Lessons from the KPMG’s tax-shelter Shocker

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ABSTRACT

The largest ever tax-shelter fraud now comes to light, implying that there is a great lesson for us. My study probes into the KPMG’s tax-shelter Shocker by encompassing causes, courses and consequences of the event. This project also features KPMG’s tax-shelter products- FLIP/ OPIS, BLIPS, and SC2. Another focus of the project is cast on the ethical issues involved. On the corporate level, social responsibilities of KPMG are to be dissected into dimensions. On the individual level, ethical dilemma faced by Hamersley, the whistle-blower, is to be evaluated from the moral perspectives.
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1. **Background**

‘Abusive tax-shelter is an affront to honest taxpayers and practitioners and undermines confidence in the fairness of our tax system,’ Everson (2003) criticized, the Commissioner of the Internal Revenue Service (IRS).

Existing legal definitions of abusive tax-shelters are complex and appear in several sections of the IRS tax code. The General Accounting Office (GAO) (2003) summarized these definitions by describing tax-shelters as ‘very complicated transactions promoted to corporations and wealthy individuals to exploit tax loopholes and provide large, unintended tax benefits.’ Professor Bankman (1999) of Stanford Law School gave a fuller definition, saying that ‘[tax-shelter] is a corporate transaction involving energetic paper shuffling aimed at having favorable tax consequences along with no, or next to no, economic consequences other than the tax consequences.’

KPMG, LLP (KPMG), a Big Four accounting firm, devoted significant resources in developing abusive tax-shelters which generated US$124 million in revenues for the firm. KPMG maintained an inventory of more than 500 active tax products which were designed to enable its clients to avoid paying taxes on the huge financial gains they enjoyed. Abusive tax-shelters deprived the Treasury Department of billions of dollars in lost tax revenue (Wall

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1 § 461(i)(3) defines **tax-shelter** for certain tax accounting rules; §§ 6111(a), (c) and (d) define **tax-shelter** for certain registration and disclosure requirements; and § 6662(d)(2)(C)(iii) defines **tax-shelter** for application of understatement penalty (U.S. Senate, 2003).
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During the last few years, government investigations and lawsuits brought by the IRS and former clients exposed the tax-shelter activities of KPMG, PriceWaterhouseCoopers, Ernst & Young, Deloitte Touche Tohmatsu, BDO Seidman, and Grant Thornton (Shaviro, 2004). Yet, KPMG was found to be the firm in the most trouble. Even after dissolving its tax-shelter practice and replacing several high level partners involved, the firm agreed to enter a deferred prosecution agreement. The agreement provides that prosecution of the criminal charge against KPMG will be deferred until December 31, 2006 if specified conditions- including payment of the US$456 million in fines, restitution, and penalties- are met (IRS, 2005).

What brought KPMG’s tax-shelter activities to light? The U.S. government’s efforts to uncover them were greatly facilitated by Michael Hamersley (2003), a former Senior Manager in KPMG’s Los Angeles Mergers and Acquisitions Tax Practice. He believed that he would be involved in something fraudulent, he decided he had no choice but to contact the government.

Hamersley (2003) commented on those abusive tax-shelters, saying that they involve a distortion or concealment of facts. ‘They require not only intellectual dishonesty, but also deception, secrecy and even conspiracy.’ KPMG, once a well-regarded accounting firm, was quick to trade on its reputation to develop a thriving, highly lucrative tax-shelter practice.
2. Objectives

‘Accountants and attorneys should be the pillars of our system of taxation, not the architects of its circumvention,’ said Everson (2005). What is happening at KPMG is obviously affecting accountants and lawyers significantly. By virtue of prominence, those so-called blue-chip firms like KPMG set the standard of conduct for others. Therefore, it will be a precious lesson to take a step back to figure out what is going on in the KPMG saga. My study is divided into the following two levels of objectives:

2.1 On the Corporate Level

KPMG’s tax-shelter controversy illustrates the continued importance of professionalism in the realm of accounting firms. Tax is an integral part of the legal system. However, tax accountants and attorneys are seeking ways to sell their expertise outside the structures of professional regulation.

The KPMG Shocker signals some of the risks taken by giant accounting firms. On the corporate level, it demonstrates how business rationality can replace professional norms. In its eagerness to become an industry leader, the firm engaged in a variety of evasive tactics to avoid detection by the IRS. One of the objectives of the study is to lift up the veil of the tactics manipulated by KPMG. Implementation of the tax products will be embodied in the project. Causes, courses and consequences of the saga will be
scrutinized. These are to be followed by the dissection of KPMG’s corporate social responsibility.

2.2 On the Individual Level

Tax is a study that encompasses creativity. Tax work is a matter of thinking outside the box when it comes to the gray areas of government codes. Yet, are there any rulers that tell how far should accountants think so that they are still within the right tax-shelter orbit? The incident reveals the fact that it is not rare for tax-shelter promoters to be confronted by ethical predicaments. They may want the money associated with large performance-based fees, but they may know that the behavior is unethical and perhaps illegal. Another objective of my study is to highlight the ethical lapse observations.

On the other hand, I will probe into the role of the main character of the Shocker. What lessons may we draw from Hamersley’s experience? What made him courageous enough to be a whistle-blower? What are the implications of his story for the profession? In my project, Hamersley’s choice of being the whistle-blower will be reasoned from the moral perspectives.
3. Literature Review

The KPMG and its tax-shelter Shocker is a hot potato for the time being. The story has not ceased to an end yet as the firm agreed to enter a deferred prosecution arrangement. There are no publications that particularly delve into the saga in depth and details. Nevertheless, there are numerous articles in which authors spent a few pages on describing the issue.

Everson (2003) described how he views abusive tax-shelters from the standpoint of the position as the IRS Commissioner in his testimony before the Senate Finance Committee Hearing. He pointed out that abusive tax transactions are a product of the structure and complexity of the IRS Code. They can be creative, complex and difficult to detect. Their creators are often extremely sophisticated, as are many of their users, who are often financially prepared and motivated to contest the IRS’s challenges.

