# KPMG, tax shelters and the ethics of tax accounting

One of the most lucrative, and contentious, areas of accounting services is tax planning. Tax is assessed in different ways in different countries. In some countries it is assessed through negotiation. A company's or individual's tax return is effectively an opening bid; the authorities counter with a much higher bid and a compromise is reached. In most developed countries, however, including Britain and the USA, the system is based on self-assessment. Here companies and individuals are legally required to submit accurate accounts, conforming to the rules on what is or is not taxable and allowable, and on the basis of which tax is calculated. In advising their clients, accountants have both a legal and a professional responsibility to ensure as far as practicable that the figures supplied to the Revenue are accurate and that their clients pay what is legally owed. Tax planning within the law is entirely legitimate. Tax rules are often complex and accountants have a duty to their clients to ensure that they do not pay more tax than necessary. Tax evasion, misrepresenting a client's financial affairs so as to lower the tax bill, is clearly illegitimate. The line between these, however, is not always a clear one, either legally or ethically.

A prominent example of illegal tax evasion concerns the use by American taxpayers of undeclared Swiss bank accounts. In 2009 the Swiss bank UBS was fined $780 million by the US Inland Revenue Service (IRS) for assisting US citizens evade taxes on an estimated $20 billion of account holdings. It also agreed to pass over details of a number of US client accounts. The fine was part of what is known as a 'deferred prosecution agreement', under which the IRS retained the right to prosecute UBS in the courts if the conditions of the agreement, in this case including a much wider release of client details, were not met, and to avoid such prosecution the Swiss government subsequently passed legislation to allow UBS to release these details. The agreement did not put any limits on the prosecution of individuals, and after an awkward period in which the only prosecution was of the whistleblower who alerted the IRS to the fraud, there was by 2011 a steady stream of prosecutions, both of individuals who failed to declare the existence of their Swiss assets and of their professional advisors. Investigations have also opened up at a second of the large Swiss banks, Credit Suisse.

A more difficult case is that of accounting firm KPMG's punishment for tax fraud in 2005, which again led to a deferred prosecution agreement, this time with a fine of $456 million. A few months later, a total of 19 KPMG partners and managers (who were not protected by the deferred prosecution agreement) and others involved in the scheme were indicted by the Department of Justice, four being eventually convicted. KPMG's tax specialists had come up with a range of tax shelters for high net worth individuals seeking to offset tax on a minimum of $10-$20 million of taxable gains. From 1996 to 2003 the IRS estimated that a total of at least $11 billion of phony tax losses were generated, depriving the Revenue (and thus the American public) of at least $2.5 billion of evaded taxes – but earning KPMG over £500 million in fees.

To understand this case we need first to understand the nature of the tax shelter offered. In general terms, the KPMG shelters were deemed by the IRS to fall in the 'Son of BOSS' class. Here the taxpayer typically buys matched long and short stock options. These are then put into a partnership. The options are sold, and the partner's funds returned. In economic terms, the taxpayer makes a

loss, but under traditional partnership accounting rules, 'contingent liabilities' – liabilities that might never arise – are treated differently in the valuation of partnership stake from ordinary liabilities or assets. So when the partnership is wound up the taxpayer declares a tax loss in respect of the asset side of the options, but no matching profit in respect of the liability side.

The basic structure of this kind of tax shelter is simple and ages old. For a fee, and with the help of bankers (in this case reportedly Deutsche Bank), your tax advisor divides $zero into a pair of large matching profits and losses, in such a way that the loss is chargeable against tax but the profit is not, either because it is artificially deferred to the distant future, or because of some quirk in the tax rules. In 2000, the IRS announced that Son of BOSS arrangements lacked economic substance and were an abuse of partnership laws, that it was changing the rules on contingent liabilities, and that losses of this kind would not be tax deductible. Moreover, if transactions of this kind were not explicitly identified on tax returns, taxpayers would be liable to harsh negligence penalties, and possible legal action, as well as the tax due. In 2004, in a kind of amnesty, it offered taxpayers who had used the device the chance to settle up without prosecution and with reduced penalties, and by 2005 had reclaimed $3.7 billion of tax due. It was not until the end of 2007, however, that a Son of BOSS scheme was found to be illegal in the courts.

The KPMG schemes seem to have been more sophisticated than that described, and at the time of the IRS and Department of Justice actions had not been found to be illegal. Moreover the prosecutions of most of the individuals were subsequently dropped, albeit for largely technical reasons. The main components of the KPMG fine were for failure to disclose and register the tax shelters, and for delays in passing information to the IRS when they investigated the scheme in 2002-3, as a result of which some tax was too long overdue to be recovered.

