its tax shelter registration and list maintenance obligations.[373]

**Developing, Marketing, and Implementing FLIP.** PwC's handling of the FLIP tax product demonstrates the firm's flawed process for developing, marketing, and implementing potentially abusive or illegal tax shelters.

FLIP, which was first developed by KPMG, apparently migrated to PwC after a KPMG tax partner familiar with the tax product took a position with one of PwC's predecessor firms, Coopers & Lybrand. The Subcommittee was told that, in 1997, Michael Schwartz, a former KPMG tax partner and member of the KPMG development team for FLIP,[374] was hired by Coopers & Lybrand as an international tax partner to run the Foreign Bank Group.[375] The Subcommittee was told that, after the merger between Coopers & Lybrand and Pricewaterhouse in 1998, Mr. Schwartz worked in the resulting firm's Finance and Treasury Group.[376]

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[369] *Id.*
[370] *Id.*
[371] *Id.*
[372] *Id.*
[373] *Id.*
[374] Subcommittee interview of John Larson (10/3/03).
[375] Subcommittee interview of Michael Schwartz (5/26/04).
[376] *Id.*

PwC told the Subcommittee that Mr. Schwartz introduced the FLIP product to various partners at the firm and was responsible for presenting the tax product to potential clients.[377] By 1998, the Personal Financial Services group within PwC had assumed the lead in marketing FLIP to potential clients and implementing FLIP transactions.[378] PwC told the Subcommittee, that, altogether, in 1997 and 1998, led by Mr. Schwartz, Coopers & Lybrand participated in 12 FLIP transactions and PwC participated in 38, for a total of 50.[379]

Like KPMG, PwC enlisted other professional firms in its tax shelter activities. For example, in addition to identifying potential FLIP clients on its own, PwC entered a client referral arrangement with First Union National Bank, which later merged with Wachovia National Bank. Under this arrangement, First Union agreed to refer its banking customers to PwC for a FLIP presentation. PwC also had an informal agreement with an investment firm called Quadra Investments, later renamed the Quellos Group, to carry out the complex financial transactions called for by the FLIP transaction. Quellos helped set up the offshore partnerships required by FLIP, for example, and also worked with various banks to arrange millions of dollars in required financing. Quellos performed similar services for KPMG.

Among other actions to ensure the smooth implementation of FLIP transactions, PwC issued opinion letters to its clients, stating that it was "more likely than not" that FLIP would be upheld, if challenged by the IRS.[380] PwC apparently continued to issue these favorable opinion letters even after learning that the FLIP transactions was the subject of Federal legislation. As PwC explained in a letter to First Union:

> We have determined with the help of our Washington National Office that the effective date [of the proposed legislation barring FLIP transactions] should occur well after any transactions currently contemplated have been completed. As well we have taken precautions that will allow us to accelerate the completion should we learn that the effective date could occur in advance of our expectations. . . . I can guarantee that we will be able to write an opinion letter for any of your clients that engage in this transaction. . . .[381]

Similar to KPMG and other promoters, PwC failed to register FLIP with the IRS as a tax shelter. The Subcommittee was told that, instead, PwC advised Quellos Group to register the tax shelter with the IRS.[382] The 1998 and 1999 FLIP transactions, based upon the advice of PwC, were registered with the IRS.[383] At the

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[377] *Id.* While Mr. Schwartz introduced partners to FLIP at Coopers & Lybrand and later PwC, these activities were apparently in addition to his primary duties serving clients within the Foreign Bank and Finance and Treasury Groups. *Id.*

[378] *Id.* The Subcommittee was told that, from 1998 to 1999, PwC assigned additional staff, three managers and a tax partner, to assist Mr. Schwartz in explaining generic tax products to potential clients. *Id.*

[379] Prepared statement of Richard J. Berry, Senior Tax Partner, PricewaterhouseCoopers LLP during Subcommittee Hearings (11/18/03).

[380] Letter dated 2/17/99 from Michael Schwartz, PwC, to Diane Stanford, Senior Vice President, First Union National Bank, Bates SEN–014602.

[381] *Id.*

[382] Subcommittee interview of Quellos representative (11/7/03).

[383] Letter dated 5/10/04, from PricewaterhouseCoopers to the Subcommittee, at 2.

same time, however, Quellos failed to register KPMG's FLIP transaction, even though the transactions were substantially the same, because, according to Quellos, KPMG had advised it not to register the product. Under questioning by Subcommittee Chairman Coleman at the November 20, 2003 hearing, the Quellos Chief Executive Officer testified that his firm had asked KPMG about registering FLIP and KPMG's response was that "[w]e have done our analysis and it is our opinion that it does not need to be registered."[384] The end result was that two substantially similar tax products, both called FLIP, received different registration treatment by Quellos, based upon differing advice provided by the two accounting firms using Quellos to help implement the FLIP transactions. In addition, neither accounting firm ever completed its own registration of FLIP, despite, in the case of PwC, advising another party to do so.

**Developing, Marketing, and Implementing BOSS.** The Bond and Options Sales Strategy or BOSS tax product provides a second illustration of PwC's flawed process for developing, marketing, and implementing potentially abusive or illegal tax shelters.

The BOSS transaction was a so-called "loss generator" intended to produce either capital or ordinary income losses at the end of a 2-year transaction which a client could then use to offset other income and shelter it from taxation.[385] It required a series of complex financial transactions to be undertaken in certain ways and at certain times to generate the promised tax losses.[386]

Like KPMG's BLIPS transaction, the BOSS transaction appeared to involve millions of dollars in at-risk investments when, in fact, the vast majority of funds used in the transaction were held in secure investments that posed little or no risk to the participating client, investment firm, or bank, while allegedly yielding multi-million dollar paper losses. The transaction typically required an out-of-pocket cash investment by the client equal to 8.5% of the target income to be sheltered or tax loss to be achieved. About half of that amount was used to pay fees to PwC; the investment advisor known as The Private Capital Management Group; the investment manager of the hedge fund trading account for the transaction, Bolton Asset Management; and Refco Bank which provided financ-

[384] Quellos testimony at Subcommittee Hearings (11/20/03).

[385] See "An Overview of the Bond & Option Sales Strategy ('Boss')," Bates SEN–016966–7.

[386] Suppose, for example, that a client's target income to be sheltered was $10 million. The BOSS transaction required the client to invest $850,000 from personal funds and obtain a $10 million recourse loan from a cooperating bank. The client would then use these funds to purchase common shares of a newly created offshore entity, referred to here as Newco. A cooperating investment firm would then purchase preferred shares of Newco for $10.9 million. At the same time, Newco would borrow $10 million from the bank. Newco would then use its $31 million in capital ($10 million from the clients, $10.9 million from the investment firm, and $10 million from the bank) to invest in two portfolios consisting of secure investments, such as 2-year money market obligations from the cooperating bank. Newco would also enter into two financial transactions known as "swaps" involving the $10.25 million and $21.1 million portfolios. In the end, only $450,000 out of the $30 million would be actually invested into a hedge fund with a chance to earn profits. All $450,000 would be taken from the personal funds contributed by the client, while the remaining $450,000 contributed by the client would be spent on fees paid to PwC, the bank, and the investment firm. At the conclusion of 2 years, Newco would distribute its $10.25 million portfolio to the client subject to the bank loan. The client would claim a $10 million capital loss upon the sale of his investment in Newco, while the client's loan of $10 million would ultimately be paid by Newco's portfolio of secure investments.

ing.[387] While the transaction also required the client to take out a large bank loan equal to the target income to be sheltered, the transaction was structured so that "all debt can be repaid without the advance by [client] of additional personal funds."[388] In short, the BOSS transaction was structured to allow the client to claim millions of dollars in tax losses, while limiting the actual funds at risk to the initial 8.5% cash contribution minus fees.[389]

Like the FLIP shelter, PwC used First Union to obtain referrals and access to the bank's clients. In April 1999, senior PwC tax professionals presented the BOSS tax product to First Union's Financial Advisory Services Due Diligence Committee. The meeting minutes attest that both First Union and PwC understood that "[t]his strategy will be a tax shelter due to the high level of leverage."[390] First Union ultimately referred 25 investors to PwC for BOSS presentations.[391]

In 1999, PwC was in the process of selling 120 BOSS transactions in exchange for substantial fees.[392] The evidence suggests that, at the time of these sales, PwC knew that this shelter was highly questionable. For example, a critical issues outline for BOSS indicates that "there exists no statutory or regulatory authority under Section 301 that illustrates a 'reduction for liabilities'" as assumed by the tax product.[393] The document also shows PwC was aware of legislative efforts to bar further use of the BOSS tax product. It notes "efforts underway in Congress to clarify the definition of 'subject to a liability' as opposed to 'assumption of a liability'" which would have caused problems for BOSS, although "PWC views the current strategy—as being outside the scope of legislation being proposed."[394] Despite the lack of statutory provisions supporting key elements of the BOSS strategy and pending legislative concerns, PwC continued to sell BOSS to its clients.

In December 1999, prior to any legislative change, the IRS issued Notice 1999–59 identifying the BOSS transaction as an abusive tax shelter.[395] For many customers, the "lynchpin of the BOSS strategy was the issuance of a PwC opinion, reflecting PwC's interpretation, on which customers could rely."[396] PwC also declared in a prepared statement issued at the time of the IRS notice that it was providing "advice to our clients with regard to legitimate tax-saving

[387] "Capital BOSS attributes," Bates SEN–016968. The evidence indicates that the typical BOSS fees for a $10 million capital loss transaction were as follows: PricewaterhouseCoopers—$150,000; The Private Capital Management Group—$150,000; Bolton Asset Management—a performance based fee; and Refco Bank—$100,000.

[388] "Capital BOSS attributes," Bates SEN–016968.

[389] *Id.*

[390] Minutes dated 4/22–23/99, of a meeting of First Union's Financial Advisory Services, Enhanced Investment Strategies, Risk Management Process/Due Diligence Committee, ("Basis Offset Strip Strategy ('BOSS') strategy minimizes ordinary income and/or capital gains. . . . The strategy will be in place by July to give as much time as possible between the steps of the strategy. This strategy will be a tax shelter due to the high level of leverage."), Bates SEN–014588–89.

[391] Letter dated 5/10/04 from PricewaterhouseCoopers to the Subcommittee, at 1.

[392] Prepared statement of Richard J. Berry, Senior Tax Partner, PricewaterhouseCoopers LLP, Subcommittee Hearing (11/18/03).

[393] BOSS—Basis Offset Strip Strategy, Critical Issues, May, 1999, Bates SEN–014599–600.

[394] *Id.*

[395] PricewaterhouseCooper's BOSS transaction is covered by IRS Notice 1999–59 (1999–52 IRB 761).

[396] Letter dated 9/28/00 from Donald McMullen, First Union Vice Chairman, Capital Management Group to James Schiro, Chief Executive Officer, PricewaterhouseCoopers, Bates SEN–016757–58.

opportunities."[397] However, after IRS Notice 1999–59 was published, PwC apparently declined to issue new opinion letters for BOSS.[398]

Moreover, in early 2000, unlike other tax shelter promoters, PwC decided to refund clients approximately 85% of the cash they had invested in the BOSS transaction. That amount, according to PwC, included all fees paid by the client to PwC in connection with the BOSS transaction.[399]

According to PwC, its negative experience with the BOSS tax product convinced the firm to abandon its abusive tax shelter activities. A senior PwC Tax Partner testified at the Subcommittee hearing as follows:

> The BOSS transaction triggered widespread public attention and controversy in the fall of 1999. As a result, we decided that we had made a regrettable mistake being in this business. Our reputation was hurt, our clients and people were embarrassed. . . .
>
> We got out of this business immediately. We established an independent and centralized quality control group. We strengthened our procedures ensure that we would never again engage in this activity. . . .
>
> We take responsibility for our actions, and we have learned from our mistakes.[400]

In response to questioning by Chairman Coleman, Mr. Berry testified that, "with respect to the BOSS transaction, . . . that in my judgment is an abusive shelter, . . . With respect to FLIP and CDS, if not abusive, they come very close to that line. . . . We regret that we ever got involved in those transactions, and we would not do them today."[401]

On June 26, 2002, PwC settled with the IRS regarding the compliance and registration requirements of the tax law for the promotion of abusive tax shelters. PwC told the Subcommittee that it was the first accounting firm to settle with the IRS. PwC entered into a settlement agreement with the IRS in which PwC agreed to make a $10 million payment to the IRS, turn over certain client lists, and allow the IRS to review not only its quality control procedures but over 130 tax planning strategies intended for sale to multiple clients.[402] According to PwC, the IRS reviewed their quality control procedures and told PwC that they were comprehensive, thorough, and effective.[403]

**(2) PricewaterhouseCoopers' Current Status**

**Finding: PricewaterhouseCoopers has committed to cultural, structural, and institutional changes intended to**

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397 See John D. McKinnon, "IRS Moves to Disallow a Tax Shelter That Generates Paper Investment Losses," *Wall Street Journal,* December 10, 1999 at A6.

398 *Id.*

399 Letter dated 1/5/00, from PricewaterhouseCoopers to Dear Investor, "Re: Bond & Option Sales Strategy Investment," Bates SEN–020060.

400 PwC prepared testimony at Subcommittee hearings (11/18/03), at 54–55.

401 *Id.*, at 59.

402 According to PricewaterhouseCoopers, none of these tax strategies were determined by the IRS to require tax shelter registration. Letter dated 5/10/04 from PricewaterhouseCoopers to the Subcommittee, at 5.