The Commissioner indicated that a significant priority in the IRS’s efforts to curb abusive transactions is their focus on promoters. He believed that some of the accounting firms were acting as promoters of tax-shelters, and not simply as tax advisers (Everson, 2003).

In the lawsuit, Hamersley (2003) described the coercive tax-shelter environment that he observed at KPMG. He said that the problem of clever tax professionals twisting the law beyond its intended bounds has long existed. He testified the disrespect for the IRS by KPMG tax-shelter promoters. They openly proclaimed their disregard for the law by making
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statements to clients and colleagues. ‘You’ll never pay tax again…Our clients do not pay federal income tax, paying tax is optional.’ This is the belief of those tax-shelter promoters.

Bankman (1999) discussed the current market in corporate tax-shelters and some possible governmental responses. He reported that market for corporate tax-shelters has increased dramatically in the past few years. As compared to the individual tax-shelters of the early 1980s, Bankman argued that today's corporate tax shelters are more complex, more sophisticated, and more aggressive in their interpretation of the tax law.

Professor Shaviro (2004) of New York University Law School expressed his opinion on corporate tax-shelters. He said that ‘there is no Platonic definition of a corporate tax shelter…the core idea is related to economic substance’. In addition, he focused on one key question- are corporate tax-shelters an ‘abuse’ that should be stopped? In his book, he reasoned why he asked this question in twofold. ‘First, a lot of money is involved…Second, the corporate tax shelter issue has struck a public chord through its association with Enron-style financial accounting abuse.’

In the article of Well (2005), he wrote that Deutsche Bank, HVB and UBS from 1997 to 2000 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 report of the Senate Permanent Subcommittee (2003) also underscored how
KPMG’s sales of questionable tax-shelters to wealthy Americans could not have happened without the participation of UBS and at least two German banks –Deutsche Bank AG and HVB Group -that provided billions of dollars in credit lines to KPMG clients. The report was produced after an in-depth investigation into the development, marketing, and implementation of abusive tax-shelters. The report gave a clear overview of the U.S. tax-shelter industry and KPMG’s tax-shelter products.

Professor Johnson (2005) of law at the University of Texas, an expert for plaintiffs who bought KPMG shelters and seek recovery of costs, argued that the basis-shift or defective-redemption shelter, called FLIP/ OPIS by KPMG, was a product to develop complete tax packages that could be sold for multimillion-dollar fees. He provided a full picture of the camouflage manipulated by the firm.

The saga of the worldwide accounting firm was followed by prong of responses. ‘We’re telling clients that there is a difference between these suspect tax-shelters and good tax planning,’ said J.H. Cohn’s Mr. DeMeola. ‘We’ve had to resign from many clients who wanted us to be too aggressive,’ expressed Christopher Loiacono, co-head of the tax practice at Manhattan accounting firm Eisner (Fernandez, 2005).

Yet, some tax professionals warned that such caution can easily backfire. ‘Everyone is gun-shy now,’ observed Herrick’s Mr. Levine. ‘Accountants have tempered their enthusiasm for creative deals and are afraid of giving advice that under normal circumstances would have
been solid.’ Being not to be aggressive is perceived as wimpy by clients. To earn money, accountants sometimes may be willing to take some risks by selling questionable products (Fernandez, 2005).

What we can capture from the above literature reviews is the fact that there are no conclusive publications or articles that summarize the whole saga into a single study. So my project will assemble piecemeal information supplied from articles that are persuasive, coherent and convincing enough to give us a full picture of the KPMG’s tax-shelter Shocker. This project attempts to fill in the literature with a discussion of the tax and ethical issues concerned.

**Remark**

The constraint of the study is the heavy reliance on the internet resources. This limits me to obtain very strong and authoritative evidences of the Shocker. Though I tried to choose articles sourced from universities, journals, and government departments, there maybe discrepancies between the real and reported situations. So, my analysis stands with an assumption that the sources are reliable and trustworthy.
4. Methodology

4.1 Overall Study: IRAC Analysis

The aim of my research is to find the regulations that govern the case. So I would like to locate both the rules which are enforced by the State and commentaries which explain these rules. IRAC reasoning will be used. It provides the underlying framework for my research work. IRAC stands for Issue, Rule, Application and Conclusion (Nedzel, 2004). Using IRAC analysis, my study: 1) identifies the question or issue to be addressed; 2) states and explains the applicable rule; 3) applies the authority to the specific facts of the situation; and 4) concludes by answering the question asked in step 1. For the methodology flowchart of my analysis, see Appendix 11.1.

Jones and Rhoades-Catanach (2005) wrote that all sources of tax information can be categorized as either primary or secondary authority. Relevant primary authorities are items written by the government. Information sourced from statutory authority, administrative authority and judicial authority are adopted throughout the research process. Secondary authorities used in this project, such as books, professional journals, and commercial tax services attempt to explain and interpret the relevant tax law.

4.2 Corporate Level: Social Responsibility Approach

The concept of social responsibility was articulated by Friedman (1970), ‘the
primary and only responsibility of business is to use its resources and engage in activities
designed to increase its profits so long as it stays within the rules of the game, which is
to say, engages in open and free competition without deception and fraud.’ My dissection
of the business conduct of KPMG is framed by the Pyramid of Social Responsibility of
Carroll (1991). In the Pyramid, there are four dimensions of social responsibilities-
economic, legal, ethical, and philanthropic. And they are viewed as steps, as illustrated in
Appendix 11.2.

4.3 Individual Level: Moral Standards Approach

The two standards making up the moral standards approach are listed below:

1. Teleology (Duska and Duska, 2003): Moral philosophy in which an act is
   considered morally right or acceptable if it produces some desired consequences
   i. Egoism: ‘One ought to act in one’s own interest.’
   ii. Utilitarianism: ‘Actions are right in proportion as they tend to promote
       happiness, wrong as they tend to produce the reverse of happiness.’

