POTENTIALLY ABUSIVE SHELTERING IN THE HIGH PROFILE TAX INDUSTRY:
KPMG, LLP AN ILLUSTRATIVE CASE STUDY

(Prepared by senior accountancy major, Kyle Schiebout, in fulfillment of Northern Illinois University's Honors Program Capstone, in conjunction with independent study advisor, Steve Blanc CPA, J.D.)
NORTHERN ILLINOIS UNIVERSITY

Potentially Abusive Sheltering in the High Profile Tax Industry: *KPMG, LLP an Illustrative Case Study*

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**ABSTRACT:**

The concept of tax sheltering is becoming increasingly attractive to clients, ambiguous to tax practitioners, and detrimental to the United States taxation system, which creates urgency for taxpayers, practitioners, and governmental officials to become educated on the industry’s latest, most complex, and controversial generation of tax products. Thus, the purpose of this research is to provide a summarization of the abusive sheltering environment, its products, and players, during the past ten years. While maintaining a focus on the most crucial level of tax sheltering, taxpayers with $10 million plus in tax liability, this thesis establishes a background of the sheltering industry, outlines potentially abusive components of high profile shelters, discusses the outcome of abusive sheltering from both government and practitioner points of view, and lastly reviews relevant ethical concerns of the issue. The research methodology is qualitative in nature and obtains the most relevant information, which is typically found in governmental reports and congressional testimony, to form a concise industry report. Research has concluded that a handful of CPA’s among the most prominent accounting firms in the world were previously involved with creating, soliciting, and implementing abusive tax shelters.
POTENTIALLY ABUSIVE SHELTERING IN THE HIGH PROFILE TAX INDUSTRY: KPMG, LLP AN ILLUSTRATIVE CASE STUDY

(Prepared by senior accountancy major, Kyle Schiebout, in fulfillment of Northern Illinois University's Honors Program Capstone, in conjunction with independent study advisor, Steve Blanc CPA, J.D.)
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Executive Summary

Traditionally the profession of public accounting has been held in the highest regard to ethical and professional standards. Given the type of work that these professionals accomplish, the intangible trait of integrity is as equally important as the technical skills they possess. Public accountants are charged with the responsibility to assure stakeholders of the well being of their respective companies as well as assisting taxpayers in self-assessment. However, the late 1990’s and early 2000’s experienced a slight breach in the long-standing record of impeccable service provided by the industry.

At around 1996, a majority of the Big-Four accounting firms and many other smaller firms increased involvement in providing tremendously complex tax shelters to high profile clients. While providing sheltering advice is not necessarily illegal, the economic environment at the time acted as a major catalyst to facilitate the progression of the tax sheltering industry. The late 1990’s experienced outstanding economical growth, particularly the technology industry, and as a result many American citizens found themselves with rather enormous tax burdens at the year’s end. What began as a legitimate attempt on the part of tax practitioners to advise their clients on strategies to manage their newfound tax burden, in some instances, rapidly spiraled out of control into a web of carefully engineered investment transactions designed only to limit a client’s tax burden.

The purpose of this research is to re-create the environment between 1996 and 2003 to explore abusive tax sheltering through an example involving the Big-Four accounting firm of KPMG, LLP. Although, it is important to note that while the names of many accounting firms may surface in the abusive tax sheltering debate, almost every case of illegal tax sheltering stems from and only involves a handful of practitioners from their respective firms. The ambiguous nature of tax law led to a heated debate over the legality of certain tax shelters, that even today in the wake of numerous governmental investigations, are not proven illegal. Instead, the overriding factor in determining the abusiveness of a shelter lies in the intent, on the part of the taxpayer, to turn a profit from the complex investment transactions advised by one’s tax accountant. Typically non-abusive tax shelters are based on investments that have legitimate potential to earn a return for the taxpayer. On the other hand, potentially abusive and abusive tax shelters are based on investments that have little chance of earning a return for the taxpayer and instead are forecasted to only create tax benefits.

As such, the intent to abuse a tax shelter is displayed in many forms. Often taxpayers were instructed to withdraw from long-term investment plans in a matter of 45 to 67 days. The

1 Accounting firms classified as Big-Four firms are the four biggest accounting firms worldwide. They each create roughly $16 billion a year in revenue and operate in approximately 140 different countries with over 100,000 employees. The firms of KPMG LLP, PricewaterhouseCoopers LLP, Deloitte & Touche LLP, and Ernst & Young LLP comprise the Big-Four.
2 Steve Blanc, CPA & J.D., interview by author, DeKalb, IL, September 22, 2006
4 Ibid.
rate of early withdrawal clearly establishes a lack of economic intent on behalf of the taxpayer, and when traced to specific tax products, proves that they are abusive in nature.

Next, in order for the sheltering transactions to operate as intended, both the accountants and lawyers involved with the product had to issue opinion letters stating the legitimacy of their tax advice. However, the letters issued for the abusive shelters were ultimately useless due to their homogenous nature. In many cases a template was used to create letters for many different clients who all had differing tax circumstances. Also characteristic of abusive sheltering is the use of sham loans. In many cases these loans were issued by an investment bank that was recruited by the lead accounting firm. Typically one component of the tax shelter involved the taxpayer taking out a loan to fund the various investment transactions. But, in many cases the taxpayer never had access to the funds loaned to him or her rather the loan transactions took place on paper, thus preventing the investment banks from assuming risk. Further, abusive tax shelters often created a lack of independence between the issuing accounting firm’s audit function and the shelter organizer’s choice of investment banks. In the case of the KPMG scandal, the involved tax practitioners recruited investment banks that were SEC audit clients of KPMG. For the sake of external auditing, this effectively made irrelevant any claim of independence between the banks and KPMG. Finally, issuing firms of abusive shelters went through great lengths to conceal and deceive governmental reviewers. As no coincidence, the complexity of high profile tax shelters was over the heads of IRS auditors. In addition, many tax shelter implementers priced engagements based on the risk of detection by the IRS. Other than the technical nature of the shelters, practitioners also used concealment methods in preparation of their clients’ tax forms.

The abusive sheltering services provided by select KPMG tax partners were chosen for this illustration because they presented the most well known and clearly outlined instance of such activity among the Big-Four accounting firms. After IRS and Tax Court scrutiny, KPMG finally settled with the Department of Justice in order to avoid criminal prosecution. The firm was assessed a $456 million dollar fine and was ordered to dissolve key functional groups responsible for the creation, implementation, and marketing of high profile tax shelters. In addition, the Department of Justice ordered that an independent monitor oversee the firm’s progress towards reform. In part because the Department of Justice made an example out of KPMG, the remaining accounting firms that were involved in the same type of activity quickly followed suit in reorganizing their functional groups.

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8 Ibid.
The initial reaction of the IRS to the discovery of abusive tax sheltering was that of "good cop v. bad cop" on the part of Mark Everson, IRS Commissioner. He claimed that the IRS and Department of Justice were prepared to pursue, to the highest degree, those still involved with abusive sheltering, while at the same time offering a grace period for taxpayers to fix their taxes if they had been involved with an abusive shelter. In addition, Everson claimed that the IRS is prepared to review potentially abusive shelters with the taxpayer in order to facilitate compliance.

Nevertheless, Congress created The American Jobs Creation Act of 2004 (P.L. 108-357), which created specific laws against necessary components of abusive tax sheltering and also widened pre-existing laws. Other than creating punitive incentives to deter participation in sheltering, this report discusses various recommendations from expert witnesses to the Congressional hearing. An interesting recommendation involves publicizing a practitioner's failure in compliance with sheltering law. This recommendation makes use of the profession's reliance on reputation as an incentive that is economically efficient; there would be no penalties on behalf of the practitioner and minimal involvement of governing bodies.