403 *Id.*

**dismantle its abusive tax shelter practice, including by establishing a centralized quality and risk management process, and strengthening its tax services oversight and regulatory compliance.**

According to PwC, after BOSS was identified by the IRS in December 1999, as an abusive tax shelter, PwC's senior management recognized that BOSS, CDS, and FLIP represented an "institutional failure" and undertook a number of reforms to ensure that similar abusive tax shelters would not be marketed by PwC in the future.[404]

**Leadership and Institutional Changes.** PwC stated that, as a first step in late 1999, it disbanded the group of tax professionals responsible for the sale of FLIP, CDS, and BOSS.[405] In 2000, PwC appointed a new head of its U.S. Tax Practice, Richard Berry, and charged him with establishing a centralized quality and risk management function for the firm's tax practice. As Head of Tax Services, Richard Berry reports directly to the Chief Executive Officer of PwC.

In the summer of 2000, PwC created a new Quality and Risk Management group to oversee the development of new PwC tax products and services, prevent PwC's participation in abusive tax shelters, and protect PwC from reputational risk.[406] The Quality and Risk Management Group (Q&RM) was established as an independent administrative unit within the Tax Practice separate from its other business units.[407] The Q&RM head reports to the head of the U.S. Tax Practice. The Q&RM group currently has seven full-time partners and five other professional staff.[408] In addition, nine tax partners in PwC regional offices spend one-third to one-half of their time on Q&RM duties, advancing quality and risk management policies and procedures across the firm's nine U.S. regions.[409]

PwC told the Subcommittee that the Q&RM head was also made a member of PwC's Tax Core Leadership group. This group includes the leaders of each of PwC's tax services business units, and PwC indicated that the Q&RM head was included to ensure that Q&RM was aware of the tax products and services being offered by each business unit and to place the Q&RM head on an equal footing with PwC's other tax leaders.[410] According to PwC, the Tax Core Leadership has weekly conference calls, face-to-face meetings once a month, and meetings with tax professionals three times a year.[411]

**Centralized Product Development Process.** In addition to the Quality and Risk Management group, PwC established a new centralized tax product development process for all tax products and services.[412] PwC explained that this "quality review process is comprehensive and has differing levels of review depending upon

[404] Subcommittee meeting with PricewaterhouseCoopers (5/27/04).
[405] PwC prepared statement at Subcommittee Hearings (11/18/03), at 4.
[406] See id., at 4.
[407] Subcommittee meeting with PricewaterhouseCoopers (5/27/04).
[408] *Id.*
[409] *Id.*
[410] Subcommittee meeting with PricewaterhouseCooopers (5/27/04).
[411] *Id.*
[412] Letter dated 5/10/04, from PricewaterhouseCoopers to the Subcommittee, at 6–7.

the complexity of the issues involved."[413] As part of this process, PwC created a new PINNACLE database as a centralized repository for tax service offerings that the firm may provide to more than one client.[414] PwC requires every proposed new tax product intended to be offered to more than one client be entered into the database so that senior PwC leadership could track and monitor all product development. PwC also requires that its business unit leaders affirm annually that all of the tax products implemented for more than one client have been included in the PINNACLE database.[415] PwC further requires the authors of specific tax products to review the PINNACLE database on a semi-annual basis to identify any compliance problems, changes in the law, or other matters.

In addition, PwC established a centralized review and approval process for all new PwC tax products. For tax products that may be applicable to more than one client but not widely applicable, so-called "Shared Solutions," PwC requires the proposed product to be reviewed and approved by a senior tax partner or recognized tax expert prior to submission into the PINNACLE database. Once included in the database, PwC requires Q&RM to review the products and determine whether Q&RM approval or Tax Core Leadership approval is required.

For tax products deemed potentially suitable for national distribution, so-called "Distributed Solutions," PwC requires additional levels of review. PwC told the Subcommittee that the proposed product must first undergo a technical analysis by "appropriate specialists," a preliminary "qualification" review by a Q&RM partner, and a preliminary review by a member of Tax leadership to identify potential problems. PwC indicated that Q&RM also has the authority to establish an independent review panel of experts to review the proposal further. PwC indicated that this panel typically consists of three tax partners who must be independent of the tax professionals developing the tax product and who must reach unanimous agreement on its technical merits in order for the proposal to advance. PwC indicated that Q&RM could also require approval of Tax Core Leadership which considers such factors as tax policy, firm ethics, and the risk of adverse publicity. PwC then requires final approval of the proposed "Distributed Solution" by both Q&RM and its Federal Tax Policy group.

PwC also implemented a system requiring mandatory Q&RM training for all PwC tax professionals lasting 2 days every 4 months. The required course includes computer-based training regarding IRS registration and list maintenance obligations.

At the Subcommittee hearing on November 18, 2003, PwC testified:

> Our experience almost 4 years ago served as a wake-up call to the Tax practice. Our partners were adamant that we get out of this business immediately. We shut down the largest transaction and returned all of our fees. We settled with the IRS. We implemented comprehensive quality control procedures to ensure that the firm would never again be engaged in the mar-

[413] PwC prepared statement at Subcommittee Hearings (11/18/03), at 5.
[414] Subcommittee meeting with PricewaterhouseCoopers (5/27/04).
[415] *Id.*

keting and development of potentially abusive tax products. As a firm, this was the best thing that could have happened to us. We acknowledge our actions and we have learned from this regrettable mistake.

## VI. ROLE OF LAWYERS

Accounting firms were far from the only professional firms active in the U.S. tax shelter industry. Some large, respected law firms also played a prominent role as illustrated by the following two case histories.[416]

### A. SIDLEY AUSTIN BROWN & WOOD

**Finding: Sidley Austin Brown & Wood, through its predecessor firm Brown & Wood, provided legal services that facilitated the development and sale of potentially abusive or illegal tax shelters, including by providing design assistance, collaboration on allegedly "independent" tax opinion letters, and hundreds of boilerplate tax opinion letters to clients referred by KPMG and others, in return for substantial fees.**

Sidley Austin Brown & Wood (hereinafter "Brown & Wood") provided legal services that included design assistance on potentially abusive or illegal tax shelters as well as collaboration on opinion letters representing to clients that a tax product could withstand an IRS challenge. In return, Brown & Wood received substantial fees. According to the IRS, Brown & Wood provided approximately 600 opinions for at least 13 "listed" or other potentially abusive tax shelters, including KPMG's FLIP, OPIS, BLIPS, E&Y's COBRA, and PwC's BOSS.[417] Brown & Wood's participation was coordinated and directed largely through the efforts of one Brown & Wood tax partner, R.J. Ruble.[418]

The evidence shows, for example, that Brown & Wood had a close relationship with KPMG that lasted at least 5 years and involved at least three key KPMG tax products, FLIP, OPIS, and BLIPS. One of the earlier communications uncovered by the Subcommittee is a December 1997 email sent by R.J. Ruble to a KPMG tax partner informing KPMG that Mr. Ruble knew various people in the "tax advantaged product" area.[419] While Brown & Wood and KPMG both deny entering into a formal agreement to develop or market tax products,[420] some documents suggest that an alliance did exist in practice. One 1997 KPMG email states, for example, that KPMG and Brown & Wood had formed an alliance or agreement "to jointly develop and market tax products and jointly share

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[416] For more information on the role of law firms in abusive tax shelters, see e.g., "Helter Shelter," American Lawyer (12/03), at 65 (Jenkins and Gilchrist's tax partner Paul Daugerdas wrote legal opinions and participated in the sale of at least 600 COBRA tax shelters promoted by E&Y and the Diversified Group).

[417] See "Declaration of Richard E. Bosh," IRS Revenue Agent, In re John Doe Summons to Sidley Austin Brown & Wood (N.D. Ill. 10/16/03).

[418] *Id.*

[419] See email dated 12/24/97, from R.J. Ruble to Randall S. Bickham, "Confidential Matters," Bates KPMG 0047356–57.

[420] See, e.g., letter dated 1/16/04, from Sidley Austin Brown & Wood to the Subcommittee at 4; Subcommittee interview of Randall Bickham (11/17/03).

in the fees." [421] Another 1997 KPMG memorandum proposes that a Brown & Wood strategic alliance "can make significant contributions to the product development process and would allow immediate brand recognition." [422] Still another KPMG memorandum, in 1998, discusses an upcoming meeting with R.J. Ruble to "institutionalize the KPMG/B&W relationship." [423] A 1999 Brown & Wood memorandum indicates that the law firm's management committee had specifically approved BLIPS as a new client matter for tax advice services to KPMG.[424]

Other evidence details the nature of the interactions between Brown & Wood and KPMG. Some suggest that R.J. Ruble participated in the development of KPMG tax products like BLIPS. For example, an email regarding BLIPS sent on December 3, 1998 from KPMG to various KPMG employees states:

> I spoke with R.J. this morning about a "tax-focused" meeting next week. As a first step before scheduling a meeting, we thought that we should first draft the base of an opinion letter in an outline format. . . . [W]e are currently working on the document and expect to circulate it next week.[425]

A memorandum dated December 3, 1998, from R.J. Ruble to KPMG demonstrates the detailed technical nature of the assistance contributed by Mr. Ruble to the development of BLIPS. Mr. Ruble writes:

> In looking at the bond premium rules in another context (i.e. a legitimate deal), I found an issue that we need to address for BLIPS. As I read it, the treatment of bond premium received by an issuer is governed by Treas. Reg. 161–12(c) and Treas. Reg. 1.163–13. The latter treats the premium as an offset to the issuer's interest deduction. The former provides that it not included in income when received and by reference to the latter. . . .
>
> When the investor transfers the assets subject to the loan to the partnership, I have always assumed that the partnership's acquisition of the property is governed solely by section 721 etc. Is this true? Could 1.61–12 over ride. Even if it did could we also say that the drop down of [the] amount equal to the premium would create an offsetting deduction. Am I worrying too much? [426]

Such communications indicate that Mr. Ruble was part of the development team for BLIPS at its earliest stages. In fact, the advice offered by him in his December 1998 email was provided 3 months before KPMG initiated its formal internal review and approval process for BLIPS in February 1999.

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[421] See email dated 12/15/97, from Randall Bickham at KPMG to multiple KPMG tax professionals, "Joint Products," Exhibit 116.

[422] Memorandum dated 12/19/97, from Randall S. Bickham to Gregg Ritchie, "Business Model—Brown & Wood Strategic Alliance," Bates KPMG 0047228–30.

[423] See Memorandum dated 3/2/98, from Randall S. Bickham to Gregg Ritchie, "B&W Meeting," Bates KPMG 0047358–59.

[424] Brown & Wood New Matter Memorandum dated 1/6/99, Bates SIDL–SCGA082444.

[425] Email dated 12/3/98, from Randall Bickham to numerous recipients including R.J. Ruble, "RE: Blips meeting," Bates KPMG 0037336.

[426] Memorandum dated 12/3/98, from R.J. Ruble to Randy Bickham, George Theofel, "Re: *BLIPS,*" Bates SIDL–SCGA083244.

In addition to development assistance, Brown & Wood provided a steady steam of concurring legal opinions to purchasers of KPMG's FLIP, OPIS, and BLIPS tax shelters. The evidence also suggests that the opinion writing for these tax products was a collaborative rather than independent process. For example one Ruble email to KPMG on BLIPS asks: "[D]id Shannon [KPMG employee] ever do the side by side comparison to make sure our legal analysis were compatible? Any changes she might suggest would be important." [427] Another KPMG email on BLIPS and OPIS states:

> Client just called, do we have an ETA on when we should be seeing the Brown & Wood OPIS opinions? It is my understanding the [SIC] for both BLIPS and OPIS, B&W is using our opinion as the starting point for their opinion? [428]

Still another KPMG email on FLIP states: "Brown & Wood requested a copy of the [FLIP] opinions to issue their opinion." [429] Eventually, in the case of BLIPS, KPMG and Brown & Wood actually exchanged copies of their drafts, eventually issuing two allegedly independent opinion letters that contained numerous, virtually identical paragraphs. The evidence suggesting side-by-side comparisons and Brown & Wood's use of KPMG opinions to write its own supposedly "independent" legal opinions shows that Brown & Wood and KPMG were close collaborators, rather than independent actors.

Brown & Wood received lucrative fees for writing opinion letters supporting tax products like FLIP, OPIS, and BLIPS. Brown & Wood told the Subcommittee that it estimates that that the firm wrote 62 opinions for FLIP, 72 opinions for OPIS, and 180 opinions for BLIPS.[430]

Brown & Wood documents show that the firm was paid at least $50,000 for each of these legal opinions. 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 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:

> *Brown & Wood fees:*
>
> Quadra OPIS98—30 bpts
> Quadra OPIS99—30 bpts
>
> Presidio OPIS98—25 bpts
> Presidio OPIS99—25 bpts
> BLIPS—30 bpts [431]

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[427] Email dated 2/3/00, from R.J. Ruble to Jeffrey Eischeid, "RE: RJ Ruble's email." Bates KPMG 0033591.

[428] Email dated 2/22/00, from Jean Monahan to Jeffrey Eischeid, "Subject: OPIS opinions," Bates KPMG 0033585.

[429] Email dated 11/9/98, from numerous authors to numerous recipients, "Subject: FLIP opinions for," Bates KPMG 0033447.

[430] Letter dated 1/16/04, from Sidley Austin Brown & Wood to the Subcommittee, at 2.

[431] Email dated 5/15/00, from Angie Napier to Jeffrey Eischeid and others, "B&W fees and generic FLIP rep letter," Bates KPMG 0036342.