2. Deontology (Ferrell, Fraedrich, and Ferrell, 2005): Moral philosophies focus on the
   rights of individuals and on the associated with a particular behavior rather than on
   its consequences
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5. Causes

5.1 Underlying Causes: Tremendous transformation in the realm of accounting

The field of accounting has changed dramatically over the last decade. Certified public accountants (CPAs) were not used to concern about competition. These days CPAs advertise their skills and short-term results in the competitive environment. Technological innovations add to their burdens. Accountants are now permitted to charge performance-based fees rather than hourly rates (Ferrell, Fraedrich, and Ferrell, 2005).

Big accounting firms formed teams dedicated to promote high-margin tax strategies. Fees to the accounting firm ranged from 10% to 40% of taxes saved. The individual tax salesmen who snagged deals could get up to 10% of this (Bryan-Low, 2003). Focusing on the tax-shelter industry itself, it no longer works primarily on providing tax advices. Instead, the industry scope has expanded to the development of generic tax-shelters products that can be pitched to multiple clients. Here we can see the industry environment tempts accountants to seek a short-cut in order to win the other competitors.

Shaviro (2004) combined two main economic substances in evaluating the increase in tax sheltering activities. On the demand side, companies are increasingly aggressive about managing. So they attempt all ways to reduce tax payments. On the supply side, financial innovation increased the available tools for creative paper shuffling. These elements constitute the active market for tax-shelter products.
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Conceivably, pressures faced by tax accountants spawn a breeding ground for engaging ethically and/or legally questionable activities. On one side, accountants have to deal with client requests to alter opinions concerning financial conditions or lower tax payments. On the other side, they have to face daily compliance with complex rules and regulations, data overload and commissions. Eventually, problems of having ethical and/or legal misconduct within the tax-shelter industry are on the rise.

Back to this case, Hamersley (2003), a former employee of KPMG, said that there was a culture in which intimidation and coercion were often used to foster the abusive tax shelter environment. In accordance with a national survey by KPMG, 38 percent of the nearly twenty-four hundred workers surveyed indicated that management would authorize illegal or unethical conduct to meet business goals (Ferrell, Fraedrich, and Ferrell, 2005).

After all, the word ‘lucrative’ best explains the expansion of tax-shelter industry. It is also the reason why banks, investment advisory firms, law firms, and even charitable organizations were willing to participate in abusive tax-shelter activities.
5.2 Outbreak of Event: KPMG’s tax-shelter Shocker, the largest ever tax-shelter fraud, came to light

§ 6111 requires each tax promoter with respect to any reportable transaction make a return setting forth information identifying and describing the transaction and any potential tax benefits expected to result from the transaction (IRS, 2005). Under this registration requirement, the IRS can more easily identify them and review their legality. Over the years, however, KPMG never registered any tax products, taking the position that the ‘tax solutions’ or ‘tax strategies’ it offered were not tax-shelters that fell within the registration requirements (U.S. Senate, 2003).

As previously mentioned, it was Hamersley (2005) who revealed KPMG’s tax-shelters activities to the outside party. In spring 2002, he began providing information to U.S. Senate Permanent Subcommittee on Investigations. In October 2002, he was placed on indefinite leave of absence by KPMG after refusing to participate in what he believed to be illegal conduct.

In June 2003, the Justice Department, on behalf of the IRS, filed suit in federal court in Washington, D.C. against KPMG, asking the court to compel the public accounting firm to disclose information to the IRS about all tax-shelters it has marketed since 1998. In August 2005, KPMG entered the deferred prosecution agreement and paid US$456 million for criminal violations.
6. Courses

6.1 Foreign Leveraged Investment Program (FLIP)/ Offshore Portfolio Investment Strategy (OPIS) (Johnson, 2005)

FLIP/OPIS was a highly profitable shelter, generating over US$45 million fees for KPMG in 1998. The firm initially called it FLIP and then changed the name to OPIS, adding complexity without changing the underlying logic. This shelter, Johnson (2005) wrote, eliminated reported gain of at least US$3.6 billion before the IRS began rolling up the participants. For visual explanation of this shelter, refer to Appendix 11.3.

Step 1: KPMG established a shell Cayman Islands\(^2\) (Cayman) corporation of partnership for each U.S. taxpayer who bought the shelter. For instance, a taxpayer was considered to own 85% of Cayman as part of the FLIP/OPIS package. *Constructive ownership* rules used in redemption was formed under § 318(a)(4).

Step 2: Cayman borrowed the amount of intended artificial loss (i.e. US$100 million) in cash from Union Bank of Switzerland (UBS) in mid-1998 to buy UBS shares.

Step 3: Two months later, UBS redeemed all the UBS stock from Cayman at the market price. Then Cayman used the proceeds to repay the loan. Indeed the US$100 million cash never left UBS’s hands, from loan through repayment. Yet, there were electronic entries for loan, issuance of stock, redemption back and repayment of the loan.

\(^2\) Cayman Islands, a Caribbean nation, is a tax haven with no corporate income tax (Jones, 2005).
Step 4: By the end of 1998, the taxpayer then purchased the option to buy the same number of UBS stock, just as Cayman was redeemed out of its shares.

Without the shelter: CCH Federal Tax Group (2003) wrote that for sales prior to May 6, 2003, gain from the sale of long-term capital assets is subject to a maximum capital gains tax rate of 20%. Assuming the U.S. taxpayer had US$100 million as capital gains, the taxpayer had to bear US$20 million as tax payment.

Under the shelter: Under constructive ownership of stock\(^3\), when the taxpayer purchased the same number of shares, the taxpayer’s new shares were regarded as owned by Cayman. Having the above arrangement, KPMG alleged that Cayman maintained the ‘same’ fractional interest in UBS under § 318.