The final portion of the paper divulges into ethics. It is important to understand why the participation in such tax sheltering was unethical. The AICPA Code of Professional Conduct specifically bans the use of contingency fees under these circumstances and finds the relationship between tax practitioner and investment banker (Sec audit client) to lack independence. Also, Circular 230, released by the Department of Treasury, is directed towards tax practitioners who practice under the IRS and establishes laws based on ethical conduct. Circular 230 recently underwent a revision to strengthen potential weaknesses related to sheltering. Lastly, Open Compliance & Ethics Group deserves an introduction as one of the premier agencies whose primary goal is to strengthen company awareness and resistance to ethical and fraudulent breaches. The primary tool aiding the achievement of this goal is an ethical framework, which is

15 The American Institute of Certified Public Accountants is the largest professional accountancy organization in the U.S. and plays a major role in overseeing professional conduct.
based in principle of a standard business model.\textsuperscript{18} Although public accounting has been forced to endure the mistakes of a few, the industry will learn from those mistakes and grow stronger as a result.

Introduction

"It was the 90’s. The surge in the market made many awash in cash, there were millions of dollars to be made – and everyone else was doing it."

-- Senator Norm Coleman

KPMG, LLP Tax Scandal

Inevitably there are overlooked mistakes or details in anything technical and complex that can lead to conflict. The tax code is no exception and occasionally contains stipulations that when interpreted by outsiders yields a different result than was originally intended by the lawmakers. These stipulations, termed loopholes, provide a great deal of ambiguity that sometimes creates legitimate situations for tax savings, but can also create situations of potential abuse.

This potential for tax abuse serves as the focus of KPMG’s\textsuperscript{19} tax scandal that took place prior to 2003. A small number of KPMG tax partners allegedly were involved in defrauding the United States through engineering, aggressively marketing, and implementing several different types of abusive tax shelters. Upon detection, certain KPMG practitioners who were involved admitted to jointly administering tax losses of around $11 billion for their clients. When translated into sheltered tax dollars, the Department of Treasury was deprived of approximately $2.5 billion. In August of 2005 KPMG settled with the government and agreed to pay a $456 million penalty to defer criminal prosecution of the firm. To this date, the KPMG tax scandal carries the largest fine for a United States fraudulent tax shelter case.\textsuperscript{20}

\textsuperscript{19} KPMG LLP is a “Big-Four” public accounting firm whose primary practices are Audit and Tax. The Audit practice offers advisory and assurance services to large and midsize businesses, while the Tax practice offers a variety of federal, state, and local tax services to businesses and certain high net worth individuals.

Governing Environment

Two frequent procedures that facilitate discovery of shelters and the eventual tax collection are tax shelter registration in the form of list maintenance requirements and auditing. Each function as a tool for the IRS to determine whether tax abuse is present. Even though the taxpayer is ultimately responsible, the concept of tax shelter registration is less well known among individual taxpayers because it is their preparer who usually registers the shelter. To prevent tax abuse, the IRS requires that implementers of a shelter, whether tax practitioner or taxpayer, disclose the specific shelter with the IRS. Then the IRS scrutinizes each one to determine whether or not it is legitimate. If the shelter is legitimate the taxpayer is allowed the deduction, but if the shelter is found to be abusive the IRS then maintains a list of all abusive sheltering transactions and those who have utilized them.\textsuperscript{21} Sections 6011, 6111, 6112 of U.S. Code provide that it is unlawful to fail in disclosure and registration of transactions used as shelters.\textsuperscript{22}

Each taxpayer is also subject to auditing. Because the IRS' main function is enforcement of tax law and the collection of the proper amount of revenue, it conducts audits to determine whether or not tax returns were filed correctly and to determine whether or not the taxpayer paid in the correct amount. According to the IRS commissioner, only one million individual taxpayers and one in six large corporations are audited every year.\textsuperscript{23}

Individuals who create enormous wealth are classified as "high net-worth" and present a special interest to the IRS. An individual that generates a ten to twenty million dollar tax burden

becomes valuable enough to overcome the cost effective threshold and warrants increased IRS scrutiny. As Perkins points out, audits of individuals with high income have increased 74% since 2002.\textsuperscript{24}

A third and less frequent avenue leading to the discovery of potentially abusive shelters is not a convention imposed by an external governing body, rather it is most likely of internal origin. "Whistleblowing" has occurred in firms throughout various industries ranging from financial services to tobacco to even governmental agencies and is the lawful, honest, and ethical practice of speaking out against misconduct in order to alert proper authorities to stop any prior abuse of the legal system.

Pertinent to abusive tax sheltering, there are two main positions where "whistleblowing" is relevant. It is possible that a potential client who had been approached to buy illegal tax products could speak out. But, it is more likely that a professional working for the firm supplying illegal products and who has the proper background and knowledge of the situation would speak out. This person is knowledgeable enough to determine whether or not ethical/professional boundaries were crossed and whether or not laws were broken. In the KPMG tax shelter scandal, Michael Hamersley, most recently a mergers and acquisitions manager, decided to step up and act as the "whistleblower." He previously served in KPMG's Washington National Tax advisory, which serves as a research division and subsequently answers in-depth and complicated federal tax inquiries from KPMG U.S. tax practices.

Hamersley was eventually expected to market illegal tax shelters, but as a last resort he notified the authorities.\textsuperscript{25}

Over the years tax law has become increasingly complex and in many instances severely difficult for individuals and companies to comply with. As a result, the market offers services of all expertise in correlation with various preparation demands. Thus, there is stratification between tax service providers. Generally the level of aptitude increases from local CPA firms to that of mid-tier firms, to that of the Big-Four firms. Very high net-worth individuals and the most prominent firms in the world create a niche market requiring expertise provided by the profession’s leaders and in many cases only the Big-Four accounting firms have the resources to serve such complex tax clients.

Three main factors provide for general conflict between the IRS and taxpayers. First, the United States bases their tax collection largely on self assessment. Each taxpaying citizen is expected to attain to the highest levels of citizenship and prepare or cause to be prepared their tax return and subsequently pay-in to the government. But, for common taxpayers there is little motivation to create additional expenses on top of their pre-existing tax liability by hiring professionals to positively make sure that their taxes are in order. Many people attempt to save on tax services and complete returns themselves. This can result in honest mistakes that either understate or overstate one’s tax liability.

Secondly, as described earlier, the tax code is at times open to interpretation. The ambiguity present in much of the tax litigation results in different stances taken by the IRS.

26 Accounting firms classified as Mid-Tier generally are larger than small local CPA firms but much smaller than the Big-Four accounting firms. In many cases these firms are organized in the same fashion as Big-Four firms and offer similar services but in most cases do not have a vast network of international offices. Examples include Crowe Chizek LLC, Grant Thornton LLP, BDO Seidman LLP, McGladrey & Pullen LLP, Plante & Moran PLLC, and Clifton Gunderson LLP.
27 Accounting firms classified as Big-Four firms are the four biggest accounting firms worldwide. They each create roughly $16 billion a year in revenue and operate in approximately 140 different countries with over 100,000 employees. The firms of KPMG LLP, PricewaterhouseCoopers LLP, Deloitte & Touche LLP, and Ernst & Young LLP comprise the Big-Four.
versus tax professionals. Due to conflicting interests, the IRS presumably is more inclined to hold a consistent equitable stance on an issue that serves the public first, while a well compensated tax practitioner working for a high net-worth client may be more inclined to hold an aggressive stance.

Finally, the third major factor contributing to conflict between the IRS and taxpayers is fraud. The most famous term used to describe this scenario is evasion. Historically, tax evasion has been linked to organized crime and the works. However, tax evasion can be present without the motivation to conceal vicious crimes or drug running; in fact it can arise if the taxpayer or practitioner simply intends to reduce a taxpayer’s liability.

In this situation, high net-worth taxpayers have motivation to seek out the best tax advice and attempt to legally decrease liability. But, in some instances these taxpayers are so concerned about preserving their wealth that they seek out or accept aggressively marketed illegal tax advice resulting in the elimination or near elimination of tax burdens in the tens of millions of dollars.

**Internal Environment**

The 1990s were profitable times for the American economy and as so, clients posted increasing tax burdens year after year. This led many experienced tax professionals to find legal ways to decrease their client’s tax burden, either through efficient tax planning or legally registered and implemented tax shelters.\(^{28}\) This expanding market also lead a much smaller group of highly intelligent and experienced tax professionals to team up with lawyers, bankers, and investment advisors to create tax savings for their clients. A small number of KPMG practitioners became extensively involved in this practice, where individuals from PwC, E&Y, and select mid-tier firms also admitted to involvement.

