Alan Levinsohn, Editor

Shuttering Tax Shelters

KPMG has avoided the fate of Arthur Andersen by admitting to criminal tax fraud over the long-simmering issue of "abusive" tax shelters and settling with the U.S. Department of Justice in August.

The government will defer prosecution and drop the case after December 31, 2006, if KPMG complies with the provisions of the agreement. KPMG must pay $456 million, which isn't tax deductible and can't be paid with insurance proceeds. It must stay out of the tax shelter business and agree to restrictions on its tax practice. Those restrictions include closing both its personal financial planning unit, which designed four shelters in question, and compensation and benefits unit, which sold other shelters that the Internal Revenue Service (IRS) has challenged as abusive tax-avoidance schemes.

KPMG earned about $124 million on those four shelters and had been fending off the government's questioning of its tax shelter business since 1996. The $456 million equals about $300,000 per partner, but, more significantly, the firm avoids an indictment.

Several KPMG executives, however, weren't as fortunate. A federal grand jury charged eight former KPMG partners and an outside lawyer with tax-shelter fraud. Those indicted include three former chiefs of KPMG's tax practice who were involved in developing, selling, or using the four shelters, which they sold to 350 wealthy Americans between 1996 and 2002. Prosecutors said the shelters created $11.2 billion in false tax losses and deprived the government of $2.5 billion of tax revenue.

KPMG must pay $456 million, stay out of the tax shelter business, and agree to restrictions on its tax practice.

Rarely—if ever—has a partner at a major accounting firm been sent to prison for professional misbehavior. But in this case, the Justice Department feared an indictment of KPMG would put the firm out of business, leaving only three international firms to audit large corporations. U.S. Attorney General Alberto Gonzales said the Justice Department weighed "collateral consequences" in deciding not to indict KPMG, referring to the 85,000 people at Andersen who lost their jobs because the firm was Enron's auditor. He said the decision to settle for a "deferred-prosecution" agreement with KPMG "reflects the reality that the conviction of an organization can affect innocent workers and others associated with the organization, and can even have an impact on the national economy." But prosecutors were under pressure to punish shelter promoters, so they targeted the individual ex-partners, and KPMG obliged, giving the government evidence to use against them.

The four shelters were called BLIPS, FLIP, OPIS, and SOS. A client with a BLIPS (Bond-Linked Issue-Premium Structure), for example, would borrow from an offshore bank to buy foreign currency from the same bank, only to sell the currency back to the lender when its value declined. The government contends this was a phony tax loss that the client could then deduct from his or her capital gains and income from other investments. SOS (Short-Option Strategy) was a similar but more complex currency deal. FLIP (Foreign-Leveraged Investment Program) and OPIS (Offshore Portfolio-Investment Strategy) involved investment swaps through the Cayman Islands.

The legality of the individual income tax avoidance techniques has never really been tested. The IRS banned these shelters, contending that the loans and investments were risk-free, bogus transactions designed only to reduce taxes. Under what's known as the economic-substance test, the IRS has claimed that shelters without a "legitimate economic purpose," i.e., done solely to reduce taxes, are improper. But federal courts have sometimes ruled that such transactions are allowable even if they carry no economic risk or opportunity for reward beyond their tax savings. So prosecutors may have difficulty proving that the ex-KPMG executives are guilty.

Most abusive shelters are based on legal tax-planning techniques. That makes it difficult to distinguish legitimate tax planning and illicit shelters. For years the Senate Finance Committee has been pushing to enact the IRS's economic-substance test into law, but the White House and U.S. House of Representatives have blocked that legislation.

Tax shelters that the IRS considers abusive aren't limited to those used by wealthy individuals. The IRS has challenged two of KPMG's corporate tax shelters as tax-avoidance schemes, according to a *Wall Street Journal* review of court records and internal KPMG documents.

The two shelters the IRS said in 2002 were abusive were called 401(k) Accel and CLAS. 401(k) Accel, short for Enhanced Deduction Acceleration Strategy, allowed companies to boost deductions for their contributions to employee 401(k) retirement plans. CLAS (Contested Liability Acceleration Strategy) helped companies create deductions for litigation claims that companies hadn't yet paid.

In a 2000 e-mail, one of KPMG's managing partners of its tax practices wrote to 23 Midwest tax partners and managers about a new version of 401(k) Accel. "We currently have 20 booked deals with total fees of approximately $777,000. This puts us in second place among all the areas for marketing this particular solution." He urged partners and staff to contact 24 large Midwestern companies. "Let's see if we can get several more of these deals booked, completed, and billed and collected prior to June 30th." In the Mid-Atlantic area, KPMG had sold 401(k)Accel to 25 companies, generating $1.2 million in fees for KPMG, an IRS court filing from 2002 showed. KPMG had sold CLAS to 29 companies, which claimed at least $1.7 billion in combined tax savings, the IRS said in the court filing.

In the 1990s, nearly every big and midsize accounting firm was moving aggressively into the tax shelter business for individuals and corporations, and the growth attracted the attention of U.S. senators. A November 2003 report from the Senate Permanent Subcommittee on Investigations concluded that "dubious tax shelters are no longer the province of shady, fly-by-night companies,...they are now big business." But of all sellers of shelters, the investigation singled out KPMG, saying "although KPMG denies being a tax-shelter promoter, the evidence establishes that KPMG devoted substantial resources to, and obtained significant fees from...potentially abusive and illegal tax shelters...costing the U.S. Treasury billions."

At the time, the IRS was investigating more than 100 tax shelter promoters, including accounting firms, law firms, and financial institutions. Both PricewaterhouseCoopers and Ernst & Young reached settlements with the IRS in 2003 related to their tax shelter sales, with E&Y paying $15 million to settle a civil claim. But KPMG reportedly continued to resist scrutiny of its tax shelter business from the IRS, Justice Department, and U.S. Senate until the survival of the firm became at risk.

Now with its admission of "unlawful conduct," KPMG—along with law firms and banks with which it jointly sold tax shelters—will be more vulnerable to lawsuits from tax shelter clients who had to pay the IRS back taxes and penalties. ■

Answers to puzzle on p. 64.

8	1	3	4	2	9	7	6	5
4	6	2	5	7	1	8	3	9
7	9	5	3	6	8	1	4	2
2	4	7	1	5	3	9	8	6
5	3	9	8	4	6	2	1	7
6	8	1	2	9	7	4	5	3
9	7	8	6	1	5	3	2	4
1	2	6	7	3	4	5	9	8
3	5	4	9	8	2	6	7	1