§§ 302(a) and (b)(1) state that a redemption is a sale or exchange if it is ‘not essentially equivalent to a dividend’. In United States v. Davis, the Supreme Court (1970) held that a redemption that transfers money to the shareholders without any change in their percentage ownership of the equity of the corporation was not in substance a sale, and would be taxed as a dividend without use of basis. By asserting Cayman still held the ‘same’ fractional interest in UBS, KPMG claimed that the Cayman redemption was not qualified as ‘a sales or exchange’ and that Cayman could not use its basis in the

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\(^3\) According to §§ 318(a)(2)(C) and (a)(3)(C), under constructive ownership of stock, if 50% or more in value of the stock in a corporation (i.e. Cayman) is owned by any person (i.e. U.S. taxpayer), the corporation is considered as owning the stock owned by that person (CCH Federal Tax Group, 2003).
redeemed stock against a dividend.

The FLIP/OPIS shelter, Johnson (2005) noted, rested on the claim that Cayman was not entitled to use its US$100 million basis on the resale of UBS shares and that its basis shifted over to the taxpayers under regulations allowing an ‘appropriate adjustment to basis’ \(^4\). The entire US$100 million Cayman cost was purportedly added to taxpayer’s basis for shares, such that taxpayer recognized the US$100 million loss when he/she sold his 1,000 UBS shares. The taxpayer bought US$100 million worth of artificial losses at a price of US$7 million in fees. At the 20% capital gains tax rate, the losses would worth US$20 million. So the tax benefits would be amounted to US$13 million \(^5\).

**IRS response:** The UBS redemption from Cayman was an exchange redemption in which Cayman was itself entitled to use its basis. Indeed the redemption by UBS from Cayman was not essentially equivalent to a dividend because Cayman did not ‘recapture’ enough of the percentage of its UBS stock it gave up, even taking Cayman’s constructive ownership of the taxpayer’s UBS stock into consideration. Under §§ 302(b)(1) and 302(a), Cayman could use its US$100 million basis in its basis in its own redemption. Hence, none of the basis was available to shift over to the U.S. taxpayer.

\(^4\) § 1.302-2(c) provides that in any case in which an amount received in redemption of stock is treated as a distribution of a dividend, proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed. Retrieved Feb 3, 2006 from http://www.irs.gov/pub/irs-irbs/irb01-33.pdf

\(^5\) US$100M (Capital gains) x 20% (Capital gains tax rate) – US$7M (Fee) = US$13M
6.2 Bond Linked Issue Premium (BLIPS) (U.S. Senate, 2003)

In 1999, KPMG approved BLIPS for sale, pitching the product as a tax-advantaged investment. The investor was told that in exchange for payments to KPMG, which were frequently in the millions, he would generate a tax loss of as much as 10 to 20 times the investment (Porter, 2004). According to the U.S. Senate Report (2003), the firm sold BLIPS to 186 individuals, and obtained more than US$53 million in revenues during 1999 and 2000. For visual explanations, see Appendix 11.4.

**Step 1:** Let us assume an U.S. taxpayer had made ordinary or capital gains income of US$20 million. Pursuant to the so-called ‘tax advantaged investment strategy’, the taxpayer formed a *single-member limited liability corporation (LLC)* and contributed 7% of the amount to be sheltered (i.e. US$1.4 million).

**Step 2:** LLC obtained a non-recourse seven-year loan (US$50 million) from a bank at an above-market interest rate, such as 16%. Because of the above-market interest rate, the bank credited LLC with an additional US$20 million load premium, which would be treated as a loss for tax purposes. The Report (2003) continued to explain that the premium was equal to the net present value of the portion of the loan interest payments that exceeded the market rate and that LLC was required to pay during the full

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6 *Limited liability company (LLC)* is the form of unincorporated business organization in which the members have limited liability (Jones & Rhoades-Caranach, 2005).
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seven-year loan. In this way, LLC received an amount of US$70 million from the bank.

Under the loan restrictions, LLC agreed to maintain ‘collateral’ in cash equal to 101% of the loan amount, including the loan premium. Porter (2004) indicated that the loan proceeds were deemed ‘collateral’ for the loan itself.

**Step 3:** Presidio, an investment advisory firm now entered the picture. LLC and two Presidio affiliates formed a partnership called a Strategic Investment Fund (Fund) in which LLC got a 90% interest. LLC contributed all of its assets while Presidio’s two affiliates contributed the rest. The Fund’s capital was amounted to US$71.6 million.

**Step 4:** LLC assigned the loan to the Fund which assumed LLC’s obligation to repay it. This obligation included repayments of the loan and loan premium. The Fund entered into a swap transaction with the bank, shrinking the loan interest rate to a market rate. The Fund agreed to pay a floating market rate (about 8 %) on the US$70 million borrowed, while the bank agreed to pay 16% fixed rate on the amount of the loan.

**Step 5:** The Fund used the US$70 million to buy euros while obtaining a guarantee that it could convert the euros back to dollars within 60 days, creating a semblance of investment activity. And the euros were placed in an account at the bank.

**Step 6:** After 60 to 180 days, LLC withdrawn, unwinding the partnership, and converting all cash into U.S. dollars. The cash was, then, be used to repay the loan plus a
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prepayment penalty is a charge imposed by a mortgage lender on a borrower who wants to pay off part or all of a mortgage loan in advance of schedule. Retrieved Feb 10, 2005 from http://www.eloan.com/s/show/glossary

Single-member LLCs are disregarded entities for federal tax purposes, the LLC’s shares are treated as directly owned by the individual member (Jones & Rhoades-Catanach, 2005).