From 2000 on the scheme was almost certainly in violation of IRS rules, but those rules, and their detailed interpretations, can be and are challenged in the courts. The charges raised included the issuing of false legal opinions in respect of the schemes, but it could well be argued that these were perfectly legitimate legal opinions. In the course of the trial of the four individuals that went ahead, in 2008, defence lawyers insisted that their clients acted in good faith that what they were doing was legal, and that they made no effort to hide it: the schemes were not registered as tax shelters precisely because, in the opinion of accountants and tax lawyers, they were not tax shelters but allowable investments. The investments were not kept secret from the IRS, as were the Swiss bank accounts in the case above, but on the contrary were quite openly declared to them, so that the clients could claim the tax losses. The prosecution argued that investments that were sold in significant numbers over many years and from which no client ever made a profit – all made large losses – could not be construed as genuine investments, but the prosecution eventually succeeded on the basis of a *judgment* that the accused could not reasonably have believed the schemes to be legitimate, not on a demonstration that they had knowingly acted illegally.

What, then, are the principles under which tax accountants should work?

The IRS Commissioner is quoted in the Department of Justice press release, given below, as saying that 'Tax professionals should help people pay what they owe – not more, not less.'

The AICPA Statement on Standards for Tax Services, the code of conduct governing US tax accounting, identifies a 'duty to the tax system', but appears to identify that primarily as a duty to

ensure so far as possible that tax returns are 'true, correct and complete'. The repeated emphasis of the Statement is on full and accurate disclosure.

The Statement also identifies a 'duty to the taxpayer', namely a duty to assist the taxpayer in paying no more tax that is legally required. This would appear to mandate accountants to identify and exploit any loopholes, since failure to do so would mean their clients paying more tax than was required on a strict legal interpretation. The Statement also notes that 'a member should not recommend a tax return position ... unless the member has a good faith belief that the position has at least a realistic possibility of being sustained administratively or judicially on its merits if challenged', which clearly allows for tax return positions that are contested by the IRS but legally untested, and even for those that might probably fail, should they be challenged, provided there is a 'realistic possibility' of their succeeding.

Duska, Duska and Ragatz, however, in their textbook on *Accounting Ethics* (p.155), argue that taking advantage of loopholes goes against the spirit of the law and is *unethical*, on Kantian grounds:

> The tax laws were developed with certain purposes in mind, certain objectives that were deemed desirable by duly elected officials. Now in any law there are loopholes that can be exploited ... But applying the Kantian universalizability principle we see that if everyone exploited the loopholes the system would not accomplish what duly elected officials thought we needed to accomplish, and indeed might collapse. It is only because most people abide by the spirit of the law and don't exploit the loopholes that the laws continue to function. Those who exploit the loopholes are *free riders* who take advantage of others. That is patently unfair.

Testifying to a Congressional committee looking at tax shelters in 1999, the chair of the AICPA Tax Executive Committee, David Lifson, noted that 'we have a complex tax system and believe that taxpayers should be entitled to structure transactions to take advantage of intended incentives and to pay no more tax than is required by law. Clearly the difficulty comes in when trying to draw a delicate balance in determining when the character of tax planning transactions morphs from legitimate to abusive.' (http://www.gpo.gov/fdsys/pkg/CHRG-106hhrg66992/pdf/CHRG-106hhrg66992.pdf) The reference to 'intended incentives' suggests that Lifson is not arguing for the exploitation of loopholes, but the context was that he was arguing against an IRS proposal to put the onus on taxpayers to demonstrate that an investment was *not* an abusive tax shelter. The overall thrust of his argument was that a country cannot institute exceptionally complex tax laws and at the same time outlaw complex responses from taxpayers and accountants. He insisted that the AICPA was strongly opposed to the deceitful use of tax shelters, but argued for a simpler and more transparent set of tax rules, rather for a heavy-handed policing of complex and often obscure rules.

**Sources**: The discussion here is partly modelled on that in Ronald Duska, Brenda Shay Duska and Julie Anne Ragatz, 2011, *Accounting Ethics*. 2nd edition (Wiley-Blackwell), Chapter 9. This is supplemented by documents on the IRS and department of Justice websites; the *Wikipedia* article

on the KPMG case, at en.wikipedia.org/wiki/KPMG_tax_shelter_fraud; and various news articles on Swissinfo.ch. for the cases of UBS and Credit Suisse.