Brown & Wood estimates that the firm received $3,418, 290 in fees from FLIP, $6,427,637 from OPIS, and $13,286,790 from BLIPS for a grand total of more than $23 million.[432]

It is also important to note that most of the "independent" Brown & Wood opinions apparently did not require extensive effort, but could be produced quickly. For example, an email states: "[i]f you have a KPMG opinion, you should also have a B&W opinion. We do ours and they use it as a factual template for their opinion, usually within 48 hours."[433] In fact, Brown & Wood reported to the Subcommittee that, in December 1999 alone, it issued 65 BLIPS opinions totaling approximately $9,290,476.[434] This data indicates that the law firm issued an average of two or more BLIPS opinions per day, at a cost of $142,000 per opinion—very quick and lucrative work. Brown & Wood also estimated that, altogether, Mr. Ruble spent about 2,500 hours preparing legal opinions for KPMG tax products, a pace that, in light of the firm's overall $23 million in fees, generated an average hourly rate of more than $9,000 per billable hour.[435]

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." Brown & Wood charged the same minimum fee—more in cases of larger transactions—for each legal opinion it issued to a FLIP, 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. These fees, with few costs after the prototype opinion was drafted, raised questions about the firm's compliance with ABA Model Rule 1.5.

At the Subcommittee hearings, Mr. Ruble, invoked his Fifth Amendment right against self-incrimination in response to questioning by the Subcommittee.[436] Thomas R. Smith, Jr., former managing partner of Brown & Wood, testified that Mr. Ruble was virtually the only lawyer within the firm engaged in providing concurring opinions for generic tax products sold to multiple clients.[437] He also testified that the firm Brown & Wood was unable to produce a copy of the firm's written procedures for reviewing tax opinion letters prior to 2000, and did not, until recently, maintain a central file of the letters actually sent to clients.

Mr. Smith testified at the hearing that, before a tax opinion letter was issued by the firm, Brown & Wood had required approval of the draft opinion by a second tax partner, but the firm had no

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[432] Letter dated 1/16/04, from Sidley Austin Brown & Wood to the Subcommittee, at 2.

[433] Email dated 7/20/97, from Angie Napier to Jeffrey Eischeid, "FW: brown & wood," Bates KPMG 0036577.

[434] See Billing Records, "Cash Receipts," Bates SIDL–SCGA039315; SIDL–SCGA037620; SIDL–SCBA063485; and SIDL–SCGA006056.

[435] Letter dated 1/16/04, from Sidley Austin Brown & Wood to the Subcommittee, at 2 ("it appears that approximately 2,500 hours were recorded by Mr. Ruble with respect to KPMG transactions.").

[436] In October 2003, Sidley Austin Brown & Wood terminated R.J. Ruble for breaches of fiduciary duty and violations of its partnership agreements.

[437] Prepared statement of Thomas R. Smith, Jr., Tax Partner, Sidley Austin Brown & Wood, at Subcommittee Hearings (11/20/03).

procedures for tracking compliance with that requirement. After the hearing, a letter provided by the law firm stated that none of the partners in the tax department considered themselves to have functioned as the requisite reviewing partner for the Ruble opinions.[438] The letter also indicated that although the firm had made the decision to discontinue the practice of issuing generic tax product opinions in May 2001, after Brown & Wood merged with another law firm, Sidley Austin, the firm discovered that additional opinions by Mr. Ruble had been issued after the date of the merger, in clear violation of the firm's policy decision.[439]

Sidley Austin Brown & Wood told the Subcommittee that to correct the problems uncovered in connection with Mr. Ruble, the firm hired in 2003, a tax attorney whose principal responsibility is to monitor internal procedures respecting tax matters and compliance with IRS requirements.[440]

### B. SUTHERLAND ASBILL & BRENNAN

**Finding: Sutherland Asbill & Brennan provided legal representation to over 100 former KPMG clients in tax shelter matters before the IRS, despite a longstanding business relationship with KPMG and without performing any conflict of interest analysis prior to undertaking these representations.**

Sutherland Asbill & Brennan is a law firm that played a very different role in the U.S. tax shelter industry. It did not help develop, promote, or implement tax shelters; nor did it write legal opinions supporting tax shelters. Instead, Sutherland Asbill & Brennan's role was to defend clients accused by the IRS of buying illegal tax shelters and understating their tax liabilities. Because many clients bought the same or similar tax shelter products from the same promoter, Sutherland Asbill & Brennan at times represented multiple clients in IRS and court proceedings, and at times attempted to negotiate "global settlement agreements" with the IRS that would allow multiple taxpayers to resolve their desputes.

Sutherland Asbill & Brennan was one of a number of so-called "friendly" law firms to which KPMG referred tax shelter participants for legal representation after the IRS had initiated enforcement action against them. KPMG apparently considered Sutherland Asbill & Brennan a "friendly" law firm due to the firm's longstanding and ongoing representation of KPMG in business litigation matters unrelated to cases involving tax shelters. In most of these cases, Sutherland Asbill & Brennan had defended KPMG against claims of malpractice by former clients. In fact, Sutherland Asbill & Brennan told the Subcommittee that, for the 4-year period from 1998 to 2002, KPMG had paid the firm $13.9 million for legal representation in matters unrelated to tax shelters.[441] In light of the law firm's longstanding close relationship with KPMG, one of the issues examined by the Subcommittee was whether a potential

[438] Letter dated 1/16/04, from Sidley Austin Brown & Wood to the Subcommittee, at 4.
[439] *Id.*
[440] *Id.* at 3.
[441] Letter dated 12/19/03, from Sutherland Asbill & Brennan to the Subcommittee, at Exhibit B.

conflict of interest existed regarding this law firm's representation of former KPMG clients in tax shelter matters raising questions about the quality of advice rendered by KPMG to those clients.

Sutherland Asbill & Brennan told the Subcommittee that it had engaged in 39 "matters," involving a total of 113 separate clients, in connection with KPMG tax products such as FLIP, OPIS, or BLIPS.[442] The firm also told the Subcommittee that at least 17 of these "matters" had come from KPMG referrals, while an additional 8 referrals came from Quellos Group, which was the investment advisor for KPMG's FLIP and OPIS transactions, or Wachovia Bank, whose subsidiary, First Union National Bank, had referred bank customers to KPMG for tax products.[443] This data indicates that the majority of the law firm's KPMG clients resulted from direct referrals by KPMG or other professional entities affiliated with the KPMG tax products.

While both KPMG and a former KPMG client have an immediate joint interest in defending the validity of the tax product that KPMG sold and the client purchased, the interests of these two parties could quickly diverge if the suspect tax product is found to be in violation of Federal tax law. This divergence in interests has happened repeatedly since 2002, as more than a dozen lawsuits have been filed by former KPMG clients seeking past fees paid to the firm and additional damages for KPMG's selling them an illegal tax shelter.

A lawyer has a professional responsibility to analyze whether a conflict of issue may impede his or her ability to zealously assert a client's interest. Sutherland Asbill & Brennan, in response to the Subcommittee's request, was unable to produce any written procedures for undertaking this type of conflict of interest analysis prior to accepting a client engagement. It was also unable to produce any analysis prepared prior to entering into its representation of former KPMG clients in matters involving KPMG tax products.[444]

The firm did produce, however, engagement letters signed by former KPMG clients, informing these clients of a possible conflict of interest should they wish to sue the accounting firm that sold them the illegal tax shelter. For example, each engagement letter signed by a former KPMG client, in which the client agreed to pay Sutherland Asbill & Brennan to represent him before the IRS in connection with a KPMG tax product, 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).[445]

According to one KPMG client interviewed by the Subcommittee, he had not understood at the time that the above statement meant that Sutherland Asbill & Brennan 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

[442] *Id.*
[443] *Id.*, at Exhibits A and B.
[444] *Id.*, at 5.
[445] See, e.g., engagement letter dated 7/3/02, between Sutherland Asbill & Brennan LLP and the client, Bates SA 001964.

shelter.[446] This client told the Subcommittee that he had hired the law firm solely on the recommendation of KPMG—he had never employed the firm before, and it did not even have an office in his state. The client told the Subcommittee that when he finally understood that the law firm was already representing KPMG in other matters, he switched counsel from Sutherland Asbill & Brennan to another firm and eventually decided to sue KPMG for selling him an illegal tax shelter.[447]

This former KPMG client was apparently not the only client unclear about the significance of the disclosure in the engagement letter. For example, Sutherland Asbill & Brennan wrote the following to another KPMG tax shelter participant to clarify the significance of the disclosure:

> All this paragraph is meant to tell you is that because of a conflict, we could not represent you in the pursuit of any claim against the parties who advised you in connection with the transaction. It was meant to alert you to this in case you wanted to retain someone who was not conflicted to advise you of your rights in that respect.
>
> This paragraph clearly was not meant to waive any rights that you might have against any of the parties who advised you to enter into the transaction. . . .[448]

A review of Sutherland Asbill & Brennan attorney notes to client files of other KPMG clients indicates that other KPMG clients seemed to have expressed interest in exploring the merits of suing KPMG and to be unaware of the law firm's inability to pursue such claims on the client's behalf. One attorney's notes state: "I advise[d] him that I cannot advise [the former KPMG client] about any rights he has vis a vis KPMG." This statement was made after the former KPMG client had signed an engagement letter with Sutherland Asbill & Brennan.[449] Another attorney's notes disclose: "They also asked [about] suits against promoters. I told them that 'I need to duck my head in the sand on these.' I purposefully try not to know anything."[450] Later, the same client "asked again about suing KPMG."[451] Both of these conversations took place after the former KPMG client had signed an engagement letter with the law firm. In short, the firm's "blanket disclosure" in its engagement letter seemed to leave at least some clients uninformed about Sutherland Asbill & Brennan's longstanding relationship with KPMG and the inability of the law firm to consider filing suit against KPMG for selling illegal tax shelters, due to its duty of loyalty to its longtime client, KPMG.

In another matter involving a former KPMG client, Sutherland Asbill & Brennan "engaged KPMG" itself to assist the law firm in

[446] This client asked Sutherland Asbill & Brennan LLP about the merits of suing KPMG and was told that the firm could not represent him in such a legal action. Subsequently, the client switched to new legal counsel.

[447] KPMG has told the Subcommittee that this is the only instance it knows in which a former KPMG client has ended up suing KPMG for selling an illegal tax shelter. Letter dated 12/9/03, from Sutherland Asbill & Brennan to the Subcommittee, at 5.

[448] Letter dated 2/13/02, from Sutherland Asbill & Brennan LLP to client, at 1. Bates SAB0035.

[449] Sutherland Asbill & Brennan LLP attorney notes to file, dated 7/14/02. Bates SAB0174.

[450] *Id., Bates SAB0052.*

[451] *Id., Bates SAB0053.*

its representation of the former KPMG client, including with respect to "investigation of facts, review of tax issues, and other such matters as Counsel may direct." [452] This engagement meant that KPMG, as Sutherland Asbill's agent, would be given 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. Sutherland Asbill & Brennan told the Subcommittee that, despite this engagement letter, the law firm never actually utilized the services of KPMG in this case. In still another matter, the law firm's notes suggest that a former KPMG client wanted to exclude all KPMG participation from their case, but the law firm demurred: "The only reason I see to cut KPMG out completely is if they want to sue. And we cannot advise on that." [453]

Still another disturbing document is a 2002 email from one KPMG tax professional to another, later forwarded to numerous additional KPMG tax professionals stating that KPMG had been given notes taken by a Sutherland Asbill & Brennan attorney during a meeting with the IRS.[454] The email states: "Notes from Jerry Cohen's meeting w/IRS on the 9th. You may distribute this. Please not[e] the comments on Flip/Opis." This email suggests that the law firm was sharing information with KPMG about tax shelter discussions that the law firm held with the IRS while representing KPMG's former clients. This information was of such interest that KPMG sent it to more than three dozen of its tax professionals. Such information sharing—obtained on behalf of one client and shared with a party that is not being legally represented by the firm in the same manner [455]—raises additional questions about the law firm's dual loyalties.

The preamble to the American Bar Association (ABA) Model Rules states "a lawyer, as a member of the legal profession, is a representative of clients, an officer of the legal system and a 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 with the Sutherland Asbill & Brennan representation is the conflict of interest that arises when a law firm attempts to represent an accounting firm's former client at the same time it is representing the accounting firm itself in other matters, and the issue in controversy is a tax product that the accounting firm sold and the former client purchased. In such a case, the issue is how the attorney can zealously represent the interests of both its clients in light of potential 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

[452] Engagement letter dated 9/3/02, from Sutherland Asbill & Brennan and KPMG, Bates SAB0180–82.

[453] Sutherland Asbill & Brennan LLP attorney notes to file, dated 11/24/03. Bates SAB0024.

[454] Email dated 7/11/02, from Ken Jones to Jeffrey Eischeid, then forwarded to multiple KPMG tax professionals, Bates KPMG0027990.

[455] See, e.g., letter dated 11/18/03, from Sutherland Asbill & Brennan LLP to the Subcommittee, at 2. Bates XX–002186.

interest issues.[456] The CRS analysis concluded that, under ABA Model Rule 1.7, a law firm should decline to represent an accounting firm's 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."

Alternatively, 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. Clearly, some Sutherland Asbill & Brennan clients were less than fully aware of the firm's conflict of interest in relation to KPMG, and did not seem to receive additional information prior to signing an engagement letter with Sutherland Asbill & Brennan.