US$21.4M (‘Loss’ + Contribution) x 45% (Max. tax rate) – US$1.4M (Fee: 7% x US$20M) = US$ 8.23M

A listed transaction is a transaction that is the same as or substantially similar to one that the IRS has determined to be a tax avoidance transaction...parties who participate in listed transactions may be required to disclose the transaction. Retrieved Mar 3, 2005 from http://www.irs.gov/retirement/article/0,,id=119551,00.html

7 Prepayment penalty

8 Single-member LLCs are disregarded entities

9 US$21.4M (‘Loss’ + Contribution) x 45% (Max. tax rate) – US$1.4M (Fee: 7% x US$20M) = US$ 8.23M

10 A listed transaction

prepayment penalty\textsuperscript{7} equivalent to the US$20 million premium originally loaned by the bank. Any remaining partnership assets were apportioned and distributed.

**Without the shelter:** As stated in the Report, the taxpayer had to pay tax on the US$20 million, which ranged from 20% to 45%, depending on his/her effective tax rates.

**Under the shelter:** For tax purpose, the LLC’s income or loss passes to its owner, the taxpayer. Reg. 301.7701-3 states that a single-member LLC is a disregarded entity\textsuperscript{8} (Jones & Rhoades-Catanach, 2005). The taxpayer could attempt to claim that he/she retained a cost basis in the partnership equaled to the contribution of LLC (US$1.4 million) and the loan premium (US$20 million). With this ‘tax loss’, the taxpayer attempted to offset the initial capital gains. The only cost to the taxpayer was a single fee charged by KPMG and the other participants in the transaction, which equaled to 7% of the intended tax loss. Hence, for an individual who got US$20 million as capital gains, the maximum saving could be extended to US$8.23 million\textsuperscript{9}.

**IRS response:** IRS Notice 2000-44 identified this kind of transactions as listed transaction\textsuperscript{10}, asserting that these types of transactions ‘do not represent bona fide losses’ (Shulman and Balacek, 2000). According to Notice 2004-67, taxpayers may need to
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disclose their participation as prescribed in § 1.6011.4, and promoters may need to register these transactions under § 301.6111-2 (Goldman and Shulman, 2004).

6.3 S-Corporation Charitable Contribution Strategy (SC2) (U.S. Senate, 2003)

The Report stated that, in 2000 and 2001, KPMG sold SC2 to 58 S-corporations, generating more than US$26 million in revenues. The so-called ‘charitable donation strategy’ sheltered a significant portion of the S-corporation’s income from taxation. Consider an U.S. taxpayer owned 100% of S-corporations\(^{11}\) which earned net income, for instance, US$ 3 million annually. For diagram depictions, refer to Appendix 11.5.

**Step 1:** The S-corporation issued non-voting shares of stock that equaled 9 times the total number of shares (e.g. corporation with 100 voting shares issued 900 non-voting shares). Then the corporation issued warrants to purchase a substantial number of company shares (e.g. 7,000 warrants) to the individual-shareholder. And the corporation issued a resolution suspending income distributions to all shareholders for a specified period of time, in which the charity was intended to be a shareholder (say, 3 years).

**Step 2:** Due to the existence of a large number of warrants, the non-voting shares had a low fair market value (e.g. US$100,000). The taxpayer ‘donated’ these shares to a

\(^{11}\) According to §§ 1363 (a) and 1366, for federal tax purposes, a S corporation is a passthrough entity; its business income is allocated and taxed directly to the corporation’s shareholders (Jones, 2005).
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qualified charity\textsuperscript{12}, making the charity the temporary owner of 90\% of the corporation’s shares. Also, they entered into a redemption agreement requiring the corporation, after a specified period of time, to buy back the shares at fair market value.

\textbf{Step 3:} During the period (i.e. 3 years) in which the charity held the non-voting shares, the S-corporation ‘allocated’ its annual net income in proportion to the percentage of overall shares the charity and the individual-shareholder held (i.e. 90:10 ratio). Yet, pursuant to the resolution previously passed, there was \textit{no} real income allocated to the charity, connoting that the corporation retained all the incomes.

\textbf{Step 4:} After the time period specified in the redemption agreement, the S-corporations redeemed the non-voting shares at the fair market value (i.e. US$100,000). Now, the individual-shareholder owned 100\% of the corporation’s shares and all of the undistributed cash from previously earned income.

\textbf{Without the shelter:} CCH Federal Tax Group (2003) wrote that computation of an S corporation’s taxable income parallels the computation of the taxable income of an individual. According to the Tax Rate Schedule X provided by UncleFed’s Tax Board (2005), in 2000, 2001 and 2002, if the taxable income of an individual was over US$300,000, the tax rate would be around 40\%. In short, all 100\% of the U.S.

\textsuperscript{12} A contribution is deductible only if made to, or for the use of, a\textit{qualified charity} (CCH Federal Tax Group, 2003).
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taxpayer’s income (i.e. US$ 9 million) would be subject to the tax rate of 40%.

**Under the shelter:** Due to its tax-exempt status, the charity paid no tax on the corporate income. KPMG alleged that all income allocated to the charity was treated as previously taxed, even after the redemption. KPMG advised that when the previously allocated income was distributed to the taxpayer, he/she could treat that as long-term capital gains rather than ordinary income, taxable at the lower capital gains rate.

First, pursuant to IRS Publication 526, the taxpayer claimed a charitable deduction (i.e. US$100,000) in the year in which the ‘donation’ took place. Second, during these years, the taxpayer only paid on the portion of the income that was allocated to him/her. The fee charged by KPMG was 10% of the expected average taxable income of the corporation for the 2 years following implementation. For the US$9 million incomes earned throughout the 3 years, only 10% of income distributed to the taxpayer was subject to the 40% tax rate. The rest (i.e. 90%) would be, purportedly, subject to capital gains tax rate (i.e. 20%). So tax savings were amounted to US$1 million.\(^{13}\)

**IRS response:** Notice 2004-30 was issued to alert taxpayers that these transactions are tax avoidance transactions and identify these transactions as *listed transactions* for purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2), and 301.6112-1(b)(2).