\(^{28}\) Steve Blanc, CPA & J.D., interview by author, DeKalb, IL, September 22, 2006.
Three major factors that contributed to the frivolous decisions of these professionals are opportunity, motivation, and rationalization. Many accounting firms experienced a lack of internal control in the form of a flawed tax development and approval process that provided opportunity for the fraud to occur. Control procedures were flawed in that partners who acted as authorities on the sheltering activity surprisingly either perpetuated the fraud or issued a passive vote of no confidence. Those who advised against illegal sheltering simply gave their advice and continued with their own work voicing no concern against the fraud that was occurring around them. Tax partners openly discussed the potential of new tax shelters and whether or not specific components would work. In many cases the approval of a product depended on the potential earnings it could provide, while ignoring legal and ethical considerations. Tax partners moved forward with these tax products on the basis that the opinion letters issued to clients maintained as little liability as possible for the issuing firm and also on the basis that practitioners involved would charge a premium for these services in order to offset the risk of getting caught.29

Next, many involved professionals took part in rather uncommon billing practices. Typically, compensation for the tax profession was not commission based, intending to prevent this type of abuse. However, certain professionals involved in the promotion of abusive tax shelters received a set percentage of the decrease in tax liability issued to clients.30

Other lingering effects of a lack of internal control include the intimidating environment created around the illegal tax shelter practice. Subordinates who were in favor of the abusive tax sheltering practice were rewarded while those who held differing views were shunned.

30 Ibid.
Moreover, participatory firms also violated auditor independence rules. This type of leadership encouraged the aggressive marketing of tax products to companies that had a pre-existing relationship with the accounting firms, specifically audit clients. Lastly, tax professionals often worked exclusively with a handful of banks, law firms, and investment advisors to achieve mass production of these shelters.

Stronger management and internal control could have mitigated these types of misdeeds. One obvious suggestion is that any type of practice or service that creates a trend should stick out and be investigated. The paper trail should then shed light on extensive compensation to certain tax partners as well as whether or not SEC guidelines were being crossed. The paper trail should have also shed light on the questionable repeated transactions between the tax professionals and their partner firms. Overall, management should set the tone of the firm and if a hostile environment is acceptable, firms will continue to have severe legal concerns.

Motivation is a second factor that contributed to the tax shelter scandal. Those involved with illegal shelters were driven to engineer such products, market them, and conceal their implementation. Internal competition was a major source of motivation, although the lure of monetary compensation is not to be understated.

At the time the abusive shelters were being provided, two core functional areas besides tax, audit services and consulting services, were becoming better revenue generators. Consulting in particular, experienced a large fluctuation in correlation with the growing market. In turn, the performance of the audit and consulting services exerted pressure on the tax function to pull their

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own weight for the firm. The Minority Staff of the U.S. Senate Committee on Homeland
Security and Governmental Affairs reports that a line from an e-mail sent throughout the tax
function at KPMG during this period stated, "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." This
was the type of competitive culture was passed down from partners and imposed on manager
level employees.

Eventually the situation arose where tax services needed a large revenue generator to
save face, and likewise, the tax shelter market presented an opportunity to engineer big revenue
through its exploitation. Just as the growing economy favored audit and consulting services, it
also increased the amount of individuals who established enormous tax liabilities through stock
option activity, thus expanding the market for fraudulent tax shelters. Many partners in the
industry dealt with individuals who had potential tax liabilities in excess of $10 million.
Therefore, this increase in market demand provided tax professionals with a potential solution to
the internal earnings tension.

The final component that allowed for the promotion of illegal tax shelters was
rationalization. Many tax professionals rationalized their products as simply selling a loophole
that was well within the legal limits. Since they contrived a view that their product was entirely
legal, they assumed the IRS did not need to review it. In actuality, those involved had a
disregard for the law, and some practitioners associated with Big-Four firms assumed that the
IRS would never extensively review their work based on their reputation as one of the few
premier accounting firms in the world. Even if their clients’ returns did come under audit

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33 U.S. Senate Committee on Homeland Security and Governmental Affairs, Permanent Subcommittee on
Investigations; U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals, prepared
by the Minority Staff of the Permanent Subcommittee on Investigations, November 18, 2003,
scrutiny, the professionals believed there was little chance that the IRS would detect any type of fraud since the transactions were tremendously complex and hidden by many layers of deception.\textsuperscript{34}

Hence, ex KPMG partners remain under fire due to Michael Hamersley’s whistleblowing. The following quote from Hamersley’s testimony to the United States Senate Finance Committee describing comments made by tax shelter promoters at KPMG serves as a summary to the rationalistic views that select tax partners at KPMG and various other firms held, “(i) the IRS will never discover the tax shelter because it does not have the resources or ability to do so, (ii) even if the IRS does discover the tax shelter, the law will likely only be changed and enforced prospectively thus the penalties will be minimal, and (iii) all public accounting firms are selling these tax shelters and the government cannot shut down all of these firms.”\textsuperscript{35} These three statements read like the following: the IRS is not smart enough to catch us, even if they do catch us we won’t be in trouble, and everyone else is doing it, so why can’t we?

Character is defined by one’s actions when no one is looking. Because of its self-assessment and lucrative nature, there may not be a service industry where character is more important than that of public accounting. As witnessed with Arthur Andersen\textsuperscript{36}, a firm’s integrity is its greatest asset.

\textsuperscript{36} Arthur Andersen, formerly the largest accounting firm in the world, was the fifth firm in addition to the current Big-Four that comprised the Big-Five accounting firms. Due to the Enron collapse and other corporate scandals, Arthur Andersen was rapidly forced out of business.
Abusive Sheltering Matrix

- Partial list of the most profitable shelters utilized in the past, broken down by major accounting firm:

  **KPMG**
  - **BLIPS** – Bond Linked Issue Premium Structure
  - **SC2** – S-Corporation Charitable Contribution Strategy
  - **OPIS** – Offshore Portfolio Investment Strategy
  - **SOS** – Short Option Strategy

  **E&Y**
  - **CDS** – Contingent Deferred Swap
  - **COBRA** – Currency Options Brings Reward Alternatives
  - **PICANTE**
  - **SOAP**

  **PwC**
  - **FLIP** – Foreign Leveraged Investment Program
  - **CDS** – Contingent Deferred Swap
  - **BOSS** – Bond and Options Sales Strategy
    - **Son of BOSS**

  **Others**
  - **CARDS** – Customized Adjustable Rate Debt Facility
  - **LILO** – Lease In/Lease Out
  - **POINT** – Personally Optimized Investment Transaction
  - **PICO** – Personal Income Company
  - **COINS**
  - **TRACT**
  - **SLAPSHOT**

- Firms linked to the KPMG, LLP shelter scandal:
  - **KPMG, LLP** – Lead accounting firm (Big-Four)
  - **Presidio** – Investment advisory firm (founded by two ex KPMG tax partners)
  - **Quellos Group, LLC** – Investment advisory firm
  - **Sidley Austin Brown & Wood, LLP** – Law firm
  - **Bayerische Hypo-und Vereinsbank A.G. (HVB)** – Investment Bank (Audited by KPMG)
  - **Deutsche Bank** – Investment Bank (Audited by KPMG)
  - **Wachovia Bank** – Investment Bank (Audited by KPMG)
  - **UBS A.G.** – Investment Bank
  - **NatWest** – Investment Bank
Illustration of Abusive Sheltering

"These sham transactions clearly lacked economic substance. Some may have believed there was a loophole that supported these transactions. But, the lure of millions of dollars in fees clearly played a role in the decision on the part of tax professionals to drive a Brinks truck through any purported loophole."

-- Senator Norm Coleman

Legal/Illegal Tax Shelter Distinction

When discussing abusive tax shelters, it is important to make a clear distinction between tax planning and tax evasion. First, in the United States, tax planning and tax avoidance are terms that are used rather interchangeably. Tax avoidance is merely the legal steps taken on the taxpayer’s behalf to steer away from transactions or situations that are taxed.