## VII. ROLE OF FINANCIAL INSTITUTIONS

**Finding: Deutsche Bank, HVB Bank, and UBS Bank provided billions of dollars in lending critical to transactions which the banks knew were tax motivated, involved little or no credit risk, and facilitated potentially abusive or illegal tax shelters known as FLIP, OPIS, and BLIPS.**

The tax shelters examined in this Report could not have been executed without the active and willing participation of major banks. Banks provided the requisite loans for hundreds of these tax shelter transactions. Three major banks investigated by the Subcommittee participated in KPMG's FLIP, OPIS, and BLIPS.[457]

[456] 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."

[457] NatWest apparently also participated in a significant number of BLIPS transactions in 1999 and 2000, providing credit lines totaling more than $1 billion. See, e.g., email dated 6/20/

Deutsche Bank participated in 56 BLIPS transactions in 1999, providing credit lines to KPMG clients totaling $7.8 billion.[458] Deutsche Bank also participated in 62 OPIS transactions from 1997 to 1999, providing credit lines that totaled $3 billion.[459] HVB Bank participated in 29 BLIPS transactions in 1999 and 2000, providing BLIPS credit lines that totaled about $2.5 billion.[460] UBS AG participated in 100 to 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.[461]

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 makes it plain that the banks were aware that the tax products were potentially abusive and carried a risk to the reputation of any bank choosing to participate in it. In exchange for their active and knowing participation, the banks obtained lucrative fees. For example, Deutsche Bank obtained $44 million in bank fees from the BLIPS transactions, and $35 million from OPIS, for a grand total of $79 million.[462] HVB obtained over $5.45 million for the BLIPS transactions it completed in less than 3 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."[463]

## A. DEUTSCHE BANK

The critical role played by major banks in KPMG's tax shelter activities is illustrated by Deutsche Bank's participation in 56 BLIPS transactions in 1999.

A number of Deutsche Bank documents show 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:

> 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 [Risk & Resources] Committee to approve reputation risk on BLIPS. This will be

00, from William Boyle of Deutsche Bank to other Deutsche Bank personnel, "Updated Presidio/KPMG trades," Bates DB BLIPS 03280.

458 See prepared statement by Deutsche Bank at Subcommittee Hearings (11/20/03), at 2.

459 *Id.*

460 See prepared statement by HVB Bank at Subcommittee Hearings (11/20/03), at 5.

461 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).

462 See prepared statement by Deutsche Bank at Subcommittee Hearings (11/20/03), at 2.

463 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.

> dealt with directly by the Tax Department and [Deutsche Bank Americas Chief Executive Officer] John Ross.[464]

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.[465]

Still another Deutsche Bank document states: "For tax and accounting purposes, the [loan] premium amount will be treated as a loss for tax purposes."[466]

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 Deutsche Bank Americas' Chief Executive Officer John Ross, who made the final decision on the bank's participation.[467] 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 liti-

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[464] Email dated 7/30/99, from Ivor Dunbar of Deutsche Bank, DMG UK, to multiple Deutsche Bank professionals, "Re: Risk & Resources Committee Paper—BLIPS," Bates DB BLIPS 6554. 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).").

[465] Undated document entitled, "New Product Committee Overview Memo: BLIPS Transaction," Bates DB BLIPS 01959–63.

[466] 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.

[467] 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.

> gation 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.[468]

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 was fully aware of the nature of the financial product they would be financing.

Additional evidence shows that Deutsche Bank was aware that the BLIPS loans it had been asked to provide were not standard 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, 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."[469] When the bank declined to make the requested representation, the KPMG's 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."[470] He tried a third time and reported: "I've pushed really hard for our original language. To say they are resisting is an understatement."[471] 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 consistent, in the light of all the circumstances such authorities consider relevant, with [the Bank's] credit and documentation standards."[472]

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

[468] *Id.* at 6520.

[469] Email dated 3/20/00, from Jeffrey Eischeid to Mark Watson, "Bank representation," Bates KPMG 0025754.

[470] Email dated 3/27/00, from Jeffrey Eischeid to Richard Smith, "Bank representation," Bates KPMG 0025753.

[471] Email dated 3/28/00, from Jeffrey Eischeid to Mark Watson, "Bank representation," Bates KPMG 0025753.

[472] KPMG prototype tax opinion letter on BLIPS, dated 12/31/99, at 11.

> 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.[473]

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. At the Subcommittee hearing on November 20, when asked about this proposal, the Deutsche Bank representative seemed to deny that the bank had actually presented it to HVB, while HVB testified that Deutsche Bank had, in fact, made the proposal to HVB which declined to accept it.[474]

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."[475] The presentation listed as the bank's "strengths" its ability to lend funds in connection with BLIPS and its "relationships with [the] 'promoters'"[476] later named as Presidio and KPMG.[477] An internal bank email a few months earlier asked: "What is the status of the BLIPS. Are you still actively marketing this product[?]"[478]

In light of the bank's concerns regarding the reputational risk associated with BLIPS, the bank discussed using attorney-client privilege to conceal its activities. In an internal email, one Deutsche Bank employee wrote to another regarding the BLIPS risk analysis documents: "I 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)."[479] 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 trans-

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[473] Email dated 6/20/00, from William Boyle to multiple Deutsche Bank professionals, "Updated Presidio/KPMG trades," Bates DB BLIPS 03280.

[474] See Subcommittee Hearings (11/20/03), at 114.

[475] Email dated 4/3/02, from Viktoria Antoniades to Brian McGuire and other Deutsche Bank personnel, "US GROUP 1 Pres," Bates DB BLIPS 6329–52, attaching a presentation dated 11/15/99, entitled "Structured Transactions Group North America," at 6336, 6346.

[476] *Id.* at 6337.

[477] *Id.* at 6346.

[478] Email dated 7/19/99, involving multiple Deutsche Bank employees, "Update NY Issues," Bates DB BLIPS 6775.

[479] 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.

action poses to the reputation of the bank, in order not to leave "an audit trail":

> 1. STRUCTURE: A diagramatic representation of the deal may help the Committee's understanding—we can prepare this.
>
> 2. PRIVILEDGE [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 affaires. 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.[480]

Despite the bank's apparent 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.[481] At the Subcommittee hearings, although the Deutsche Bank representative testified that, "it was very clear from the opinions and everything that there were significant tax benefits that the investor may report on its return" from the BLIPS transaction, he resisted characterizing BLIPS as a "tax-driven" transaction, as set forth in an internal bank document.[482]

Deutsche Bank told the Subcommittee that, in October 2000, it reorganized and refocused the business strategy of the Structured Transaction Group that had been handling tax products like BLIPS. According to Deutsche Bank, the group is now called the Structured Capital Markets Group and does not execute tax advantaged transactions such as BLIPS to multiple clients. Instead, the bank provides investment and borrowing services to meet specific client requirements.[483]

### B. HVB BANK

HVB Bank participated in 29 KPMG BLIPS transactions during 1999 and 2000, providing credit lines totaling about $2.2 billion and generating millions of dollars in bank fees. According to HVB, Robert Pfaff first approached HVB Bank in late August or early September 1999 to solicit their participation in BLIPS.[484] Mr. Pfaff, a former KPMG tax professional, was then an employee of Presidio, the investment firm assisting KPMG with BLIPS transactions. During that initial meeting, Mr. Pfaff told HVB that

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[480] Email dated 7/30/99, from Ivor Dunbar of Deutsche Bank, DMG UK, to multiple Deutsche Bank professionals, "Re: Risk & Resources Committee Paper—BLIPS," Bates DB BLIPS 6554.
[481] Subcommittee interview of Deutsche Bank (11/10/03).
[482] See Subcommittee Hearings (11/20/03), at 107–112.
[483] Letter dated 1/9/04, from Deutsche Bank's legal counsel to the Subcommittee, at 2.
[484] Subcommittee interview of HVB Bank (10/29/03).

KPMG and Presidio worked together to develop the structure of the investment transaction and wanted HVB to provide financing.[485]

According to HVB, as a result of that meeting, HVB Bank was put in touch with Deutsche Bank which provided HVB with copies of draft loan documentation.[486] Presidio then arranged a meeting in which its staff explained the BLIPS transaction and, according to HVB, emphasized that BLIPS was an investment strategy. HVB told the Subcommittee, however, that it was clear to HVB at this meeting that BLIPS had inherent tax benefits.[487] In addition, HVB told the Subcommittee that Presidio had indicated that Stage I of BLIPS was to start and end within the same calendar year, requiring HVB to participate in the transaction by no later than October 1999.[488] Handwritten notes stemming from this meeting with Presidio also characterize the 7% fee charged to KPMG clients for BLIPS as "paid by investor for tax sheltering."[489]

At the Subcommittee hearing, when asked whether the bank knew that BLIPS was a transaction that had been designed to avoid taxes, HVB's representative stated, "I think to dispute the notion that there were inherent and significant tax benefits is ridiculous. However, the investment strategy was described to us as a significant motive for these investors to enter into this transaction."[490] He also denied learning later that BLIPS was primarily a tax avoidance scheme.[491] HVB Bank indicated further that, at the time it became involved with BLIPS, KPMG had provided the bank with an opinion stating that BLIPS complied with Federal tax law and the bank felt it could rely on that opinion. 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.[492]

A year later, when it became clear that the IRS would list BLIPS as an abusive tax shelter, an internal HVB memorandum acknowledged that BLIPS was a tax transaction and ordered a halt to fi-

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[485] *Id.*
[486] *Id.*
[487] *Id.*
[488] *Id.* HVB told the Subcommittee that, although BLIPS was represented as a 7-year investment program, HVB knew that BLIPS was a 60-day transaction driven by tax benefits. In fact, HVB's credit request documentation given to senior management for approval of BLIPS states: "HVB has been approached by Presidio to make the series of 7-year premium term loans noted above to the investment vehicles of individuals interested in investing in Presidio's product. . . . HVB will earn a very attractive return if the deals runs to term. If, however, the advances are prepaid within 60 days (and there is a reasonable prospect that they will be), HVB will earn a return of 2.84% . . .)," BLIPS credit request dated 9/14/99, Bates HVB 000148.
[489] Undated one-page, handwritten document outlining BLIPS structure entitled, "Presidio," which Alexandre Nouvakhov of HVB acknowledged during his Subcommittee interview had been written by him, Bates HVB 000204.
[490] Subcommittee Hearings (11/20/03), at 102.
[491] *Id.* at 103.
[492] Credit request dated 9/26/99, Bates HVB 001166.

nancing 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 believes 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.[493]

HVB's representative explained to the Subcommittee that the apparent bank risk in lending substantial sums to a shell company 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.[494] The bank explained, for example, that from the time the loan was issued, 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 low-risk bank-approved investments.[495] These requirements 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."[496] HVB also wrote: "The Permitted Investments . . . are either extremely conservative in nature . . . or have no collateral value for margin purposes."[497] 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

[493] Memorandum dated 8/16/00, from Dom DeGiorgio and Richard Pankuch to Christopher Thorpe and others, "Presidio BLIPS Transactions," Bates HVB 003346.

[494] Subcommittee interview of HVB representative (10/29/03).

[495] 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 60 days at its option.").

[496] 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.")

[497] BLIPS credit request dated 9/14/99, Bates HVB 000155.

Lender or an affiliate. . . . Lender must authorize trades before execution."[498] As indicated earlier, both Deutsche Bank and HVB received lucrative fees in exchange for providing the low-risk loans KPMG clients needed.

Documents related to two transactions that allegedly took place in 1999, involving HVB clients, raise further questions about the investments allegedly undertaken by HVB in connection with the BLIPS transactions. 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 Mobile 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.[499]

Other documents suggest that, as Presidio requested, HVB then "reversed" the referenced 1999 currency trades and executed them the next month in early 2000.[500] When asked about this matter, HVB told the Subcommittee that they had been unaware of this email exchange, that the bank could not make currency trades "look as though they did not occur at all," and they would research the transactions to locate the paperwork and determine whether, in fact, the trades or paperwork had been altered.[501]

HVB later told the Subcommittee that it had been unable to "locate any tickets documenting the original or reversing trades."[502] In fact, HVB said that trade tickets had not been created for many of the currency transactions associated with the BLIPS transactions.[503] HVB explained that the lack of documentation meant that the bank was unable to evaluate either the specific trades or the paperwork. In a letter to the Subcommittee dated January 12, 2004, HVB theorized that the original transactions had been executed in error and the bank had executed another foreign currency transaction to offset the results of the first trade. HVB also told the Subcommittee that, because the bank is not a tax advisor, it could not explain the email's assertion that the original trades had negative "tax consequences" requiring correction.[504]

HVB's inability to find any of the trade tickets documenting the currency trades discussed in the email is disturbing. Its admission that the bank often failed to prepare documentation for BLIPS-related currency trade raises added concern, since such paperless

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[498] Document dated 3/4/99, "BLIPS—transaction description and checklist," Bates KPMG 0003933–35.

[499] Email dated 12/28/99, from Kerry Bratton of Presidio to Alexandre Nouvakhov and Amy McCarthy of HVB, "FX Confirmations," Bates HVB 002035.

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

[501] Subcommittee interview of HVB bank representatives (10/29/03).

[502] Letter dated 1/12/04 from HVB's legal counsel, Caplin & Drysdale, to the Subcommittee, at 3.

[503] Subcommittee interview with HVB's legal counsel, Caplin & Drysdale (2/20/04).

[504] *Id.*

trades are not only contrary to normal banking and securities practice, but raise questions about whether the trades actually took place or were simply bookkeeping shams undertaken to justify a BLIPS client's alleged tax losses.