\(^{13}\) US$8.9M (Taxable income: US$3M x 3yrs - Charitable deduction US$0.1M) x 90% (Income ‘allocated’ to the charity) x 20% (Individual tax rate 40% - Capital gains tax rate 20%) – US$0.6M (Fee: 10% x Taxable income US$3M x 2yrs) = US$1.002M
7. **Consequences**

As mentioned above, KPMG agreed to pay US$456 million to defer prosecution of the firm. The latest news on 28, March 2006 is that a former KPMG tax partner pleaded guilty in the tax-shelter fraud case, admitting that he helped rich people escape millions of dollars in taxes by helping them create fraudulent documents and sham companies (Neumister, 2006).

Corporate fraud has far-reaching consequences to the marketplace. The Shocker conveyed a primary message, ‘tax work is illegal’ to clients. They are now wary of any tax advice. So accountants are conscientiously educating clients via formal marketing programs as well as in-depth private meetings. At the same time, firms are turning away the customers still looking for rule-breaking practitioners (Fernandez, 2005).

IRS (2004) responded the incident by revising Circular 230 which is applicable to tax professionals who practice before the IRS. The revisions provide standards of practice for written advice that reflect current best practices and are intended to restore and maintain public confidence. These ensure that tax professionals do not provide inadequate advice, and increase transparency. According to Circular 230, § 10.33 governs tax-shelter opinions. A practitioner who provides a tax-shelter opinion analyzing the Federal tax effects of a tax-shelter investment shall comply with the requirements stated (Treasury Department, 2005). IRS planned to shift significant resources in fiscal years 2003 and 2004 to address abusive shelters (GAO, 2003). For the chart depicting the shift, see Appendix 11.6.
8. Ethical Issues

8.1 KPMG’s decision to sell the shelters

Companies always emphasize on making money. Individuals are self-interested decision-makers. This money-oriented goal was rooted in economist Adam Smith (1952)’s concept. He explained that humans can only be motivated by self-interest. By applying the Pyramid of Corporate Social Responsibility, all the levels deserve closer considerations (Carroll, 1989). For visual illustration of the Pyramid, see Appendix 11.2.

**Economic:** I agree with Adam Smith that people are motivated by money. However, in the Pyramid, economic just serves as the most basic level. According to Carroll (1989), companies have an economic responsibility to be profitable. By selling questionable tax-shelters products, KPMG could obtain short-term monetary benefits. Overall, KPMG collected at least US$124 million in fees for its shelters (Johnson, 2005). Every temptation is attracting. Nevertheless, the benefits gained in this way did not last for long as the firm had to pay US$456 million for criminal violations. KPMG failed to fulfill the economic responsibility in the long run.

**Legal:** In the realm of Corporate Finance, reward-to-risk ratio is positively related (Ross, Westerfield & Jordan, 2004). The handsome rewards implied that high legal risks were involved. Hamersley (2003), the former employee of KPMG, testified that ‘the promoters know that these transactions could never survive the light of day in court’. Yet,
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Philip Weisner, the chief of the KPMG National Tax Office, thought that enough revenue from the sales would be able to offset the risks of litigation (Johnson, 2005). The lawsuit is still in the process, so the firm has not yet been found guilty officially.

Nevertheless, the Shocker triggered auditor independence issues. Hamersley (2003) pointed out that during the course of audit, tax partners were seeking way to develop a relationship with management so as to enable the sales of tax shelters. This violated the SEC auditor independence rules under Section 208(a) of the Sarbanes-Oxley Act. ‘An accountant is not independent under the standard…when the accountant provides certain non-audit services to an audit client.’ (Guy, Carmichael, and Lach, 2001). When KPMG auditors reviewed client’s financial statements, they examined the client’s tax return and its use of the tax product to reduce its tax liability and increase its income. Problems concerning conflict of interest arose as KPMG, in practice, audited its own work.

On the other hand, another auditor independence issue was spawned while KPMG worked with its audit clients- Deutsche Bank, HVB, and Wachovia Bank (U.S. Senate, 2003). These banks did play their roles in implementing KPMG’s products.

Ethical: The third level, companies should have ethical responsibility (Carroll, 1989). Despite the internal dissent, KPMG decided to go ahead with the sales of the

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14 Section 208(a) of the Sarbanes-Oxley Act of 2002...to revise the Commission's regulations related to the non-audit services that, if provided to an audit client, would impair an accounting firm's independence (SEC, 2003).
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questionable tax-shelter products. Weisner identified the shelter as a high-risk operation. However, during the Permanent Subcommittee (2003) on Investigations’ hearings, Weisner said that ‘KPMG provided our clients with a “more likely than not” opinion as to their tax consequences. In other words, we informed our clients that based on the facts and actions they took, they would have a “more likely than not” — or a greater than 50 percent — chance of prevailing if the IRS challenged the transaction.’ Deliberate concealments of facts from clients were highly unethical.

Philanthropic: The highest level of the Pyramid requires companies to fulfill philanthropic responsibilities which refer to activities that promote human welfare or goodwill (Carroll, 1989). Improving the quality of life and reducing government involvement are main objectives of this level. Tax is the main income of a country. It sustains the well-being of the society and public. KPMG admitted that it engaged in a fraud that generated at least US$11 billion dollars in phony tax losses (IRS, 2005). This definitely harmed the government.

To wrap up the above points, KPMG traded its reputation for short-term benefits. The source of the misconduct is ethics. As a prominent worldwide CPA firm, it should set the code of ethics for other firms. By probing into the Shocker based one the four dimensions of the Pyramid, I will say that KPMG is not qualified to be a responsible corporate citizen.
8.2 Hamersley’s decision to be the whistle-blower

‘My decision to blow the whistle was an easy one. I was placed in a position of having no other choice but to participate in the lawful conduct and bear the associated risk,’ Hamersley (2003) testified. Whistle-blowing is an act that exposes an employer’s wrongdoing to outsiders, such as the media or government regulatory agencies. However, it is never easy to be a whistle-blower. Historically, the fortunes of whistle-blowers have not been as positive. Most were labeled as traitors and many lost their job (Ferrell, Fraedrich, and Ferrell, 2005).