Tax avoidance occurs when potential tax liability was never created and results from legal planning advice. Regardless of ethics, it is smart business advice that takes advantage or will take advantage of current or future tax law. A simple example involves timing issues. A local CPA firm may recommend that their clients wait until they experience a specific loss before selling investments that would yield an overall gain. Therefore, the gain on selling investments will cancel due to the co-existing loss, and the client will have reduced tax liability in comparison to the otherwise scenario.

Moreover, as a client’s tax situation becomes increasingly complex, so does tax planning advice. Other examples of tax avoidance involve using tax deductions, changing one’s tax status through incorporation or establishing an offshore company, trust, charitable remainder trust or foundation in a tax haven.37 Still, if implemented correctly, each of these techniques are legal and plainly maintain the taxpayer’s reduced tax liability position.

But, as tax complexity rises, the boundary between legal and illegal tax planning begins to blur, and thus increases the potential for unintentional or intentional misstatement. It is fitting that abusive tax shelters would need to be much more complex than the already complex tax law in order to create tax savings without detection.

Tax evasion, specifically abusive sheltering, is a criminal activity intended to eliminate or reduce a taxpayer’s liability through illegal means. Whereas legal tax planning usually occurs before business transactions, illegal planning typically occurs after a taxpayer has completed transactions and owes a certain liability on those transactions. This type of planning intends to manipulate the tax system until the client’s liability is significantly reduced or eliminated.

*Wikipedia* defines evasion as the following, “tax evasion is the general term for efforts by individuals, firms, trusts, and other entities to evade taxes by illegal means. Tax evasion usually entails taxpayers deliberately misrepresenting or concealing the true state of their affairs to the tax authorities to reduce their tax liability, and includes, in particular, dishonest tax reporting (such as declaring less income, profits or gains than actually earned; or overstating deductions).” To build upon this definition, the Government Accountability Office offers a more specific description of a particular type of tax evasion. The GAO defines abusive tax shelters as, “very complicated transactions promoted to corporations and wealthy individuals to exploit tax loopholes and provide large, unintended tax benefits.”

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Charges Against KPMG Conspirators

In connection with the KPMG scandal, nineteen professionals were indicted under Internal Revenue Code (26 U.S.C. 7201), Tax Evasion. In order for those defendants to be found guilty, the prosecution has to prove beyond a reasonable doubt the following:

1. the “mens rea” or “mental” element of willfulness – the specific intent to violate an actually known legal duty;
2. the “attendant circumstance” of the existence of a tax deficiency – an unpaid tax liability; and
3. the “actus reus” (i.e., guilty conduct) – an affirmative act (and not merely an omission or failure to act) in any manner constituting evasion or an attempt to evade either the (A) assessment of a tax or (B) the payment of a tax.

Also, the same nineteen professionals were indicted under Internal Revenue Code (18 U.S.C. 371), Conspiracy, and three of those nineteen professionals were indicted under Internal Revenue Code (26 U.S.C. 7212a), Obstruction of the Due Administration of Internal Revenue Laws.

While tax shelters can be implemented as legal tax avoidance techniques, these three types of allegations disclose that tax shelters can also be implemented maliciously through a drawn out process. First, the process involves a product or plan to plainly not pay taxes (attempt to evade or defeat tax). Secondly, the process involves a collusion scheme in order to launch the product (conspiracy to commit offense or to defraud the United States). Finally, the process may involve a scheme to cover up the crime (corrupt or forcible interference). The next subsection provides a description of common alleged illegal components found in and around KPMG’s abusive tax shelters that support one of these three main abusive functions.

42 “19 Individuals Charged in Superseding Indictment Filed in Criminal Tax Case Related to KPMG Tax Shelters,” Department of Justice press release.
Abusive Components of KPMG Scandal

Every news article or press release surrounding this issue has proposed, in one form or another, that a certain group of tax professionals acted in a fraudulent way or filed or caused to be filed fraudulent returns or acted with the intent to defraud the United States. All of these descriptions are vague and only allude to the fact that a select group of tax professionals possibly broke the law. These types of statements fail to answer the question of how exactly the tax professionals may have broken the law. The following will isolate major components of the allegations and show why they were necessary:

Intent – Many tax shelters are built upon unusual investment criteria. These trends prove that those involved with abusive tax shelters purely had the intent to decrease tax liability. Proof of intent lies in the fact that clients who were taking advantage of BLIPS, OPIS, or SC2, etc., which purportedly were long-term investments of around seven years, routinely withdrew from the transaction after 45 to 67 days.\footnote{United States of America v. Stein, Lanning, Smith, Eischeid, Wiesner, Larson, Pfaff, Makov, Delap, Gremminger, Ruble, Ritchie, Bickham, Watson, Warley, Rivkin, Hasting, Rosenthal, Greenberg, S1 05 Cr. 888 (LAK).} Clearly, if a financial professional thinks there is a genuine possibility that his client will make money off of a long-term investment, he will not advise the client to withdraw after a fraction of the planned investment period.

It would be more reasonable for a financial advisor to create a complex web of legitimate investment transactions and suggest that 1 client out of 100 withdraw from the investment, possibly due to personal financial needs. But, in the KPMG scandal, every client withdrew on time, like clockwork. Hundreds of clients defected on these transactions in a rather short period of time, 1996 – 2002, which established a trend of intent. In turn, this trend of ulterior motivation lead many to ponder whether or not the transactions were legitimate in the first place.
Lack of Economic Substance – The investment products marketed by some professionals at KPMG and Presidio lacked economic substance or purpose, meaning they were highly unlikely to turn a profit and instead would only create tax savings. These transactions were designed to yield tax benefits that were far greater than any profit potential. Therefore, there was no legitimate business reason for hundreds of clients to purchase them. Regardless of the inability to make money, financial advisors supplied the cover-up rationale that such investments were an attempt to diversity client portfolios.

The California Franchise Tax Board issued the following before the U.S. Senate Permanent Subcommittee on Investigations:

Transactions used in FLIP and OPIS involve the use of offshore accounts, warrants, options and stock redemption to accomplish a shifting of basis and creation of artificial losses. The transactions require the cooperation of offshore accommodators such as Union Bank of Switzerland. The transactions make use of Internal Revenue Code section 318 attribution rules and Treasury Regulations section 1.302-2(c) basis adjustments to increase the basis of stock and subsequent loss on the sale of that stock. In response to similar findings, the IRS issued a notice alerting taxpayers that tax benefits resulting from this type of activity are specifically disallowed for tax purposes. It is the duty of any qualified professional issuing these products to know whether or not this particular set of investments is legitimate under the Internal Revenue Code. It is likely most shelter promoters possessed this knowledge, but nevertheless issued these types of investment plans.

Irrelevant Boilerplate Opinion Letters – First, opinion letters serve the function of insulating taxpayers from potential penalties if they are audited. When the IRS uncovers questionable practices upon audit and asserts penalties, the taxpayer is able to claim that he or she relied upon the advice or opinion of his or her CPA or that of a lawyer. Valid and reliable

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opinion letters contend that questionable practices have been researched by the practitioner and are "more likely than not" to withstand scrutiny by the courts.

Boilerplate opinions in the arena of abusive tax sheltering, however, often included many false statements of security. The lawyers and accountants who issued opinion letters under these circumstances may have had knowledge that the transactions would not pass scrutiny for tax purposes if the true facts came to light. In most cases opinion letters were identical except for names, dates, and amounts. Most surprising of all, the letters merely quoted what the code says, instead of making an interpretation of law based on each client's specific and factual tax situation.46

The following are common false boilerplate assertions in the context of the KPMG tax shelter scandal:

1) "That the client requested KPMG's opinion regarding the U.S. federal income tax consequences of certain investment portfolio transactions."47 Quite the opposite is true. There is extensive evidence through email and personal correspondence that proves certain KPMG partners' active marketing of illegal tax shelters. They sought out very particular clients that met specific criteria, most important of which was a tax liability of at least $10 million. Partnership culture at the time was in stiff earnings competition, and subsequently, managers were instructed to "Sell, Sell, Sell" and to look the other way when signing off on unethical an illegal returns.48 This aggressive marketing lead to the intimidating environment described by Hamersley and often left many non-supporters of the shelters with few options.