### C. UBS BANK

UBS AG, one of the largest banks in the world, participated in 100 to 150 FLIP and OPIS transactions in 1997 and 1998, providing credit lines for KPMG clients which, in the aggregate, were in the range of several billion Swiss francs. UBS told the Subcommittee that it became involved with these tax products after being contacted by KPMG and the Quellos Group and asked to assist in KPMG's FLIP and OPIS transactions, referred to collectively by UBS as "redemption transactions." [505]

UBS documentation clearly and repeatedly describes these transactions as motivated by tax considerations. 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 emphasized 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"].[506]

At another point, the UBS document explains the "Economic Rationale" for redemption transactions to be: "Tax benefit for client," [507] while still another UBS document states: "The motivation for this structure is tax optimization 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." [508]

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

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[505] Subcommittee interview of UBS representative (10/28/03).

[506] 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 UBS000009–15.

[507] *Id.* at Bates UBS000010.

[508] UBS internal document dated 11/13/97, "Description of the UBS 'Redemption' Structure," Bates UBS000031.

gains tax evasion scheme to US tax payers," meaning the redemption transactions. The letter continued:

> 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.[509]

In response to the letter, UBS halted all redemption trades for several months.[510] 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.[511]

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.

### D. FIRST UNION NATIONAL BANK

**Finding: First Union National Bank promoted to its clients generic tax products which had been designed by others, including potentially abusive or illegal tax shelters known as FLIP and BOSS, by introducing and explaining these products to its clients, providing sample opinion letters, and introducing its clients to the promoters of the tax products, in return for substantial fees.**

Deutsche Bank, HVB Bank, and UBS helped KPMG implement its tax products by providing KPMG clients with substantial financing and securities transactions necessitated by the tax products. Other banks, such as, Wachovia Bank, acting through First Union National Bank, played a different role, assisting KPMG by providing client referrals and marketing assistance for its tax products, in return for substantial fees. The Subcommittee investigation

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509 Letter dated 2/12/98, addressed to SBC Warburg Dillon Read in London, Bates UBS000038.

510 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.").

511 Subcommittee interview with UBS representative (10/28/03).

determined that First Union provided this same assistance to other tax shelter promoters, including PricewaterhouseCoopers, and, in fact, had implemented a systematic review and approval process for offering a variety of third-party tax shelter products to First Union clients.

The manager of First Union's Financial Advisory Services Group describes the development of this review and approval process in a 1999 email:

> The Financial Advisory Services Group (FAS), specifically the Personal Financial Consulting Group within FAS began introducing Enhanced Investment Strategies ("Strategies") to qualified First Union clients under the direction of my predecessor, Ralph Lovejoy in 1997. Ralph left First Union in April 1998 to join Quadra Investments and later TPCMG. Both firms have been heavily involved in the creation of leading edge strategies.
>
> When I was appointed manager of FAS in April 1998, Personal Financial Consulting was in the process of being introduced to certain strategies offered by KPMG. KPMG was offering these strategies through Quadra Investments. The law firm of Pillsbury Madison had written a tax opinion letter on both, but we wanted a Big 5 firm to write one if we were going to consider introduction of these strategies to any of our clients. As the year progressed, KPMG could not reach a decision as to whether or not to write the tax opinion letter on each strategy so Quadra (Ralph Lovejoy) introduced us to PriceWaterhouseCoopers, who was also familiar with both strategies and had been writing a tax opinion on them.
>
> As I learned more and more about these strategies, it was evident that a due diligence process needed to be established to more formally evaluate and select which strategies and/or strategy providers should be considered before introducing any strategies to future clients. As a result, in early 1999 we established a Due Diligence Committee (see attached) and sent an RFP to contacts we or our integral partners with First Union had with four of the five Big 5 firms. (see attached). We met with these firms (KPMG, PWC, Deloitte & Touche and Arthur Andersen) and received formal responses from KPMG and PWC indicating their interest in presenting their strategies to the newly formed Due Diligence Committee. After review of each strategy and strategy provider (including review of both financial and non-financial facts), the committee approved KPMG and PWC as strategy providers on April 9, 1999 and, the use of three strategies for 1999, one of which included [PwC's] BOSS. For each strategy reviewed and approved by the Committee, the strategy provider agreed to write a tax opinion of at least "More likely than not."[512]

This document shows that First Union began introducing banking clients to third-party tax products as early as 1997. In addition, it shows that, in 1999, the bank set up a formal procedure to evaluate specific tax shelter promoters and their tax product offerings.

[512] Letter dated 12/17/99, from Diane Stanford to Gail Fagan, "RE: BOSS," Bates SEN–016895–6.

As a result, in April 1999, First Union formally approved making client referrals to KPMG and PwC and offering these firm's tax products to its clients.[513]

First Union explained to the Subcommittee how its new procedure worked in practice. It said that its relationship managers or trust specialists who dealt with wealthy bank customers typically identified suitable potential clients for third-party tax products.[514] These bank employees then referred the clients to First Union's Financial Advisory Services Group. The FAS Group, in turn, assigned senior advisers within its Personal Financial Consulting Group to explain the particular tax products to the clients and arrange introductions to KPMG, PwC, or other tax shelter promoters such as Quellos Group.[515]

First Union told the Subcommittee that, with respect to KPMG and PwC tax products, First Union typically received $100,000 for each client referral.[516] This fee was then split between the relationship manager or trust specialist who had identified the client and the Financial Advisory Services group that had arranged the referral to KPMG or PwC.[517] First Union estimated that, for the 5-year period 1997 to 2002, the revenues it obtained for providing client referrals on tax products totaled about $13 million.[518]

First Union told the Subcommittee that its Financial Advisory Services Due Diligence Committee, also known as the Capital Management Group Risk Review Subcommittee, met periodically with various tax shelter promoters to discuss and approve specific tax products that could be presented to First Union clients. For example, according to the Due Diligence Committee's minutes, the committee met on April 27, 1999 to review five new tax products being promoted by KPMG and PricewaterhouseCoopers:

> The committee reviewed five strategies and scored each strategy as a committee . . .:
>
> *KPMG PWC*
>
> | *Name* | *Score* |
> | --- | --- |
> | —TRACT | 3.85 |
> | —IDV | 2.825 |
> | —CREW | 3.52 |
>
> *PWC*
>
> | *Name* | *Score* |
> | --- | --- |
> | —BOSS | 3.66 |
> | —PACT | 3.64 |

[513] First Union also provided referrals to strategy providers other than KPMG and PwC. According to a former First Union employee, the due diligence process was designed in part to centralize referrals of various strategies and strategy providers to banking clients. Multiple banking groups were providing referrals of various strategies and strategy providers designed by law firms and investment advisors. Subcommittee interview with former First Union employee (5/27/04).

[514] Subcommittee interview with First Union representatives (5/21/04).

[515] *Id.*

[516] *Id.*

[517] *Id.* First Union indicated that the senior advisors in Personal Financial Consulting were compensated indirectly through bonuses.

[518] These revenues included First Union referrals related to eight other tax products provided by entities other than KPMG and PwC. Subcommittee meeting with First Union representatives (5/21/04).

> Because IDV did not score a 3.0 or higher, it was eliminated for further consideration. Reasons for the low score included (a) long term time frame and the transaction causes high economic risk to the client and bank, (b) projected low demand of the product mostly due to economic risk.[519]

Tax products which received the committee's initial approval were then sent to First Union's Capital Management Group (CMG) Risk Review Oversight Committee, which periodically met to discuss them and provide the final approval necessary before a tax product could be presented to First Union clients. For example, a CMG Risk Review Oversight Committee memorandum discusses the approval of the KPMG BLIPS transaction:

> The CMG Risk Review Oversight Committee ("committee or OC") met on September 1. . . .
>
> Senior PFC Advisor and CMG Risk Review Subcommittee ("subcommittee or SC") member Tom Newman presented an overview of an enhanced investment strategy for OC vote to be able to present it to selected First Union clients. KPMG brought the BLIPS strategy (referred to hereafter as the "Alpha" strategy) to First Union. . . .
>
> Before the Alpha strategy was discussed, each member of the committee signed a confidentiality agreement at KPMG's request. In general, signing the agreement confirmed the understanding that committee members would hold the information about the strategy in the strictest of confidence and specific details of Alpha would not be discussed outside the meeting. . . .
>
> Highlights of the Alpha discussion:
>
> - The Alpha strategy is a highly leveraged investment strategy that could be used to generate either a capital gain offset or an ordinary income offset.
> - The strategy is to be considered only for individuals with more than $20 million in capital gains or ordinary income in either 1999 or future year. . . .
> - First Union's fees would be determined and outlined in an engagement letter entered into directly with the client and would approximate 50 basis points for non-KPMG clients who implement the strategy (minimum fee of $100,000) and 25 basis points for existing KPMG clients (minimum fee amount of $50,000). . . .
>
> When discussion concluded, members of the committee immediately and unanimously approved the strategy.[520]

These and other documents demonstrate that First Union had an active and elaborate structure for the review and approval of third-party tax shelters to be marketed to First Union clients. The evidence also demonstrates that First Union was well aware that it was promoting products intended to reduce or eliminate taxes and was willing to keep these products confidential, perhaps in an at-

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[519] First Union Due Diligence Committee Minutes, Bates SEN–014577–78.

[520] Memorandum dated 9/3/99, from Karen Chovan, Financial Advisory Services to CMG Risk Review Oversight Committee, "Meeting Minutes of September 1. . . ." Bates SEN–008629–31.

tempt to evade IRS detection. It is also worth noting that First Union's due diligence process for approving third-party tax products nowhere required either the bank's legal counsel or an outside tax expert to review the technical merits of the proposed products to ensure compliance with the law.[521]

Once a KPMG or PwC tax product was approved by First Union,[522] the bank appears to have expended considerable effort to interest its banking clients, arrange a meeting with the promoter, and facilitate sales. The extent of First Union's efforts is illustrated in this letter written by a First Union banking client who purchased a FLIP tax product but never received a promised legal opinion supporting it. The client wrote:

> [T]he Bank [First Union] prior to the Engagement Date introduced the partnership to the investment counseling firm of QA Investments of Seattle Washington ("Quadra"). The Bank and Quadra together presented an Investment Strategy (the "Strategy") . . . which involved the organization of an off shore partnership with a foreign entity for the purpose of making investments in foreign corporations. The Bank and Quadra represented the Strategy as having the foremost potential to make a significant profit while having in a circumstance or situation of an investment loss a significant income tax advantage. The Bank and Quadra represented that they would assist the Partnership in its latter efforts to engage the services on an independent accounting firm to provide the Partnership with tax advice and opinion which would address the Partnership's concerns pertaining to Internal Revenue Code 6662.
>
> The Bank and Quadra represented that they would cause to have issued in a timely manner to the Partnership a Legal Opinion which could provide the Partnership with a defense in the event that the whole or certain aspects of the Strategy were ever challenged by the Internal Revenue Service (the "IRS") or in the event that the tax returns of the Partnership were examined as regards the transaction of the Strategy. The Legal Opinion was to be issued by the law firm of Pillsbury, Madison & Sutro, LLP, its successor being: Pillsbury, Winthrop. LLP. The Bank and Quadra even supplied Partnership council with a sample draft opinion. Needless to say the Partnership does rely upon its receipt of the reference Legal Opinion and did rely upon the representations made regarding re-

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[521] Subcommittee meeting with First Union representatives (5/21/04). First Union's legal department was apparently limited to drafting and approving engagement letters to banking clients.

[522] First Union approved KPMG's BLIPS, FLIP, and SC2 tax products for their banking clients. See memorandum dated 9/3/99, from Karen Chovan, Financial Advisory Services to CMG Risk Review Oversight Committee, "Meeting Minutes of September 1 . . ." Bates SEN–008629–008631 (approving BLIPS); memorandum dated 6/12/00 from Karen Chovan, Financial Advisory Services to CMG Risk Review Oversight Committee, "Meeting Minutes of June 2 . . .," Bates SEN–008637–39 (approving SC2); letter from Thomas Newman to First Union customer, Bates SEN–021020 ("we [First Union] brought to your attention a transaction referred to as the Bond & Option Sales Strategy ('BOSS') developed by Pricewaterhouse Coopers LLP ('PwC') and The Private Capital Management Group. . . . In connection with that transaction, First Union earned a fee as a selling agent."). According to First Union, the total number of bank customers that actually implemented KPMG products is as follows: 23 FLIP; 1 OPIS, 1 BLIPS; 3 FOCUS; 3 SC2; 25 SOS. For the SOS strategy, First Union indicated that KPMG was involved but did not issue opinions. According to First Union, the following number of bank customers that actually implemented PwC products is as follows: 19 BOSS; 6 CDS. Subcommittee interview of First Union representatives (5/21/04).

> ceipt of same in arriving at its decisions to engage the services of both the Bank and Quadra. The partnership would most likely not have invested in the Strategy in the absence of these representations. To the best of its knowledge at no time has the Partnership ever received a Legal Opinion from the law firm referenced nor does the Partnership have any knowledge of the existence of such a Legal Opinion.[523]

This letter as well as other evidence indicate that First Union expended significant effort introducing and explaining tax products designed by others to the bank's clients, providing sample opinion letters, and introducing financial advisors and accountants to their clients. Without these activities, First Union clients might not have purchased KPMG or PwC tax products. The $13 million in tax product fees obtained by First Union indicate that, because of the bank's activities, more than one hundred First Union clients purchased these and other tax products promoted by the bank.

Because KPMG was the bank's auditor, First Union's multi-year participation in the promotion of KPMG tax products also raises disturbing auditor independence issues. In 2003, the SEC opened an informal inquiry into whether the client referral arrangement used by KPMG and Wachovia violated the SEC's auditor independence rule. In its second quarter filing with the SEC in August 2003, Wachovia provided 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 had issued a "formal order of investigation" into this matter, and the bank is continuing to cooperate with the inquiry.