After all, I think Hamersley’s decision was justified because I believe he had a proper motivation. Knowing that such action may require him to sacrifice his career, he still took the deed. An ethical dilemma involves options. Indeed there are other options available. Why did he choose to blow the whistle? His choice can be explained from the following moral aspects.

**Teleology:** First of all, let us think of his decision from a teleological perspective. Theories of teleological philosophies are often referred as consequentialism. Two important teleological philosophies that guide decision making in individual business decisions are egoism and utilitarianism (Ferrell, Fraedrich, and Ferrell, 2005).

**Egoism** defines right or acceptable behavior in terms of its consequences for the *individual*. Egoists believe that they should make decisions that maximize their own
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self-interest (Duska and Duska, 2003). Indeed Hamersley (2003) was nominated for promotion to partner before the shocker came to light. So if he chose to keep quiet, he could probably reach a higher position in the company and earn more money. To egoists, being ethical will be a bad business if it contravenes one’s self-interest. Knowing that they may lose the jobs and fearing that KPMG may attempt to sue them as they disclose information about KPMG’s unlawful acts, it is manifest that egoists will decline to be a blower. Therefore, there is no doubt that Hamersley is not an egoist.

In his book, Brooks (2000) wrote that utilitarians aim at maximizing net benefit to society as a whole. When they are confronted by ethical dilemmas, they will ask ‘does the action maximize social benefits and minimize social injuries?’ If a utilitarian is put into the shoes of Hamersley, he/she will compute the benefits and harms of the consequences for everyone affected (Duska and Duska, 2003). To be the whistle-blower in this situation, the greatest benefit will probably to curb the tax-shelter activities that deprived the government huge amounts of money. Ultimate victims are citizens. Hence, blowing the whistle can prevent further damage to the public. Also, it helps to uphold the ethical standards and professionalism of the industry.

However, the action may also bring harmful consequences. From the personal aspect, whistle-blowing breaks the close tie between parties. KPMG will lose reputation and indemnity. Partners involved will be indicted. If the firm closes down, all employees
Lessons from the KPMG’s tax-shelter Shocker

will lose their jobs.

Duska and Duska (2003) continued to explain that utilitarianism is the ethical theory that uses a cost-benefit approach. After using Ford’s cost-benefit analysis (Dowie, 1977), a utilitarian, like Hamersley, will choose to be a whistle-blower. Action taken in this way is for the sake of the State and the industry.

Deontology: Immanuel Kant is the leading founder of deontology (Hinman, 2006). Duska and Duska (2003) also highlighted the idea that, pursuant to Kant, if one is doing something simply to fulfill a desire, he/she is not acting out of a moral motive. To act morally one does something simply because it is the moral thing to do. In the written testimony, Hamersley (2003), he did not explicitly show his ultimate motive of his action. After quitting KPMG, he joined California Franchise Tax Board, which aims at combating abusive tax-shelters (California Franchise Tax Board, 2005). So this is reasonable to believe that his choice of whistle-blowing inclined to his moral motive. From the angle of Kant’s philosophies, Hamersley is an ethical and moral person.

Whistle-blowers are sometimes viewed as trouble makers. However, I think whistle-blowers are what our society squarely needs. People, like Hamersley, are of very high ethical standards. Their actions deserve our applause and appreciations. Indeed, the fate of a wrongdoer is predictable. Individuals should realize that what they do today will determine their destinies in the future.
9. Conclusions

The KPMG’s tax-shelter Shocker profoundly illuminates the continued importance of accounting professionalism. Competitions among the industry drive the aggressiveness of the firm. It is so ironical that KPMG’s eagerness to be stronger resulted in losing money and reputation. On the other side of the story, we can see that there are always loopholes in the legal system. Sarbanes-Oxley Act was followed by revisions to Circular 230, which aims at plugging the loopholes in tax-shelter regulations.

Nonetheless, simply surveillance from the government cannot make the system tick. Self-disciplines of firms and individuals are the best solutions to curb misconducts. To be a good corporate citizen, a firm should recognize the essence of ethics to success in business.

In addition, Hamersley’s experience is just the tip of an iceberg. It portrays the significance of personal accountability. So we should have faith in our own judgments and not simply follow what the seniors do. The ‘reason’ that ‘everyone else is doing it’ is just an excuse. It can never be sufficient to justify us for engaging in questionable conducts.

At stake is the future of KPMG. Accounting giant Andersen folded after being indicted on obstruction of justice charges for its role the Enron accounting scandal. Now KPMG is trying to avoid the same fate. The Shocker has not yet ceased to an end. And there may be some other hidden shockers. So, lessons are ahead waiting for us.
10. Bibliography


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11. **Appendixes**

11.1 Methodology Flowchart (Nadzel, 2004)

**Stage 1**
Preparation and background research:
- Analyze facts
- Determine area of law
- Understand research terms and initial query
- Research **primary and secondary sources**
- Revise query

**Stage 2**
Research primary authority:
- Scavenge from secondary authority
- Computer searches
- Revise query

**Stage 3**
Prewrite:
- Verify, update and analyze research
- Fill any research gaps
- Verify analysis with further secondary authority

11.2 Pyramid of Corporate Social Responsibility (Carroll, 1991)

- **Philanthropic** Responsibilities
  - Be a good corporate citizen

- **Ethical** Responsibilities
  - Be ethical

- **Legal** Responsibilities
  - Obey the law

- **Economic** Responsibilities
  - Be profitable
Lessons from the KPMG’s tax-shelter Shocker

11.3 Foreign Leveraged Investment Program (FLIP)/ Offshore Portfolio Investment Strategy (OPIS)

11.3.1 Steps of FLIP/ OPIS transactions

Step 1:  (In mid-1998)
Creation of a Shell Cayman Islands corporation

Step 2:  (In mid-1998)
Buying shares from UBS
Lessons from the KPMG’s tax-shelter Shocker