2) “That the investment strategy was based on the expectation that a leveraged position in the Foreign Bank securities would provide the investor with the opportunity for capital appreciation”\(^49\) Clients could not have had legitimate expectations to profit from these transactions when the marketing tactics that the involved practitioners employed included asking the client exactly how much they wanted to pay in taxes and informing them that their entire tax burden could be eliminated. From the very beginning the relationship between professional and client had always been solely for the intent of tax savings instead of profitable investments. Involved professionals were more interested in bragging about how much tax savings they could create instead of describing profitable investments.

3) “That clients reviewed the economics underlying the investment strategy and believed it had a reasonable opportunity to earn a reasonable profit from each of the transactions”\(^50\) If the client had an opportunity to review the opinion letter, they may have realized that regardless of the inherent purpose of opinion letters, which was to provide professional and legal assurance on questionable issues, involved tax professionals were attempting to reduce their own liability instead. In effect, they were attempting to revert any responsibility incurred through the opinion letters back to the client by saying the client contacted their respective firm for sheltering services and the client believed the investments had economic substance. Clients most likely would have disagreed with the opinion in that they would have recognized that there was little chance to earn a profit. Instead, they trusted professional advice from some of the leading tax practitioners in the world at KPMG, E\&Y, and PwC!


\(^{50}\) Ibid.
4) “That one of the participants in the transaction was a foreign person unrelated to the other participants”\textsuperscript{51} However, Presidio acted as the investment advisor to many transactions. In the early days of these shelters John Larson and Robert Pfaff were tax partners who acted as two key influences in the developmental process of tax shelters at KPMG. Later they left KPMG and started Presidio in response to the need for a conspiring investment firm. As a result, both Larson and Pfaff handled many shelter transactions in conjuncture with KPMG.

5) “That money was paid by the FLIP and OPIS clients for an investment component of the transactions (a warrant or a swap)”\textsuperscript{52} Clients asserted that they paid-in capital to an investment. But, in most cases the paid-in capital represented consideration to KPMG, Presidio, Sidley Austin Brown & Wood, and Deutsche Bank, etc. This carries further proof that any supposed investment lacked economic substance. Clients merely paid a percentage of their desired tax reduction as a fee to those who engineered the loss. Sham loan transactions followed a similar procedure as well and are referenced later.

6) “That there was no evidence of a ‘firm and fixed’ plan to complete the steps making up the shelter in a particular manner”\textsuperscript{53} On the contrary, clients were instructed to complete a specific series of steps in order. BLIPS is a perfect example. First, create an S-corporation. Second, obtain a loan from a KPMG recommended bank. Third, partner with Presidio. Fourth, transfer the “loan” to the partnership and use the “loaned” funds to “invest” in foreign currencies. Fifth, defect from the partnership and investment sixty days later. And sixth, record the transferred loan as a loss. It is clear that this particular process completed in this exact order was pertinent to creating a loss. It is unbelievable on the part of some KPMG partners to assert that

\textsuperscript{51} United States of America \textit{v.} Stein, Lanning, Smith, Eischeid, Wiesner, Larson, Pfaff, Makov, Delap, Gremminger, Ruble, Ritchie, Bickham, Watson, Warley, Rivkin, Hastings, Rosenthal, Greenberg, S1 05 Cr. 888 (LAK).
\textsuperscript{52} Ibid.
\textsuperscript{53} Ibid.
they never advised clients of such a plan since it is not feasible that a client would ever find themselves taking these six steps in sequence for profitable investment purposes.

7) "That the clients were 'more likely than not' to survive an IRS challenge to the transactions based on the 'step transaction doctrine' – a legal doctrine permitting the IRS to disregard certain transactions having no economic substance or business purpose and the purported tax effects of those disregarded transactions."54 The mentioning of this doctrine in the opinion letter, although maybe common practice, is borderline admittance that the string of investments lack economic substance. It appears that the KPMG opinion writers wanted to cover all possible bases. In addition, the tax partners promoting the shelters knew that this assertion was false and thus, required every professional that promoted sheltering products to not leave behind any physical materials describing the product since it would ruin all chances of the client escaping the doctrine's negative impact.55

Sham Loans – In some cases, bank loans were an integral part of the shelters that some partners implemented. Adding to the list of proof that the investments entered into by clients were of no economic substance, the loans pertained to certain steps in the investment and were in all material aspects fabricated. The Superseding Indictment states, "... none of the banks assigned any capital cost to these purported BLIPS loans. Indeed, at least two of the banks did not fund the loans at all."56 Mark Watson, an ex KPMG tax partner who was extensively involved in abusive tax shelters, admitted that the loan transactions were, "nothing more than window dressing."57 The result was fake loan transactions supporting concurrent, irrelevant

55 Ibid.
56 Ibid.
investment transactions that together would ultimately create tax savings. In most cases the banks never shifted funds to a position compromised by access to the client and never even attempted to collect interest on the loan. Large investment banks, who often were internationally headquartered and thus, somewhat removed, would simply sign their blessing and accept a portion of the client's total consideration paid for the tax product.

**Lack of Independence** – Not only did the lack of independence stretch between KPMG and their recommended investment advising firm, it stretched between KPMG and their recommended investment banks as well. Many components of the sheltering process were highly questionable and KPMG partners needed supporters in those lines of business that would cooperate. It is already established that the investment advising was completed in large part by ex KPMG tax partners at Presidio. Incidentally, the banking function was covered predominantly by KPMG's SEC audit clients, which introduces auditor independence infringement.⁵⁸

KPMG compromised the accuracy of future audits of these banking institutions by recruiting them to record non-existent loan transactions. At the time, it was unforeseeable whether or not those transactions would pay material respect in future audits. Regardless, there was an undeniable transformation of the relationship between the investment banks and KPMG as a result of co-conspiring in potential fraud.

The case may have been that involved tax professionals were genuinely attempting to expand upon the audit business relationship, but there is little evidence to support that. The KPMG tax group evaluated and approached each conspirator in the same fashion that they approached potential clients. Surely a strong sales pitch was necessary to recruit one of the

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nation’s most prominent law firms as well as some of the world’s most prominent banking institutions.

Concealment/Intent to Deceive – Once all the pieces to the puzzle are in place, tax shelter products were approved and ready to implement, co-conspirators were on board, and clients agreed to buy the product, the final housekeeping issue was to conceal the fraud in a manner that first, would not attract attention to the client’s return and secondly, would circumvent the IRS if the client’s return fell under audit.

Creators of the tax shelters took special care in the design of the products hoping that the IRS would not recognize, understand, or trace the potential fraud. This is specifically why shelter promoters insisted on charging a lofty premium for their services. They needed to receive large enough compensation to outweigh the risk of detection. Had the designers of the shelters not taken such precautions, then IRS detection was imminent and none of the partners would have sought involvement.  

Other than the extremely intricate and complex nature of the shelter products, KPMG pursued additional sources of concealment such as:

1) Omitting Tax Shelter Registration – The law states that in every situation that a tax shelter is used, the preparer has to register the shelter with the IRS and describe the nature of the transaction(s). Then, the IRS issues a number, specific to the shelter, that each taxpayer who utilizes the shelter is required to report on their tax return. This procedure is what “list maintenance requirements” refers to and is a major resource that the IRS uses to track and prevent sheltering abuse. The process makes shelters known to the IRS so that they can investigate a shelter’s use and determine whether any legal boundaries were crossed. This

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60 Ibid.
registration requirement is part of self-assessment and tax preparers have the duty to inform the IRS if they wish to use a specific product. Overall, list maintenance increases the transparency of the tax shelter industry.