The SEC's Business Relationship rule states: "An accountant is not independent if, 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

[523] Letter from Partnership to Thomas D. Newman dated 4/6/01, "Re: Engagement of First Union National Bank to provide financial advisory services," Bates SEN–008750–52.

an audit client. . . ."[524] KPMG's Tax Services Manual states: "Due to independence considerations, the firm does not enter into alliances with SEC audit clients."[525] 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."[526] KPMG policy is that "[a]n oral business relationship that has the effect of creating an alliance should be treated as an alliance."[527]

In Subcommittee interviews, KPMG denied any alliance with First Union with respect to tax product referrals, but evidence uncovered by the Subcommittee suggests otherwise. For example, an interoffice memorandum dated May 25, 1998, from First Union to KPMG states: "Ted, I thought I'd write to confirm our discussions by phone on Friday regarding the alliance that [First Union National Bank] FUNB has with KPMG/Peat Marwick on offering Enhanced Investment Strategies (Tax Strategies) to selected clients. . . ."[528] Another First Union document, also in May 1998, sent by a First Union manager to other bank professionals, shows the bank working directly with KPMG on an ongoing basis to promote KPMG tax products, and its insistence that KPMG personnel be included in all tax product presentations to the bank's clients:

> As you know . . . [w]e have agreed to a process that requires that our Personal Financial Consultant Sr. Advisors (Castrucci, Rudolph, Newman, and Martin) be introduced to the client FIRST and then after making a further assessment of the client's qualification, will bring in KPMG. It is our understanding that our ability to be paid a planning fee (which is generally in the range of $100,000) is dependent on this agreement with KPMG. We have been aware of some instances where Trust Specialists and/or Trust admin are going directly to Quadra, cutting out KPMG AND our planners. PLEASE COMMUNICATE TO YOUR SENIOR PEOPLE THAT A PLANNER MUST BE INVOLVED IN THIS PROCESS TO ENSURE THAT OUR ONGOING RELATIONSHIP AND AGREEMENT WITH KPMG IS PRESERVED.[529]

Still another First Union document, written in 1999, by First Union's Capital Management Group, to provide an overview of the bank's client referral services states: "CMG has entered into agreements with outside investment advisors in order to bring leading edge investment techniques to First Union customers (and prospects). . . . [A]s part of this relationship, KPMG Peat Marwick LLP will serve as the 'Tax Strategist and Consultant' with respect to all the investment strategies to protect the interests of First Union and its customers."[530]

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[524] 17 C.F.R. § 210.2–01(c)(3).

[525] KPMG Tax Services Manual, § 52.1.3 at 52–1.

[526] *Id.*, § 52.1.1 at 52–1.

[527] 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 73.

[528] Memorandum dated 5/25/98, from Diane Stanford to Ted Beringer, "KPMG Tax Strategies," Bates SEN–014862–63.

[529] See email dated 5/19/98, from Diane Stanford to multiple bank personnel, "Subject: IMPORTANT UPDATE—TAX STRATEGIES," Bates SEN–014864 (emphasis in original).

[530] Capital Management Group Enhanced Investment Strategy Series Overview, Bates SEN–014700–02.

Another internal First Union document, describing a 1999 meeting between KPMG and First Union's Financial Advisory Services Due Diligence Committee, shows that both firms were fully aware that a formal alliance between the two businesses raised auditor independence concerns:

> Present from KPMG were Sandy Spitz and Jeff Eischeid. Sandy answered questions regarding their proposal to be a strategy provider, specifically regarding fee sharing and internal overlap. Regarding a fee sharing arrangement, Sandy stressed that KPMG and FUNB can never appear to be involved in a joint venture. The two organizations must always be independent, due to the audit relationship.[531]

While First Union and KPMG claim that each client paid First Union directly, and there was no fee sharing arrangement nor referral fee paid by KPMG to First Union, the evidence suggests that such claims attempt to elevate form over substance. The overwhelming evidence is that KPMG and First Union had an on-going alliance to promote the sale of KPMG tax products to First Union customers.[532] In the Subcommittee's view, this relationship comprised a "direct or material indirect business" relationship between the bank and its auditor.

## VIII. ROLE OF INVESTMENT ADVISORS

**Finding: Some investment advisors, including Presidio and Quellos, assisted in the development, design, marketing, and execution of potentially abusive or illegal tax shelters such as FLIP, OPIS, and BLIPS.**

Investment advisors also played a major role with respect to the development, marketing, and implementation, of generic tax shelters sold to multiple clients. The Subcommittee's in-depth examination of KPMG tax shelters provided a detailed view of this role with respect to two investment firms: Presidio Advisory Services and the Quellos Group, formally known as Quadra.

Both Presidio and Quellos assisted in the development and design of potentially abusive or illegal tax shelters sold by KPMG. Both assisted in the marketing of these tax shelters to multiple clients. In addition, both assisted KPMG in the implementation of these tax shelters by establishing partnerships, participating in loans, and executing some of the currency or security trades required to produce the claimed tax benefits for KPMG clients. In addition, each had relationships with banks that were instrumental in providing the client loans necessary for the tax shelters, as well as certain investment services. Presidio and Quellos were far from alone in providing such services in the tax shelter industry. Many other investment advisors such as the Diversified Group, Bolton Capital Planning, The Private Capital Management Group, and Bricolage Capital have provided similar services with respect to tax shelters that were developed and promoted by others.

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[531] Minutes dated 4/23/99, of Financial Advisory Services "Enhanced Investment Strategies," "Risk Management Process/Due Diligence Committee Meeting," Bates SEN–014588–89.

[532] First Union denies any formal agreement or alliance despite the language used in these documents. Subcommittee meeting with First Union representatives (5/21/04).

## A. PRESIDIO ADVISORY SERVICES

Robert Pfaff and John Larson are two former KPMG employees who left the firm in 1999, to form Presidio Advisory Services.[533] While at KPMG, Mr. Pfaff was a partner and Mr. Larson was a senior manager. Evidence uncovered by the Subcommittee shows that Mr. Pfaff played an instrumental role in formulating KPMG's business plan for promoting generic tax shelters to multiple clients. For example, in July 1997, a month before he left KPMG, Mr. Pfaff wrote a memorandum to the top two officials in KPMG's tax practice with a number of suggestions for KPMG's Tax Advantaged Transaction Practice."[534] The memorandum stated, for example, that KPMG needed to reward "idea-generators" for tax products, a suggestion later carried out by KPMG's Tax Innovation Center.[535] It recommended that KPMG "gain entrance to the international banking, investment and leasing community and have an alignment with the 'handful' of law firms who are skilled and respected in this area."[536] KPMG eventually formed relationships with Deutsche Bank, HVB, First Union, Sidley Austin Brown & Wood, and others, as chronicled in this Report.

Mr. Pfaff also recommended that KPMG establish a relationship with an investment firm, such as Presidio, to market its tax products. He explained: "To avoid IRS scrutiny, KPMG had to market its tax products as investment strategies, but if it characterized it services as providing investment advice to clients, it could attract SEC scrutiny and have to comply with Federal securities regulations. . . . [I]t was this dilemma that led me to the conclusion that KPMG needs to align with the likes of a Presidio."[537] He expressed his desire for a close relationship between KPMG and Presidio with the "goal of developing mutually-beneficial products."[538]

In fact, since Presidio's inception in 1997, the vast majority of its work has involved developing, marketing, and implementing tax products with KPMG.[539] The basis for this working relationship was a formal operating agreement that Presidio and KPMG entered into in September 1997, with respect to the FLIP tax product. Under the terms of this agreement, KPMG offered Presidio the right of first refusal to present FLIP to KPMG clients.[540] KPMG also committed to using its best efforts to introduce Presidio to its clients, on a right of first refusal basis.[541] In return, Presidio offered KPMG a right of first refusal to promote all other tax-based products Presidio developed.[542] In addition, Presidio committed to using its best efforts to assist KPMG in developing tax products

[533] Messrs. Larson and Pfaff 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").
[534] See email dated 7/29/97, from Larry DeLap to multiple KPMG employees, "Subject: Revised Memorandum," Bates KPMG JAC331160–69.
[535] *Id.*
[536] *Id.*
[537] *Id.*
[538] *Id.*
[539] Subcommittee interview with Presidio representative (6/20/03). The Presidio representative told the Subcommittee that 95% of the company's revenues had come from its work with KPMG.
[540] See Letter dated 9/19/97, from Gregg Ritchie to John Larson, Bates P41292–94.
[541] *Id.*
[542] *Id.*

that KPMG brought to Presidio's attention.[543] KPMG committed to using its best efforts to assist in developing and distributing new tax products with Presidio.[544] Also, KPMG committed that its development costs in jointly developing tax products with Presidio would be borne by KPMG.[545] In July 1998, KPMG and Presidio modified and again executed this agreement.[546]

Presidio played a key role in three of the KPMG tax shelters examined by the Subcommittee, FLIP, OPIS, and BLIPS. While at KPMG, both Robert Pfaff and John Larson were part of the development team for FLIP. After they established Presidio, they implemented six FLIP transactions for KPMG.[547] According to an internal KPMG email, Mr. Pfaff was also part of KPMG discussions to re-design FLIP, which eventually led to development of the OPIS tax product.[548] The email indicates that, for about 6 weeks, a senior KPMG tax professional and Robert Pfaff 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.

Presidio took an even more substantial role in developing BLIPS. According to Presidio, it initiated the development of this product in the fall of 1998.[549] Whereas the idea for FLIP started within KPMG, and Presidio and KPMG co-developed OPIS, Presidio alleges that the idea for BLIPS originated in discussions involving Messrs. Pfaff, Larson, and two San Francisco based attorneys.[550] To develop the idea further, Presidio told the Subcommittee that it hired Amir Makov, formerly with Deutsche Bank, to provide economic and investment expertise.[551] Presidio told the Subcommittee that it had wanted to present KPMG with a polished "turn-key" tax product that could be easily sold to multiple clients.[552] The evidence suggests that, at some point in 1998, Presidio formed a working group which also included KPMG tax professionals Randy Bickham, and Jeff Eischeid, and Brown & Wood's R.J. Ruble.[553]

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[543] *Id.*
[544] *Id.*
[545] *Id.*
[546] See memorandum dated 7/2/98, from Gregg Ritchie to Larry DeLap, "Subject: Presidio Operating Agreement," Bates KPMG 0047221–23. KPMG later determined that the original agreement was a "Level II alliance," as defined in KPMG's Tax Manual due to each of the parties "right of first refusal" and the provisions to "jointly develop products." See email dated 6/5/98, from Larry DeLap to Gregg Ritchie, "Subject: Re[2]: Presidio Alliance Form," Bates KPMG 0047208–17 (stating that removal of provisions would create a Level I alliance not requiring Management Committee approval). This statement implies that the original agreement did not get the necessary Management Committee approval in contravention of KPMG procedures. The modified 1998 agreement removed the two provisions.
[547] See email dated 6/5/098, from Larry De DeLap to Gregg Ritchie, "Subject: Re[2]: Presidio Alliance Form," Bates KPMG 0047208–17, at 13.
[548] Email dated 3/14/98, from Jeff Stein to Gregg Ritchie, "Subject: Simon Says," Bates KPMG 0034380–88.
[549] Subcommittee interview with Presidio representative (10/3/03).
[550] *Id.* One attorney is believed to be George Theofel. See Memorandum dated 12/3/98, from R.J. Ruble to Randy Bickham, George Theofel, "Re: *BLIPS*," Bates SIDL–SCGA083244; email dated 4/28/99, from Francesco Piovanetti to Nancy Donohue, "Subject: presidio—w.revisions, I will call u in 1 min.," Bates DB BLIPS 6911–13 (stating that "Presidio, in conjunction with ICA, have developed a new product called BLIPS."). George Theofel was affiliated with Jackson Tufts Cole & Black, a law firm in San Francisco, and later Integrated Capital Associates. According to Martindale-Hubbell, George Theofel is currently an attorney based in San Rafael, CA.
[551] Subcommittee interview with Presidio representative (10/3/03).
[552] *Id.*
[553] See email dated 12/3/98, from Presidio Advisors to Randy Bickham, Jeff Eischeid, Tracie Henderson, George Theofel, and R.J. Ruble, "Subject: RE BLIPS meeting," Bates KPMG 0037336.

In addition to contributing to the development of the BLIPS concept, Presidio played a critical role in KPMG's internal evaluation of BLIPS' viability. KPMG documentation indicates that, at a critical meeting in May 1999, Presidio described BLIPS as presenting only a remote probability of producing a profit for the clients who bought it, thereby causing several KPMG tax professionals to recommend against approving the product for sale to clients.[554] KPMG subsequently determined to approve BLIPS sales despite the concerns of its tax professionals, but only after also requiring Presidio and each BLIPS purchaser to represent in writing that BLIPS provided a reasonable opportunity to produce a profit. At the Subcommittee's hearing on November 18, 2003, a former KPMG tax partner, Mark Watson, testified that Presidio had essentially changed its analysis of BLIPS' profitability, while at the hearing on November 20, a Presidio representative, John Larson, testified that Mr. Watson may have misunderstood the firm's earlier analysis. Upon further questions by Subcommittee Chairman Coleman, however, Mr. Larson also acknowledged that none of the BLIPS transactions executed by KPMG clients ever actually made a profit. KPMG nonetheless claims to have relied on Presidio's representation about BLIPS' profitability in reaching its conclusion that BLIPS met the requirements of Federal tax law and could be sold to KPMG clients.