## Annex 1: IRS press release 2005-83, 29th August 2005

http://www.irs.gov/newsroom/article/0,,id=146999,00.html

WASHINGTON — KPMG LLP (KPMG) has admitted to criminal wrongdoing and agreed to pay $456 million in fines, restitution and penalties as part of an agreement to defer prosecution of the firm, the Justice Department and the Internal Revenue Service announced today.

In addition to the agreement, nine individuals—including six former KPMG partners and the former deputy chairman of the firm—are being criminally prosecuted in relation to the multi-billion dollar criminal tax fraud conspiracy. As alleged in a series of charging documents unsealed today, the fraud relates to the design, marketing, and implementation of fraudulent tax shelters.

In the largest criminal tax case ever filed, KPMG has admitted that it engaged in a fraud that generated at least $11 billion dollars in phony tax losses which, according to court papers, cost the United States at least $2.5 billion dollars in evaded taxes. In addition to KPMG's former deputy chairman, the individuals indicted today include two former heads of KPMG's tax practice and a former tax partner in the New York, NY office of a prominent national law firm.

"Corporate fraud has far-reaching consequences, both to the marketplace and those whose livelihoods depend on companies that maintain honest business practices," said Attorney General Alberto R. Gonzales. "Today's agreement requires KPMG to accept responsibility and make amends for its criminal conduct while protecting innocent workers and others from the consequences of a conviction. The stiff financial penalty announced today means that the firm is paying for its conduct, while the guarantees of cooperation, oversight, and meaningful reform will help to ensure that its future business is conducted with honesty and integrity."
The criminal information and indictment together allege that from 1996 through 2003, KPMG, the nine indicted defendants and others conspired to defraud the IRS by designing, marketing and implementing illegal tax shelters. The charging documents focus on four shelters that the conspirators called FLIP, OPIS, BLIPS and SOS.

According to the charges, KPMG, the indicted individuals, and their co-conspirators concocted tax shelter transactions—together with false and fraudulent factual scenarios to support them—and targeted them to wealthy individuals who needed a minimum of $10 or $20 million in tax losses so that they would pay fees that were a percentage of the desired tax loss to KPMG, certain law firms, and others instead of paying billions of dollars in taxes owed to the government. To further the scheme, KPMG, the individual defendants, and their co-conspirators allegedly filed and caused to be filed false and fraudulent tax returns that claimed phony tax losses.

KPMG also admitted that its personnel took specific deliberate steps to conceal the existence of the shelters from the IRS by, among other things, failing to register the shelters with the IRS as required by law; fraudulently concealing the shelter losses and income on tax returns; and attempting to hide the shelters using sham attorney–client privilege claims.

The information and indictment allege that top leadership at KPMG made the decision to approve and participate in shelters and issue KPMG opinion letters despite significant warnings from KPMG tax experts and others throughout the development of the shelters and at critical junctures that the shelters were close to frivolous and would not withstand IRS scrutiny; that the representations required to made by the wealthy individuals were not credible; and the consequences of going forward with the shelters—as well as failing to register them—could include criminal investigation, among other things.

The agreement provides that prosecution of the criminal charge against KPMG will be deferred until Dec. 31, 2006 if specified conditions—including payment of the $456 million in fines, restitution, and penalties—are met. The $456 million penalty includes: $100 million in civil fines for failure to register the tax shelters with the IRS; $128 million in criminal fines representing disgorgement of fees earned by KPMG on the four shelters; and $228 million in criminal restitution representing lost taxes to the IRS as a result of KPMG's intransigence in

turning over documents and information to the IRS that caused the statute of limitations to run. If KPMG has fully complied with all the terms of the deferred prosecution agreement at the end of the deferral period, the government will dismiss the criminal information.

To date, the IRS has collected more than $3.7 billion from taxpayers who voluntarily participated in a parallel civil global settlement initiative called Son of Boss. The BLIPS and SOS shelters are part of the Son of Boss family of tax shelters.

The agreement requires permanent restrictions on KPMG's tax practice, including the termination of two practice areas, one of which provides tax advice to wealthy individuals; and permanent adherence to higher tax practice standards regarding the issuance of certain tax opinions and the preparation of tax returns. In addition, the agreement bans KPMG's involvement with any pre-packaged tax products and restricts KPMG's acceptance of fees not based on hourly rates. The agreement also requires KPMG to implement and maintain an effective compliance and ethics program; to install an independent, government-appointed monitor who will oversee KPMG's compliance with the deferred prosecution agreement for a three-year period; and its full and truthful cooperation in the pending criminal investigation, including the voluntary provision of information and documents.