**Step 3:** (2 months later)

Stock redemption from Cayman

U.S. Taxpayer → Shell Cayman Islands entity

Constructive ownership:
Own 85% of Cayman

Shell Cayman Islands entity → UBS

Use the proceeds to repay the loan

2 months later, redeem all the stock

**Step 4:** (By the end of 1998)

Creation of artificial loss

U.S. Taxpayer → Shell Cayman Islands entity

Constructive ownership:
Own 85% of Cayman

Shell Cayman Islands entity → UBS

Lend $100M in mid-1998

Use the $100M to buy UBS shares

2 months later, redeem all the stock

Use the proceeds to repay the loan

Purchase an option to buy the same no. of UBS shares

Artificial loss:
The cost was purportedly added to taxpayer’s basis for the shares
11.3.2 Differences between the KPMG’s claim and IRS response

KPMG’s claim

§ 318: Constructive Ownership

No decrease in UBS/
No change in fractional interest

The redemption is taxed as a dividend without use of basis

The $100M basis shifts over to the U.S. taxpayer

IRS response

Decrease in fractional interest
(see next page)

The redemption is an exchange

§§ 302(b)(1) & 302(a):
Cayman could use the $100M basis

None of the basis was available to shift over to the U.S. taxpayer
11.3.3 Illustration of the decrease in fractional interest (Simplified situation)

Before redemption

Outstanding Shares: 96 shares

Corporation's Shares: 1,000 shares

Shares held by Cayman: 2 shares \((\frac{2}{1000} = 0.2\%)\)

Shares held by U.S. Taxpayer: 2 shares \((0.2\%)\)

After redemption

Outstanding Shares: 96 shares

Corporation's Shares: 1,002 shares

Shares held by U.S. Taxpayer: 2 shares \((\frac{2}{1002} = 0.1996\%)\)

Decrease in fractional interest
From 0.2% to 0.1996%
11.4 Bond Linked Issue Premium Structure (BLIPS)

Steps of BLIPS transactions (U.S. Senate, 2003)

Step 1: Creation of a Shell Corporation, LLC

![Diagram of Step 1]

Step 2: Bank loan to LLC

![Diagram of Step 2]
**Lessons from the KPMG’s tax-shelter Shocker**

**Step 3: Creation of the Fund**

- **U.S. Taxpayer**
  - $1.4 M (7% of the premium - planned loss)
  - Loan: $50 M, premium: $20 M (7-yr loan @ above-market rate i.e. 16%)

- **LLC**

- **Bank**

- **Presidio**
  - $15.5 M < 1%
  - $71.4 M < 90%

- **Fund**
  - $71.6 M

**Step 4: Loan transfer and Interest rate swap**

- **U.S. Taxpayer**
  - $1.4 M (7% of the premium - planned loss)

- **LLC**
  - Loan transfer
  - $71.4 M < 90%

- **Bank**
  - Swap: reducing loan interest rate to a market-based rate i.e. 8%

- **Presidio**
  - $15.5 M < 1%
  - $71.4 M < 90%

- **Fund**
  - $71.6 M
Lessons from the KPMG’s tax-shelter Shocker

**Step 5: Semblance of investment activity**

- **U.S. Taxpayer**
  - $1.4 M (7% of the premium - planned loss)
  - Loan: $50 M
  - Premium: $20 M (7-yr loan @ above-market rate i.e. 16%)

- **LLC**
  - Loan transfer
  - $71.4 M <90%>
  - Swap: reducing loan interest rate to a market-based rate i.e. 8%

- **Bank**
  - Remaining assets <90%>
  - Repay loan + prepayment penalty (loan premium)

- **Fund**
  - $71.6 M
  - Remaining assets
  - USD >>> EURO

**Step 6: Winding**

- **U.S. Taxpayer**
  - $1.4 M

- **LLC**
  - Remaining assets <90%>
  - Withdraw

- **Bank**
  - Repay loan + prepayment penalty (loan premium)

- **Fund**
  - $71.6 M
  - Remaining assets

- **Presidio**
  - P1
  - P2
  - USD <<< EURO

- **P1**
  - $15,566 <1%

- **P2**
  - $140,000 <9%
11.5 S-Corporation Charitable Contribution Strategy (SC2)

Steps of SC2 transactions (U.S. Senate, 2003)

**Step 1:** Issues of shares and warrants

- S-corporation (with 100 voting shares)
  - 7,000 Warrants (held by taxpayer)
  - 900 Non-voting Shares

**Step 2:** ‘Donating’ shares to the chosen Charity

- S-corporation (with 100 voting shares)
  - Redemption Agreement
  - 7,000 Warrants (held by taxpayer)
  - 900 Non-voting Shares
  - Qualified Charity
Lessons from the KPMG’s tax-shelter Shocker

**Step 3:** (During the 3 years)
Allocating incomes

- **S-corporation**
  - Distribution of income 10%
  - Individual Shareholder (the taxpayer) (100 voting shares)
  - Qualified Charity (900 non-voting shares)

**Step 4:** (After 3 years)
S-corporation redeemed the non-voting shares

- **S-corporation**
  - Buy at fair market value (US$100,000)
  - Sell back the non-voting shares
  - Individual Shareholder (the taxpayer) (100 voting shares)
  - Qualified Charity (900 non-voting shares)
Lessons from the KPMG’s tax-shelter Shocker

**After SC2 transactions:** Final position of the individual shareholder

![Diagram showing the flow of distribution of income between an S-corporation and an individual shareholder](image)

11.6 Shift in Examination Resources Allocated to Abusive Tax Shelters (GAO, 2003)

![Bar chart showing the shift in examination resources](image)

*Note: Fiscal year 2002 full-time equivalents include actual time spent on the entire returns containing shelters, not on the shelter issues alone. Fiscal year 2003 and 2004 full-time equivalents are planned amounts that are focused more on the shelter issues themselves.*