In addition to contributing to the development of KPMG tax products, Presidio also played a key role in marketing and implementing them. For example, Presidio made numerous presentations to KPMG clients related to FLIP, OPIS, and BLIPS. Presidio also undertook many actions to implement the transactions called for by the tax products, including by forming partnerships, executing trades, and working with banks to secure client loans and develop the trading strategies for the tax shelter transactions. With respect to BLIPS, for example, Presidio initiated contact with HVB Bank in the fall of 1999,[555] and then worked with HVB to help structure loan terms and refine the investment strategy.[556] Earlier in 1999, while KPMG was still vetting BLIPS through its Washington National Tax review and approval process, evidence indicates that Presidio was already talking to Deutsche Bank about the product. For example, a Deutsche Bank email dated February 28, 1999, mentions that Presidio has "developed a new product called BLIPS," and urges the need for Deutsche Bank to get "TOP Level Global Markets Go Ahead to proceed."[557] Another Presidio document, detailing the strategic business plan for the year 2000, suggests "schedule[ing] a meeting with Deutsche Bank the week of November 15, 1999 to discuss the 2000 business plan and to introduce the 'specs' for the '1001' product" and scheduling a "meeting with UBS in November 1999 with the goal of securing their buy-in as the 'co-lead' bank."[558]

[554] See Levin Report, reproduced in the Senate hearing record, at 178–184.
[555] Subcommittee interview of HVB Bank (10/29/03).
[556] See memorandum dated 9/14/99, from Robert Pfaff to Dom DiGiorgio, "Subject: BLIPS loan test case," Bates HVB 000202.
[557] Email dated 4/28/99, from Francesco Piovanetti to Nancy Donohue, "Subject: presidio—w.revisions, I will call u in 1 min.," Bates DB BLIPS 6911–13.
[558] See Presidio Year 2000 Strategic Plan, Bates KPMG 0042855–59.

A final point concerns the legal obligation of tax shelter promoters to register their tax products with the IRS and maintain lists of the clients who bought them. At the Subcommittee hearings, a former senior tax official at KPMG, Larry DeLap, testified that he thought the BLIPS transaction should have been registered with the IRS and that Presidio should have completed the registration. Presidio told the Subcommittee in an interview, however, that while it did conduct activities rising to a level of a promoter, Presidio did not believe the KPMG transaction met the definition of a tax shelter under IRS regulations.[559] Presidio failed to register FLIP, OPIS, or BLIPS.

## B. QUELLOS GROUP

The Quellos Group, formerly known as Quadra Capital Management, provided investment advisory services similar to Presidio with respect to KPMG's FLIP and OPIS transactions. In addition, Quellos promoted PwC's version of FLIP. According to Quellos, it began its relationship with KPMG in 1994, when structuring a portfolio for a mutual client. [560] In May 1996, John Larson, then still employed by KPMG, called Quellos for assistance with structuring the investment aspects of FLIP. Quellos told the Subcommittee that KPMG gave it specific criteria under which to develop the financial transactions. Quellos told the Subcommittee that it had understood at the time that designing financial transactions with criteria such as using a foreign corporation's stock and options, setting up an offshore corporation, completing the transaction within a short time frame (i.e., 51 days), purchasing a warrant, and hedging to limit downside risk, were intended to produce beneficial tax consequences. Quellos also noted that the tax structure was developed first, and the investment strategy was then incorporated into the tax structure—facts which further demonstrate that FLIP was primarily intended as a tax transaction.

Like Presidio, Quellos also helped KPMG convince a major bank, UBS AG, to provide financing to FLIP clients and participate in specific FLIP transactions.[561] Quellos told the Subcommittee that, among other tasks, it worked with UBS to fine-tune the FLIP financial transactions, helped KPMG make client presentations about FLIP and, for those who purchased the product, helped complete the required paperwork and transactions, using Quellos securities brokers.

In addition to serving as the investment advisor for KPMG's FLIP and OPIS transactions, Quellos also served as the investment advisor for PwC's version of FLIP, a transaction which was substantially similar in all material respects to the KPMG version. At the Subcommittee hearings, however, Quellos testified that it had taken action to register with the IRS the FLIP transaction promoted by PwC, but not the FLIP transaction for KPMG. When questioned by Chairman Coleman about this disparate treatment, Quellos explained that it acted in accordance with the guidance

[559] Subcommittee interview of Presidio representative (10/3/03).
[560] Subcommittee interview of Quellos representative (11/7/03).
[561] See, e.g., memorandum dated 8/12/96, from Jeff Greenstein to Wolfgang Stolz, Bates UBS 000002 (stating with respect to FLIP, "this tax motivated transaction is designed for U.S. companies requiring a tax loss.").

provided by the two accounting firms, one of which advised it to register and the other of which advised it that registration was unnecessary.

Quellos also told the Subcommittee that it subsequently raised the registration issue again with KPMG. On October 9, 1997, Quellos wrote a memorandum to KPMG seeking "a letter confirming earlier discussions that the redemption transaction [FLIP] was not required to be registered as a tax shelter."[562] In response, KPMG wrote a memorandum on October 10, 1997, stating that the tax shelter registration requirements applicable to Quadra "must be made by your Firm in conjunction with your own tax counsel," and that KPMG "has determined that it will not register this engagement as a tax shelter."[563] Quellos testified at the Subcommittee hearings that it "deferred again to their decision, viewing [KPMG] as the primary promoter, that if they decided that it did not need to be registered for themselves that we would go with that assessment." Quellos also stated that they viewed KPMG's statement that Quellos had to make its own registration decision as an attempt by KPMG "to absolve them of any liability that they may have for our decision."[564]

## IX. ROLE OF CHARITABLE ORGANIZATIONS

> **Finding: Some charitable organizations, including the Los Angeles Department of Fire and Police Pensions and the Austin Fire Fighters Relief and Retirement Fund, participated as counter parties in a highly questionable tax shelter known as SC2, which had been developed and promoted by KPMG, in return for substantial payments in the future.**

In the case of the SC2 tax shelter examined in this Report, KPMG and its clients could not have executed any SC2 transaction without the active and willing participation of a special type of charitable organization, such as a governmental pension plan, that is authorized to own S Corporation stock and receive distributions or allocations of income from that stock without incurring a tax on unrelated business income.[565]

KPMG encountered difficulties in locating and convincing appropriate charitable organizations to participate in SC2 transactions, but eventually convinced several tax-exempt entities to do so.[566] KPMG refused to identify to the Subcommittee any of the tax-exempt entities it contacted in connection with the SC2 or any of the tax-exempt entities that actually participated in SC2 transactions by accepting S Corporation stock, claiming their identity was Atax return information" that it could not disclose. The Subcommittee was nevertheless able to identify and interview two tax exempt organizations which, between them, participated in 33 of the 58 SC2

[562] Memorandum dated 10/9/97, from David L. Smith to Gregg Ritchie, Bates KPMG JAC 329291.
[563] Memorandum dated 10/10/97, from Gregg Ritchie to David L. Smith, Bates KPMG JAC 328964.
[564] Quellos testimony at Subcommittee Hearings (11/20/03), at 127.
[565] For a more detailed description of the SC2 shelter, see the Levin Report, Appendix B, at 122–125.
[566] For more information about KPMG's efforts to locate qualified tax-exempt entities willing to participate in SC2 transactions, see Section V(A)(1) of this Report.

transactions KPMG arranged.[567] Both turned out to be municipal pension funds: the Los Angeles Department of Fire and Police Pensions, and the Austin Fire Fighters Relief and Retirement Fund.

The evidence indicates that both of these pension funds knew that they were participating in transactions whose primary purpose was to provide tax benefits to each person who "donated" S Corporation stock to the fund.[568] Both pension funds also knew that the shares they received were intended to be in their possession on a temporary basis, to be followed in a few years by their re-sale of the shares to the original owners. Both pension funds agreed to participate in the transactions in exchange for what they hoped would be substantial payments in the future. The Los Angeles pension fund, for example, as of November 2003, had participated in 28 SC2 transactions over 3 years, re-sold "donated" stock to 11 of the original "donors," and obtained $5.9 million in exchange, while the "donors" themselves attempted to shelter from taxation many millions of dollars in S Corporation income earned during the period in which the pension funds held the shares.

On April 1, 2004, the Internal Revenue Service declared SC2 and similar transactions to be abusive tax shelters that did not legally exempt S Corporation income from Federal taxation.[569]

## A. LOS ANGELES DEPARTMENT OF FIRE AND POLICE PENSIONS

The Los Angeles Department of Fire and Police Pensions (referred to as "Los Angeles pension fund" or "pension fund") is a $10 billion pension fund that serves the police and fire departments in the city of Los Angeles, California.[570] The Los Angeles pension fund participated in 28, or nearly 50 percent, of the 58 SC2 tax products sold by KPMG between 1999 and 2002.

At the time of the Subcommittee hearings in November 2003, the pension fund held $7.3 million worth of S Corporation stock received through 16 SC2 transactions, and had sold back stock to 11 S Corporation shareholders in exchange for payments totaling $5.9 million.[571] Subsequently, in December 2003, three more donors re-

[567] Subcommittee interviews with the Fire and Police Pensions of Los Angeles (10/22/03) and the Austin Fire Relief and Retirement Fund (10/14/03) confirmed their participation in the SC2 transactions. The Subcommittee also learned of a fire fighter's pension fund in West Virginia that participated in SC2 transaction by accepting S Corporation stock donations.

[568] While documents provided by KPMG to the pension funds made it clear that the persons providing stock would be able to shelter income through the SC2 transaction, the Los Angeles Department of Fire and Police Pensions indicated that it had not realized the SC2 transactions were elaborate tax avoidance schemes until contacted by the Subcommittee staff about them.

[569] IRS Notice 2004–30 (4/1/04).

[570] Information about the Los Angeles pension fund and its participation in SC2 transactions is taken from documents supplied to the Subcommittee by the pension fund; Subcommittee staff interviews with representatives of the pension fund; a Statement for the Record by Thomas Lopez, Chief Investment Officer of the Fire and Police Pensions of Los Angeles, reprinted in the Subcommittee hearings (11/18/03) at 3016 as Hearing Exhibit 153 (hereinafter "Los Angeles pension fund statement"); and Responses to Supplemental Questions for the Record by the pension fund, reprinted in the Subcommittee Hearings at 3017–24 (hereinafter "Los Angeles pension fund supplemental response").

[571] See Los Angeles pension fund statement; documents supplied to the Subcommittee by the pension fund. In two of the instances, the pension fund had participated in the SC2 transactions by accepting S Corporation stock from KPMG clients on December 31, 1999, 3 months prior to KPMG's approving SC2 as a generic tax product in March 2000. See e-mail dated 3/30/2000, from William Kelliher to Larry DeLap and other KPMG personnel, "SC2," Bates KPMG 0049901–03, reprinted in the Subcommittee Hearings at 1861–63. The pension fund also told Subcommittee staff that one of the 28 SC2 transactions, implemented on December 31, 2001, was subsequently revoked by the taxpayer on June 18, 2002. The redemption agreement speci-

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deemed their S Corporation shares from the pension fund, while one donor revoked a gift of stock that had been made in an SC2 transaction.[572]

The Los Angeles pension fund told Subcommittee staff that KPMG had contacted it "out of the blue" about the SC2 tax shelter in the fall of 1999, and that although it willingly participated in the SC2 transactions, it would not have done so absent being approached, convinced, and assisted by KPMG.[573] The pension fund also told the Subcommittee that it never conducted its own due diligence review into whether the SC2 transactions complied with Federal tax law.[574] Instead, the pension fund had relied upon representations made to it by KPMG that the transaction met the requirements of the tax code.[575]

The Los Angeles pension fund's lack of due diligence extended to other matters as well. For example, the pension fund relied upon KPMG to make sure that specific donations were from legitimate businesses, and frequently depended upon KPMG to screen donors and companies prior to its accepting donations.[576] The pension fund told Subcommittee staff that KPMG often did not disclose the names of specific donors and companies to the fund until shortly before a transaction was entered into by the parties.[577] Over a 3-year period, the Los Angeles pension fund accepted stock donations from S Corporations located in Arizona, California, Delaware, Georgia, Hawaii, Kansas, and North Carolina, relying primarily on the representations and due diligence conducted by KPMG.[578]

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fied that redemption period did not begin until December 31, 2004, but the pension fund returned the stock without remuneration.

[572] Los Angeles pension fund Supplemental Response at 8.

[573] See Los Angeles pension fund statement; Los Angeles pension fund Supplemental Response at 2; and other documents supplied to the Subcommittee by the pension fund. The Los Angeles pension fund was contacted by Lawrence E. Manth, then a partner in KPMG's Los Angeles office, and Douglas P. Duncan, then a manager in the same Los Angeles office.

[574] Subcommittee staff interviews with representatives of the Los Angeles pension fund. The pension fund also sought and received legal guidance from Seyfarth, Shaw, Fairweather & Geraldson, its legal counsel. See letter dated 12/30/99, from Sayfarth, Shaw, Fairweather & Geraldson to the pension fund, reprinted in the Subcommittee Hearings as Hearing Exhibit 155 at 3757–66. The advice sought by the fund and provided by the law firm did not, however, address the tax consequences of the SC2 transaction, but merely the narrow issue of whether the fund had the legal authority to accept a donation of S Corporation stock. The letter stated in part:

> 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 on 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. *Id.* at 2. The law firm's letter to the pension fund also characterized the transaction as "very unusual." *Id.* at 1.