Richard Breeden, former Securities and Exchange Commission Chairman, has been appointed to serve as the independent monitor. After his duties end, the IRS will monitor KPMG's tax practice and adherence to elevated standards for two years.

Should KPMG violate the agreement, it may be prosecuted for the charged conspiracy, or the government may extend the period of deferral and/or the monitorship.

"Today's actions demonstrate our resolve to hold accountable those who play fast and loose with the tax code," said IRS Commissioner Mark Everson. "At some point such conduct passes from clever accounting and lawyering to theft from the people. We simply can't tolerate flagrant abuse of the law and of professional obligations by tax practitioners, particularly those associated with so-called blue chip firms like KPMG, that by virtue of their prominence set the standard of conduct for others. Accountants and attorneys should be the pillars of our system of taxation, not the architects of its circumvention."

The nine individuals named in the indictment are:

• Jeffrey Stein, former Deputy Chairman of KPMG, former Vice Chairman of KPMG in charge of Tax, and former KPMG tax partner;
• John Lanning, former Vice Chairman of KPMG in charge of Tax, and former KPMG tax partner;
• Richard Smith, former Vice Chairman of KPMG in charge of Tax, a former leader of KPMG's Washington National Tax, and former KPMG tax partner;
• Jeffrey Eischeid, former head of KPMG's Innovative Strategies group and its Personal Financial Planning Group, and former KPMG tax partner;
• Philip Wiesner, former Partner-In-Charge of KPMG's Washington National Tax office and former KPMG tax partner;
• John Larson, a former KPMG senior tax manager;
• Robert Pfaff, a former KPMG tax partner;
• Raymond J. Ruble, a former tax partner in the New York, NY office of a prominent national law firm; and
• Mark Watson, a former KPMG tax partner in its Washington National Tax office.

The indictment alleges that as part of the conspiracy to defraud the United States, KPMG, the nine defendants and their co-conspirators prepared false and fraudulent documents— including engagement letters, transactional documents, representation letters, and opinion letters—to deceive the IRS if it should learn of the transactions. KPMG, the indicted defendants and their co-conspirators are also charged with preparing false and fraudulent representations that clients were required to make in order to obtain opinion letters from KPMG and law firms—including Ruble's law firm—that purported to justify using the phony tax shelter losses to offset income or gain.

The conspirators allegedly concealed from the IRS the fact that the opinion letters provided by KPMG and the law firms were not independent and were instead prepared by entities involved in the design, marketing and implementation of the shelters. Had the IRS known this, the opinion letters would have been rendered worthless.

KPMG admitted that the opinion letters issued for the FLIP, OPIS, BLIPS and SOS shelters were false and fraudulent in numerous respects, including false claims that transactions were legitimate investments instead of tax shelters; and also false claims that clients were entering into certain transactions making up the shelters for investment purposes or to diversify their portfolios, when these actually served to disguise the shelters.

KPMG also admitted that the clients' motivations were to get a tax loss, and with respect to BLIPS, the opinion letters also included false claims about the duration of the transaction and the clients' motivation for terminating the transaction. According to the charges, BLIPS was also based on false claims about the existence and investment purpose of a loan, when these were in fact sham loans that had nothing to do with any investment, and at least one of the banks never even funded the purported loans.

According to the charging documents, Smith, Eischeid, and others caused KPMG to provide false, misleading and incomplete documents and testimony in response to a Senate subpoena, which was delivered as part of an investigation into tax shelters being conducted by the Senate Governmental Affairs Committee's Permanent Subcommittee on Investigations.

Assistant U.S. Attorneys Justin S. Weddle and Stanley J. Okula, Jr.—together with Special Assistant U.S. Attorney and Tax Division Trial Attorney Kevin M. Downing—are in charge of the prosecution. The investigation and prosecution are being supervised by Shirah Neiman, Chief Counsel to the U.S. Attorney for the Southern District of New York.

For the IRS, the case was investigated by a team of special agents and revenue agents from the agency's criminal and civil divisions.

The individual defendants are scheduled to be arraigned by Judge Lewis Kaplan.

The charges contained in the indictment are merely accusations, and the defendants are presumed innocent unless and until proven guilty.