However, the professionals involved with KPMG’s tax scandal decided not to notify the IRS in order to disclose their shelters. Therefore, the clients who benefited from abusive shelters did not have a list number to report on their returns. The primary reason that KPMG decided not to register their shelters was that it would draw attention and increase the chances of detection. Had the shelters been legitimate, tax partners would not have had objections to registering a quality product and instead could have used list maintenance to their advantage in assuring clients that their product was high caliber.

The professionals involved in this scandal rationalized the omission of registering the shelters as a “business decision.” They concluded that if they do register the shelters the IRS will disallow the use of those shelters and in turn, competitors such as PwC and Ernst & Young will gain market share. This strategy follows the, “if everyone else is doing it, I can do it too” mentality and better serves the purpose of rationalizing an illegal act through the prediction that since many are involved with the same type of crime, punishment can not be very harsh; the authorities can’t catch all of us syndrome.

Indeed, many accounting firms and law firms were taking part in this sheltering practice but not all of them could be so harshly disciplined due to the precarious nature of public accounting and the auditing/tax demand that they satisfy. The audit industry in particular has undergone such tremendous change due to the collapse of Arthur Andersen and the introduction of Sarbanes-Oxley that the government most likely decided only to make an example out of
KPMG. The decision on behalf of the other players in the abusive sheltering industry to abandon the practice after the first signs of distress, and in some cases return fees, was something that KPMG advisors to the non-registration business strategy did not foresee. Because KPMG partners continued with the practice, the firm became the primary target.

2) Grantor Trust Netting – Tax law requires that a taxpayer’s return clearly report income, gain, and loss items. Since the abusive shelters created losses that would attract attention, shelter implementers, who also prepared their clients’ returns, needed to hide these false losses in order to decrease the chances of fraud detection. So, the KPMG partners simply did not report individual loss items and instead reported a figure net of gains and losses.

Although other concealment methods involved the tricky purchase and sale of poor performing stocks, a majority of the time KPMG partners used a method known as grantor trust netting to hide specific loss items on the returns of many FLIP, OPIS, and BLIPS clients. According to the Superseding Indictment, grantor trust netting is, “a trust that, because of certain features enumerated in the tax code, is disregarded as an entity for federal income tax purposes. RITCHIE and his co-conspirators devised a scheme to insert a grantor trust into a tax shelter transaction, and then, rather than disregarding the grantor trust as required by the tax code, reporting the large phony tax shelter loss and the taxable gain or income those losses were used to offset only on the grantor trust information return, while reporting only the small net of those numbers on the client’s individual income tax return.”

In the relevant scenario, grantor trust netting was a practice based on the intent to unnecessarily added complexity. Abusive tax sheltering depends on this type of strategy to reduce transparency.

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61 Sarbanes-Oxley (Pub. L. No. 107-204, 116 Stat. 745) is a federal law passed in 2002 in response to rampant corporate scandal. It established the PCAOB as well as increased reporting standards and whistleblower provisions. The act created compliance problems for public companies that in turn were passed to major accounting firms.

3) Sham Attorney-Client Privilege – Once investigators became suspicious that fraudulent activity had been occurring, their first instinct was to learn more about the situation and what activity had been taking place. An excellent strategy to accomplish this is to review correspondence between the abusive shelter providers, co-conspirators, and clients. After all, the shelter providers had to explain how the shelters worked and had to direct each party through the sheltering process.

KPMG conspirators acknowledged that the authorities would eventually request information from the benefited clients as to what had been going on. In an attempt to combat this type of inquiry, involved partners hid behind an attorney-client privilege when no true privilege existed. Attorney-client privilege states that, “confidential communications between an attorney and a client in the course of the professional relationship can not be disclosed without the consent of the client . . .”\textsuperscript{63} This law extends to tax practitioners who are practicing directly under an attorney and means that privilege exists between an attorney, the attorney’s accountant, and client.

However, the tax shelter plans created by KPMG talent, and others, were not inclusive to a direct attorney-client relationship. Law firms involved had no correspondence with the clients and no legal professional relationship. In reality there was no need for any law firm to request KPMG’s services on any sheltering matter. In fact, KPMG recruited the law firms, not vice versa, which additionally destroyed any extension of the attorney-client privilege. Instead, the KPMG partners twisted the truth as an incentive for clients to abstain from discussing the shelters.

Further, it is unclear whether or not any partners asserted that their clients exercised tax practitioner-client privilege, which given the true circumstances would be more applicable. According to the IRS, tax practitioner-client privilege allows non-attorney tax practitioners to benefit from the same basic principle of the attorney-client privilege except under some circumstances relating to tax shelters as according to the following:

(a) Uniform application to taxpayer communications with federally authorized practitioners
   (1) General rule
   With respect to tax advice, the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney shall also apply to a communication between a taxpayer and any federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney.
   (2) Limitations Paragraph (1) may only be asserted in—
   (A) any non-criminal tax matter before the Internal Revenue Service; and
   (B) any non-criminal tax proceeding in Federal court brought by or against the United States.

(b) Section not to apply to communications regarding tax shelters The privilege under subsection (a) shall not apply to any written communication which is—
   (1) between a federally authorized tax practitioner and—
      (A) any person,
      (B) any director, officer, employee, agent, or representative of the person, or
      (C) any other person holding a capital or profits interest in the person, and
   (2) in connection with the promotion of the direct or indirect participation of the person in any tax shelter (as defined in section 6662 (d)(2)(C)(ii)). (Title 26, Sec 7525)^64

Incidentally, there would be no accountant-client privilege present due to KPMG’s promotion and the client’s participation with tax shelters.

4) Obstruction of Investigations – A final and most desperate attempt against complete detection was the continued denial of any participation with the above referenced shelters. In response to a summonses requiring that a knowledgeable person from KPMG testify regarding KPMG’s involvement in tax shelter abuse, Jeffrey Eischeid took the stand. According to the Superseding Indictment, Eischeid’s testimony was, “false, misleading, and evasive.”^65 Also, “among other things, EISCHEID falsely denied that KPMG’s fees were based on anticipated tax

benefits and misrepresented KPMG’s role in devising, marketing, and implementing tax shelters."

In addition to the alleged false testimony, KPMG professionals handling the summonses for documents in conjunction with the various tax shelters withheld the requested information claiming that what they had already submitted was substantially complete relating to the summonses. Subsequent testimony provided by other KPMG professionals also denied involvement in abusive tax sheltering after the withholding of documents requested by the IRS.

Evasive testimony continued when KPMG professionals further refuted the acceptance of fees based off of a percentage of the fabricated tax losses sold to clients. They denied the firm’s involvement in engineering, aggressively marketing, and implementing the shelters. They denied that certain shelters were based off of the investor’s (client’s) defect from investment transactions after a set time period. Overall, the efforts of some KPMG professionals to obstruct investigations were denials of many components that the creators of these abusive shelters strived to conceal through the “veneer of legitimacy.”

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67 Ibid.
KPMG, LLP: Abusive Tax Sheltering Case Study

Appendix A offers a text description of how both BLIPS and SC2 works, while Appendix B is an accompanying slide show that provides a visual description of the relationship between the conspiring parties and transactions.

Appendix A: Walk-thru and description of BLIPS and SC2


Appendix B: Accompanying Slides

- Bond Linked Issue Premium Structure (BLIPS)
- S-Corporation Charitable Contribution Strategy (SC2)

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Almost a year ago, the Permanent Subcommittee on Investigations opened an in-depth investigation into the development, marketing and implementation of abusive and illegal tax shelters by professional firms like accounting firms, banks, investment advisors, and law firms. I was then the Subcommittee Chairman and initiated this effort following our Enron investigation which, among other misconduct, disclosed that company’s use of elaborate tax dodges. We have continued this investigation with the support of the Subcommittee Chairman Norm Coleman, for which we thank him.

Unlike legitimate tax shelters, abusive tax shelters have no real economic substance, are designed to provide tax benefits not intended by the tax code, and are almost always convoluted and complex. Crimes like terrorism, murder, fraud and embezzlement produce instant recognition of the immorality involved. But abusive tax shelters are MEGOs–that means “My Eyes Glaze Over.” Those who cook up these concoctions count on their complexity to escape scrutiny and public ire.