[575] Subcommittee staff interviews with representatives of the Los Angeles pension fund. At the same time KPMG was marketing SC2 to tax exempt organizations, as explained earlier in this Report KPMG tax professionals were expressing uncertainty within the firm as to whether SC2 would withstand IRS scrutiny. See, e.g., e-mail dated 12/20/01, from William Kelliher to David Brockway, Bates KPMG 0012720–24 (". . .In my opinion, there was (and is) a strong risk of a successful IRS attack on SC2 if the IRS gets wind of it."), reprinted in Subcommittee Hearings as Hearing Exhibit 59, at 604–608; and e-mail dated 4/11/00, from Larry DeLap to KPMG's Tax Professional Practice Partners, AS-Corporation Charitable Contribution Strategy (SC2)," Bates KPMG 0015631 ("This is a relatively high risk strategy."), reprinted in the Subcommittee Hearings as Hearing Exhibit 50 at 584.

[576] Los Angeles pension fund Supplemental Response at 2–3.

[577] *Id.* at 3; Subcommittee staff interviews of representatives of the Los Angeles pension fund.

[578] Subcommittee staff interviews with representatives of the Los Angeles pension fund; and documents supplied to the Subcommittee by the pension fund related to particular transactions. The Los Angeles pension fund also told Subcommittee staff that, after September 2002, it dealt

On paper, in each SC2 transaction, the Los Angeles pension fund generally received 90% of an S Corporation's outstanding shares and was entitled to 90% of the corporation's distributions. Yet the pension fund did not manage or oversee its S Corporation holdings as if it were a true shareholder with a substantial financial interest in the performance of the corporation. For example, the pension fund indicated to the Subcommittee that it did not know whether the distributions, if any, that were made to it while it owned the S Corporation stock were consistent with the historical distributions of the S Corporation; the pension fund did not keep track of the annual income allocated but not distributed to it; and it did not know what happened to any unallocated funds after it re-sold the shares to the original owners. When the owners of shares in one S Corporation asked the pension fund to redeem their shares earlier than the time period specified in the redemption agreement, so that the S Corporation could be purchased by another company, the pension fund relied on KPMG's assertion that the per share redemption price paid to the pension fund reflected the new, higher value of the S Corporation's shares.[579]

Further, the Los Angeles pension fund told the Subcommittee that it did not expect to obtain significant amounts of money from the S Corporations during the period in which it was a shareholder, but expected instead to obtain a substantial payment when it re-sold the shares to the original owners or their S Corporation.[580] In fact, the pension fund disclosed that, in many instances, the S Corporations in which it was a shareholder had suspended all distributions during the period of time in which the pension fund held its stock. The Los Angeles pension fund told the Subcommittee that only nine corporations, less than one-third of the 28 S Corporations in which it had holdings through SC2 transactions, had made any distributions to the pension fund while it was a stockholder.[581] The pension fund also disclosed that at least six of these nine S Corporations had apparently made a distribution to the pension fund only to take advantage of an extension clause in the redemption agreement enabling the S Corporation owners to shelter income for an additional year if a distribution was made to the pension fund.[582]

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with a second professional firm, Meritage Financial Partners, LLC ("Meritage"), in connection with the SC2 transaction. The founding members of Meritage include former KPMG employees Lawrence Manth, Douglas Duncan, Andrew A. Atkin, and Robert E. Huber, all of whom had worked on the SC2 tax shelter. The California Secretary of State indicates that Meritage Financial Partners, LLC, filed for certification with the state on August 2, 2002. Meritage remains listed as an active business.

[579] Los Angeles pension fund Supplemental Response at 4–5, 7; Subcommittee interviews with representatives of the Los Angeles pension fund.

[580] Los Angeles pension fund Supplemental Response at 1–2; Subcommittee staff interviews with representatives of the Los Angeles pension fund.

[581] In its Supplemental Response to the Subcommittee, the Los Angeles pension fund reported eight corporations had made distributions. The pension fund later informed the Subcommittee that an additional S Corporation had subsequently made a distribution of income to the fund.

[582] Documents supplied to the Subcommittee by the pension fund related to particular transactions; and Subcommittee staff interviews with representatives of the Los Angeles pension fund. The six instances in which a distribution was made by an S Corporation to the pension fund are as follows:

(a) A redemption agreement between the pension fund and one S Corporation extended the redemption date from June 15, 2003 to June 15, 2004, if the S Corporation made a dividend payment in the amount of $50,000. Although the S Corporation paid a dividend of only $9,000, the pension fund extended the redemption date to July 15, 2004. (b) A redemption agreement automatically extended the beginning of the redemption period date from June 30, 2002 to June

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The pension fund told the Subcommittee that, in all of the 28 SC2 transactions in which it participated, it had expected to retain ownership of the S Corporation stock only for a specified period of time, generally 2 to 4 years, as established in a redemption agreement which it entered into with the original stock owners at the time of the stock assignment.[583] The pension fund indicated that every SC2 transaction had included an executed redemption agreement, and every one of the redemption agreements had enabled the pension fund, after holding the S Corporation stock for a specified period of time (typically 2, 3, or 4 years), to require the original stock owners or their S Corporation to redeem the shares.[584] The pension fund further indicated that the SC2 transactions had unfolded as planned, ending in a re-sale of stock to the owners or their S Corporation, unless the owner or corporation had asked the pension fund to return the shares earlier or later than the specified period or had otherwise revoked the gift. The evidence shows that there were no instances in which the Los Angeles pension fund sold S Corporation shares to any party other than the original owners of the stock.[585] In addition, in all instances in which the pension fund returned shares to the original owners earlier or later than the period originally established in the redemption agreement, it was the owners who had requested the change.[586]

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30, 2003, if the S Corporation made dividend payments in the amount of $75,600, before June 30, 2002, which it did. The S Corporation made a second dividend payment of $7,600 before June 30, 2003, and the pension fund again extended the redemption date to June 30, 2004. (c) A redemption agreement automatically extended the beginning of the redemption period date from June 30, 2002 to June 30, 2003, if the S Corporation made a dividend payment of $114,975. On June 25, 2002, the corporation made a distribution of exactly $114, 975. The S Corporation had a further option to extend the redemption date from June 30, 2003, to June 30, 2004, if it made another distribution of $144,900, before June 30, 2003. On June 27, 2003, it made a distribution of exactly $144,900. (d) A redemption agreement automatically extended the beginning of the redemption period date from June 30, 2002 to June 30, 2003, if the S Corporation made distributions of $144,900, to the pension fund before June 30, 2002. On June 26, 2002, the S Corporation, in fact, made a distribution of exactly $144,900. (e) A redemption agreement automatically extended the beginning of the redemption period date from July 15, 2003, to July 15, 2004, if the S Corporation made a dividend payment in the amount of $135,000. The S Corporation had a further option to extend the redemption until June 30, 2004, if it made an additional dividend payment of $114,975, before June 30, 2003. It paid dividends of $114,975, before June 30, 2003, and extended the redemption agreement until June 30, 2004. (f) A redemption agreement automatically extended the beginning of the redemption period date from January 2004 until January 2005, as long as the S Corporation paid the pension fund $30,000 in dividends. The pension fund did not provide the Subcommittee with the amount of dividends it received from the S Corporation. The pension fund did not provide information to the Subcommittee about the redemption agreement between the pension fund and a seventh S Corporation.

[583] Subcommittee staff interviews with representatives of the Los Angeles pension fund.

[584] Subcommittee staff interviews with representatives of the Los Angeles pension fund; Los Angeles pension fund Supplemental Response at 1–3; documents provided to the Subcommittee by the pension fund related to specific transactions. The redemption agreement also required that if the tax exempt received a purchase offer from an outside party for the shares, the S Corporation and its shareholders had a right of first refusal. While none of the redemption agreements entered into by the pension fund explicitly required the pension fund sell its non-voting shares back to the original owners, there were no instances in which the pension fund sold S Corporation shares to any party other than the original owners of the stock.

[585] Documents supplied to the Subcommittee by the Los Angeles pension fund related to particular transactions; Subcommittee staff interviews with representatives of the Los Angeles pension fund.

[586] See documents supplied to the Subcommittee by the Los Angeles pension fund related to particular transactions. In seven of the 28 SC2 transactions, the original owners of the shares or the related S Corporation had sought an early redemption (in five instances) or revoked the gift outright (in two instances). The pension fund indicated that, in some instances, Douglas Duncan from KPMG's Los Angeles office, acting on behalf of the original stock owners, had approached the pension fund about early redemption or revocation of the stock donation. The pension fund told Subcommittee staff that it had agreed to these early redemptions because "a dollar in the hand is worth two in the bush." In other instances, the pension fund had agreed to an extension of the redemption period at the request of the original owners of the shares or

## B. AUSTIN FIRE FIGHTERS RELIEF AND RETIREMENT FUND

The Austin Fire Fighters Relief and Retirement Fund (referred to as "Austin pension fund" or "pension fund") is a $400 million pension fund that serves the fire departments of Austin, Texas.[587] Like the Los Angeles pension fund, the Austin pension fund told the Subcommittee that KPMG had contacted the pension fund "out of the blue" about the SC2 transaction. The pension fund administrator told Subcommittee staff that he was "uncertain why anyone out-of-state would be interested in contributing to the Austin pension fund . . . but that the fund could not look a gift horse in the mouth."[588] The Austin pension fund participated in five SC2 transactions and received stock from S Corporations in California, Mississippi, New Jersey, and New York. The first transaction occurred in October 2000, and the last in March 2001.

The Austin pension fund told the Subcommittee staff that documents it received from KPMG in connection with the SC2 transaction were referred to its legal counsel for review prior to accepting any stock donations. The pension fund indicated that its legal counsel conducted a due diligence review only with respect to the materials KPMG had provided, and concluded that KPMG had found a "loophole" or "wording" in the Internal Revenue Code which enabled the pension fund to accept S Corporation stock donations.[589] However, legal counsel did not provide the pension fund with a written legal opinion, and the pension fund did not seek further legal advice from another outside firm before accepting S Corporation stock. The pension fund told the Subcommittee staff that, regardless of the advice it had received from legal counsel, it remained skeptical that such S Corporation stock donations would ever result in future income to the pension fund.[590] The pension fund nonetheless participated in five SC2 transactions over a 6-month period.

Like the Los Angeles pension fund, the Austin pension fund conducted little, if any, due diligence related to the specific SC2 transactions presented to the fund by KPMG. For example, the Austin pension fund told the Subcommittee that it had relied on KPMG or the relevant S Corporation to determine the fair market value of the non-voting stock that was donated to the pension fund and for the value of that same stock several years later when the fund re-sold it to the donors or their S Corporation. The Austin pension fund administrator told the Subcommittee staff that the pension fund did not conduct any of its own valuations, but simply "took

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the related S Corporation. In one other instance, the pension fund indicated that the S Corporation had asked the pension fund to retain ownership of the stock after the redemption period had lapsed, because the original owners of the shares did not have sufficient funds at that time to redeem the stock at fair market value. The pension fund then retained the stock for 11 months beyond the time period established in the redemption agreement. See Los Angeles pension fund Supplemental Response at 4.

[587] Information about the Austin pension fund and its participation in SC2 transactions is taken from documents supplied to the Subcommittee by the pension fund; and Subcommittee staff interviews with representatives of the pension fund.

[588] Subcommittee staff interviews with representatives of the Austin pension fund.

[589] *Id.*

[590] *Id.*, the Austin pension fund told the Subcommittee staff during a telephone interview conducted on May 11, 2004, that "it [referring to SC2] appeared to be a tax loophole, but from the standpoint of our members we couldn't overlook a donation."

KPMG's word" regarding the value of the donated stock.[591] Moreover, the fund administrator characterized the S Corporation stock as "basically useless" and stated that he believed the fund would only receive income from the stock when the original owner repurchased it. He indicated, however, that the sentiment at the pension fund was not to "look a gift horse in the mouth."[592]

The Austin pension fund told the Subcommittee that the SC2 transactions were, in fact, carried out as planned by KPMG. Of the five SC2 transactions in which the pension fund had participated, the Austin pension fund administrator indicated that one original stock owner had redeemed the shares at the conclusion of the period specified in the redemption agreement; in two instances, shares were redeemed by the original owners earlier than the period established in the redemption agreement, at their request; and two transactions remained outstanding.[593]

On April 1, 2004, the Internal Revenue Service issued a notice declaring the SC2 shelter and similar transactions to be abusive tax avoidance transactions and deeming them "listed transactions."[594] In addition, the IRS declared that tax exempt parties in the transactions would be treated as participants in the transactions. According to an IRS release accompanying the 2004 notice, it was "the first time the IRS has exercised its authority under the tax shelter regulations to specifically designate a tax exempt party as a participant in a tax avoidance transaction."[595]

KPMG stopped marketing new SC2 transactions in 2002, but many of the 58 SC2 products it had sold previously remained active in 2003 and 2004. Similarly, while the Los Angeles and Austin pension funds told the Subcommittee that they had stopped entering into new SC2 transactions, both continued to hold S Corporation stock from earlier transactions and planned to re-sell their S Corporation holdings to the original stock owners for additional, substantial sums.

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[591] *Id.*
[592] *Id.*
[593] *Id.* With respect to the two transactions still outstanding, the Austin pension fund indicated that the redemption date for one of the transactions had been extended in a similar fashion as in the examples cited earlier with the Los Angeles pension fund, and in the second transaction, the original stock owner was seeking to extend the redemption date to a future year after the distribution of dividends to the Austin pension fund.
[594] IRS Notice 2004–30 (4/1/04).
[595] "Treasury and the IRS Issue Guidance on S Corporation, Tax Exempt Entity Transaction," IRS 2004–44 (4/1/04).