## Annex 2: Department of Justice press release 05 tax 547, October 2005

http://www.justice.gov/opa/pr/2005/October/05_tax_547.html

### SUPERSEDING INDICTMENT OF 19 INDIVIDUALS FILED IN KPMG CRIMINAL TAX FRAUD CASE

WASHINGTON, D.C. - The Justice Department and Internal Revenue Service (IRS) today announced the filing of a superseding criminal indictment in the largest criminal tax case ever filed. Nineteen individuals were charged with conspiracy to defraud the IRS, tax evasion and obstruction of the Internal Revenue Laws arising out of illegal tax shelters that Big 4-accounting firm KPMG and others designed, marketed and implemented. According to the charges, the shelters generated at least $11 billion in fraudulent phony tax losses and resulted in at least $2.5 billion in tax evaded by wealthy individuals.

The indictment charges the former Deputy Chairman of KPMG, several former heads of KPMG's tax practice; the former CFO of KPMG; the former head of KPMG's Department of Professional Practice; a former KPMG Associate General Counsel; a former tax partner in the New York office of a prominent national law firm; and numerous other former KPMG tax partners. KPMG, headquartered in New York with offices in most major cities of the United States, acknowledged its criminal wrongdoing in a deferred prosecution agreement approved by the court on August 29, 2005. "The Department of Justice is committed to enforcing the tax laws to make certain all individuals comply with their tax obligations," said Acting Deputy Attorney General Robert McCallum. "To this end, the Department will vigorously prosecute any individual who makes false

representations to the Internal Revenue Service. The prosecution of this case sends a strong message that tax professionals must be honest in their dealing with the IRS."

Among other charges, the indictment alleges that from 1996 to early 2004 the 19 defendants, KPMG, and others conspired to defraud the IRS by designing, marketing and implementing illegal tax shelters, and focusing on four shelters known as FLIP, OPIS, BLIPS and SOS. It is charged that this illegal course of conduct was approved and perpetrated at the highest levels of KPMG's tax management and involved numerous KPMG partners and other personnel. "The development and promotion of abusive tax shelters had a corrupting effect on the legal and accounting professions," said IRS Commissioner Mark Everson. "Tax professionals should help people pay what they owe-not more, not less."

According to the charges, the alleged conspirators designed, marketed and implemented the shelters so that wealthy individuals who had large incomes or a large capital gain could eliminate all taxes on that income or gain by simply paying to KPMG all-in costs and fees of from 5-7% of the income or gain they wished to shelter. The shelters were marketed only to individuals who needed a minimum of $10 million or $20 million in losses, and according to the charges, the defendants and their co-conspirators filed and caused to be filed false and fraudulent tax returns that incorporated the phony tax losses. In addition, the defendants and their co-conspirators took specific steps to conceal the very existence of the shelters from the IRS and from IRS scrutiny-by among other things-failing to register the shelters with the IRS as required, and by fraudulently concealing the shelter losses and income on tax returns, according to the indictment.

The indictment also alleges that from 2002-2003, in response to the IRS examination of KPMG for failure to register tax shelters and related matters, certain of the defendants continued the fraud on the IRS by concealing KPMG's involvement and role in certain shelters; intentionally failing to produce documents that were called for by summonses issued by the IRS; and providing false and evasive testimony to the IRS regarding the nature and scope of KPMG's involvement with certain shelters. In addition, in connection with the investigation into tax shelters being conducted during the pendency of the IRS examination by a Senate Subcommittee, certain defendants provided false, misleading and incomplete information and testimony at a hearing and a false response regarding documents that were called for in a subpoena issued by the Senate, relating to the personal use of tax shelters by KPMG and certain KPMG partners. "It is hard to imagine anything that can serve to undermine our voluntary system of taxation more than the crimes charged today, where so many professionals banded together with wealthy individuals to perpetrate this massive fraud on the tax system. This was an orchestrated case of deliberate tax evasion, and not legitimate tax planning. Professionals, including lawyers, accountants, bankers, so-called investment advisors and their firms -- as well as taxpayers -- should be on notice that the government will pursue even the most complicated tax-fraud schemes designed to help the wealthy evade paying their fair share."

The investigation is ongoing. Assistant U.S. Attorneys Justin Weddle, Stanley J. Okula and Special Assistant U.S. Attorney Kevin M. Downing are in charge of the prosecution. Shirah Neiman, Chief Counsel to the U.S. Attorney, is supervising the investigation and prosecution.

The charges contained in the indictment are merely accusations, and the defendants are presumed innocent unless and until proven guilty.