The tax shelter industry of today is fundamentally different than it was a few years ago. Instead of individuals and corporations going to their accountant or lawyer and asking for tax advice, the engine driving the tax shelter industry today is the effort of a horde of tax advisors cooking up one complex scheme after another–so-called “tax products” that are unsolicited by any client– and then using elaborate marketing schemes to peddle these products across the country.

In order to gain a deeper understanding of the issues involved in the marketing of these tax products, the Subcommittee conducted in-depth case studies examining four tax products designed, marketed and sold by a leading accounting firm, KPMG, to individuals or corporations to help them reduce or eliminate their U.S. taxes. These four products are known to KPMG and its clients as BLIPS, FLIP, OPIS, and SC2. We are releasing a 125-page Minority Staff Report today detailing what we found in these four case histories.

The testimony today will disclose a tawdry tale: a highly compromised internal review and approval process at KPMG, highly aggressive marketing efforts to sell tax schemes aimed at producing paper tax losses, and schemes which attempt to disguise tax reduction scams as business activity in the case of BLIPS or a charitable donation in the case of SC2.

An excerpt from a long email by a top KPMG tax professional on whether KPMG should approve BLIPS for sale to clients illustrates the skewed priorities. He said the decision on BLIPS came down to this:
"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."

Being paid "a lot of money" for a dubious tax scheme – that's what it all comes down to.

The testimony today will pull back the curtain on the pressure cooker environment within KPMG to mass market its tax products to multiple clients. Again, one detail illustrates the extent of the problem: the full-fledged telemarketing center that KPMG has maintained in Fort Wayne, Indiana and staffed with people trained to make cold calls to find buyers for specific tax products. The telemarketing scripts, the thousands of cold calls made to sell the tax product known as SC2, the re-visits to potential buyers who said no the first time, all show KPMG pushing its so-called tax products.

The testimony today will also show the lengths to which KPMG went to hide its tax products and its sales efforts from the IRS. Despite its 2003 inventory of 500 active tax products, KPMG has never registered, and thereby disclosed to the IRS the existence of, a single one of its tax products. It has claimed in court and to the Subcommittee staff that it is not a tax shelter promoter. Today's testimony will disclose, however, that some tax professionals within the firm advised the firm, to no avail, to register some of its products as tax shelters. You will also hear about improper tax return reporting by KPMG, file cleanups, and other efforts to hide their activities from the IRS and public scrutiny.

Finally, you will hear today and in the hearing on Thursday that, in ventures as large and profitable as the marketing of these tax shelters, there were many professionals ready to join forces with KPMG to carry out the complex financial structures required to camouflage the tax schemes behind a facade of economic substance. These professionals included:

- Banks which financed the loans for sham transactions designed to create a veneer of economic substance;
- Investment advisory firms which cooked up phony financial transactions to create the appearance of a business purpose; and
- Law firms which wrote boiler plate legal opinions to justify dubious tax schemes and shield taxpayers from penalties.

With such a formidable array of talent and expertise, potential clients were persuaded to buy and use the deceptive shelters KPMG was peddling and the U.S. Treasury was effectively defrauded of taxes owed as a result.

**BLIPS and SC2 Case Studies**

We are going to focus on two shelters, BLIPS and SC2. Let's first look at BLIPS, which stands for "Bond Linked Issue Premium Structure."

Inside KPMG, BLIPS was called a "loss generator," because the intent of the tax product was to generate a paper loss that the buyer could then use to offset other income and shelter it from taxation. For this example, we'll suppose the BLIPS buyer – let's call him the "taxpayer" – has a taxable gain or taxable income of $20 million that the BLIPS transaction is intended to shelter by creating a $20 million paper loss.
First Slide
The first step is the BLIPS taxpayer sets up a shell corporation, called a Limited Liability Company or LLC. The taxpayer gives this shell company out-of-pocket cash equal to 7% of the $20 million paper loss he wants to create. In this case, that means the taxpayer provides $1.4 million. This money will be used for fees for the firms that are part of this scheme and for an investment program set up as the fig leaf of economic substance to hide what is really a tax scam.

Second Slide
The next thing that happens is a bank makes a so-called "7-year loan" of $50 million to the shell company (LLC). The BLIPS taxpayer agrees to pay an above market interest rate on the "loan," say 16%. Because he is willing to pay such a high interest rate, the bank also credits him with a so-called $20 million "loan premium" that, not coincidentally, is equal to the tax loss that the taxpayer is buying from KPMG. (If the taxpayer later pays off the "loan" early, as planned, the bank will charge a prepayment penalty that, not coincidentally, will approximate the "loan premium" and make sure it is repaid.) The bank credits the taxpayer's account, which stays at the bank, with the $50 million "loan" and the $20 million "premium" for a total of $70 million.

There are more wrinkles. For instance, in order to get the $70 million, the taxpayer and his shell company have to agree to severe restrictions on how the "loan proceeds" can be used and to maintain "collateral" in cash or liquid securities in an account at the same bank equal to least 101% of the "loan" and "premium" amount, meaning about $70.8 million.

Think about that for a moment, because this collateral requirement is one key to understanding why this "loan" is a sham. A cash collateral requirement of 101% means, in effect, that none of the "loan proceeds" can really be put at risk. That money – more than the amount of the "loan" itself – has to be kept safe in an account at the bank which on paper "loaned" it.

Third Slide
Enter Presidio. They are the investment advisory firm that works hand in glove with KPMG and handles a lot of the leg work of the transaction. Presidio directs two companies it controls, Presidio Growth and Presidio Resources, to participate in the transaction.

Fourth Slide
Next, Presidio and the taxpayer's shell company form a partnership called a Strategic Investment Fund (SIF). The taxpayer's shell company (LLC) contributes all of its assets to the partnership—the $1.4 million in cash from the taxpayer and the $70 million credit from the so-called "loan" and "loan premium." The Presidio companies contribute about $140,000. Based on these contributions, the taxpayer has a 90% interest and Presidio collectively has a 10% interest in the Fund.

Fifth Slide
Here's the switcheroo. The shell company decides, with the consent of the bank, to assign or transfer the so-called bank "loan" to the Fund (SIF).

Sixth Slide
Next comes the fig leaf. The Fund takes the money it has and supposedly engages in foreign currency investments. The Fund takes the so-called “loan proceeds” – the $70 million – and simply converts it into Euros and puts it in what one bank calls a “Synthetic Dollar Account.” The Fund also signs a contract to guarantee it can convert the Euros back to the same number of dollars at no risk in 30 or 60 days. The Fund also puts at risk a very small amount of money – never more than what the taxpayer has contributed – by shorting foreign currencies pegged to the U.S. dollar. Not much of an investment program. While the BLIPS “loan” is supposed to last 7 years, every taxpayer that has bought it – 186 out of 186 – pulled out early – as planned. They quit because the point of BLIPS is not to invest money, but to generate a paper loss for tax purposes before the end of the tax-year.

Seventh (Last) Slide
Now we're at the unwind. At day 60, the taxpayer pulls out of the partnership. The partnership – the Fund – repays the “loan” to the bank plus a “prepayment penalty” to cover the “premium,” so that the whole $70 million is returned to the bank. The Fund then distributes any remaining assets to its partners, which usually is little or nothing.

The taxpayer’s $1.4 million is usually mostly gone in fees, but that’s a price he was more than willing to pay for a $20 million tax loss. Because of the way the loan was structured, KPMG told the taxpayer he can claim that his “cost basis” to participate in the partnership is equal to the $20 million “loan premium” and the $1.4 million in cash that he contributed to the partnership. That means he supposedly can claim a $21.4 million loss on his tax return.

If this doesn’t make sense to you, it’s because the whole transaction is an elaborate concoction to create the impression of economic substance. The taxpayer didn’t use the $70 million “loan proceeds” at all – due to the collateral requirement, he parked that $70 million in a Synthetic Dollar Account at the bank and used his own money to make a few, safe currency transactions. He could have made those without any “loan” at all. The point of the “loan” was simply to generate a tax loss to shelter the taxpayer’s other income.

KPMG approved BLIPS for sale in October 1999, and sold it to 186 people until, in September 2000, the IRS listed it as a potentially abusive tax shelter. In one year, KPMG obtained at least $53 million in fees, making it one of KPMG’s top revenue producing tax products.

Now let’s look at the second shelter, SC2, which stands for S-Corporation Charitable Contribution Strategy. An S-corporation is organized under Subchapter S of the tax code, and its income is attributed to its shareholders and taxed as ordinary individual income instead of corporate income. Instead of generating a phony paper loss, this tax product generated a phony charitable donation.

First Slide:
The first step is that KPMG approaches an existing S-Corporation, usually owned by one person, with a purported “charitable donation strategy.”

The corporation takes several steps to prepare for the SC2 transaction.
First, let's assume that the S-Corporation had 100 shares of common stock. On KPMG's advice, the S-Corporation issues and distributes to its sole shareholder an additional 900 non-voting shares plus 7,000 warrants to buy 7,000 more shares of the company stock in the future. The corporation also issues a "non-distribution" resolution stating that the company will not distribute any of its income to its shareholders for a specified period of time, usually 2 or 3 years.

Next, KPMG introduces the individual-shareholder to a qualified tax-exempt charity, and the individual donates the 900 non-voting shares to this charity. The charity signs a redemption agreement with the corporation which allows the charity to require the corporation to buy back the donated stock after a specified period of time -- usually the same amount of time specified in the corporation's non-distribution resolution.

At the time the charity signs the redemption agreement, it understands that the S-Corporation has issued warrants to the individual-shareholder, which, if exercised, would dilute the value of the charity's stock in the company. The charity also knows that the S-Corporation is planning to distribute little or no income while the charity is a stockholder.

The individual-shareholder also provides the charity with a pledge stating that if, on the date of redemption, the value of the non-voting stock has fallen below what it was when donated, the individual will personally make up the difference with a cash contribution to the charity. The pledge essentially provides the charity with a floor, but not a ceiling, on the amount it will receive on the redemption date.

The redemption agreement and non-distribution resolution are the keys to understanding why SC2 is a sham. Everyone participating in this situation knows from the outset that the stock donation is not intended to be permanent. It is intended to be temporary. The clear understanding of all of the parties is that the charity will be selling the donated stock back to the donor in a few years.

But the appearance for the moment is that the S-corporation now has two shareholders. The charity owns 900 non-voting shares, and the individual owns 100 voting shares and 7,000 warrants.

**Second Slide:**

For the next 2 or 3 years while the charity is a shareholder in the S-Corporation, due to the non-distribution resolution, the corporation "allocates" but does not actually distribute 90% of its net income to the charity and 10% to the individual-shareholder. The difference between allocations and distributions is critical. Under federal tax law, an S-Corporation shareholder, unless tax-exempt, pays income tax on the net income "allocated" to it on the company books, not on the cash actually distributed. According to KPMG, that means that the 90% of company income allocated to the charity is tax-exempt, while the individual has to pay taxes on only the 10% allocated to him. That's true even though the charity often never sees a nickel of the money supposedly "allocated" to it and agrees to forgo that income.

**Third Slide:**

Now we are two or three years down the road after significant net income has been
accumulating inside the company, when the charity's redemption right kicks in. The charity sells back the 900 non-voting shares to the S-Corporation for cash. While this cash payment pales in comparison to the amount of sheltered corporate income, because of the way the shares are valued, it is nonetheless a significant amount for the charity.

Fourth Slide:
Now for the payout for the individual-shareholder. The charity has sold back its shares and is no longer a shareholder in the S-Corporation. All of the income that has built up in the corporation for the last 2 or 3 years is distributed to the individual-shareholder. KPMG advises him that, on the 90% of the income "allocated" to the charity, which is now his, he can claim the income is capital gains, taxable at the lower capital gains rate, rather than the higher ordinary income rate.

KPMG approved SC2 for sale in March 2000, and, over the next 2 years, sold it to about 58 corporations. This tax product became one of KPMG's top tax products in 2000 and 2001, generating more than $28 million in fees for the firm. KPMG discontinued the sales in late 2001. In early 2002, the IRS asked KPMG to produce documents related to SC2 and is now reviewing the product.

End of Slides.

We may hear this morning that KPMG has seen the light and that it and the other large accounting firms no longer develop and sell these types of aggressive shelters. Let's hope that is the case. However, the report we are releasing today depicts a powerful engine going at full speed, developing and selling 500 "active tax products" as of February 2003, the response date for the Subcommittee subpoena. Having claimed all year to my staff that these tax products are legitimate, KPMG's prepared testimony today is that the firm has not only turned off, but dismantled that 500-cylinder engine. List me as skeptical.

I'm afraid we cannot trust this industry to police itself. We need to take strong and forceful action to stop the pilfering of our Treasury and the damage to the credibility of our tax system. We need stronger penalties on tax shelter promoters, an end to auditor conflicts of interest, a better economic substance test, and more enforcement dollars for the IRS to go after tax shelter promoters and their abusive schemes. These and other actions are outlined in the Report my staff has released today. These reforms are, of course, only part of the answer. The firms involved in designing, hawking and implementing these dubious tax products need to restore professional pride.

KPMG now says it has stopped selling aggressive tax products. PriceWaterhouseCoopers has withdrawn from a number of transactions and refunded some client fees. Ernst & Young says it will no longer market certain transactions to its public company audit clients and will require those clients to obtain audit committee approval before Ernst & Young will sell tax shelter services to their executives. That's a start. The engine of deception and greed needs to be turned off, dismantled, and consigned to the junkyard where it belongs.

That's what happened after the Enron collapse – exposure helped put an end to some deceptive financial scams. If that is the result of this investigation, it will move the production and promotion of abusive tax shelters out of big business, although it may well be picked up by the fly-by-night hucksters from whom such behavior is less surprising.
BLIPS
Bond Linked Issue Premium Structure

Prepared by U.S. Senate Permanent Subcommittee on Investigations,
Subcommittee Staff of Senator Carl Levin,
November 2003
Taxpayer Transfers Funds to Shell Corp. (LLC)

$1.4 million
(7% of planned loss – “premium”)
Bank "Loan" To LLC
(Collateralized by US Dollars or Euros)

Face Value: $50 million
Premium: $20 million
7 yr "Loan"
@ Above Market Rate 16%

$1.4 million

$71.4 million
Presidio
Co-Designer and Implementor of Shelter

Face Value: $50 million
Premium: $20 million

7 yr "Loan"
@ Above Market
Rate 16%

Bank

$1.4 million

$71.4 million
Creation of Strategic Investment Fund

Face Value: $50 million
Premium: $20 million

7 yr "Loan" @ Above Market Rate 16%

Bank

$1.4 million
$71.4 million
90%

SIF
$71.5 million

P.G.
$15,586
1%
$140,000
9%

P.R.
"Loan" Assumption and Interest Rate Wash "Swap"

Face Value: $50 million
Premium: $20 million
7 yr "Loan" @ Above Market Rate 16%

Bank

Wash Swap

LLC Now Repays as 7 year "Loan" of $70 million at Market Rate

$1.4 million

$71.4 million

90%

Assignment of Loan Obligation

SIF

$71.5 million

P.G.

$15,588

1%

$140,000

9%

P.R.
Investment "Scheme"

- Face Value: $50 million
- Premium: $20 million

7 yr "Loan" @ Above Market Rate 16%

- LLC
  - $71.4 million
  - Assignment of Loan Obligation 90%

- Bank
  - LLC Now Repays as 7 year "Loan" of $70 million at Market Rate

- SIF
  - $71.5 million
  - Emerging Mkt. Currencies (Foreign Currencies)

- P
  - $140,000
  - $15,536

- P.G.
  - 1%

- P.R.
  - 3%

Stage I - 60 Days (Apparently Terminates)
Stage II - 120 Days
Stage III - 6.5 Years
Taxpayer Claimed Loss: $20 million basis (equal to premium) plus capital contribution ($1.4 million) plus or minus any loss or gain from sale of assets
Step 1

S-Corp. Creates and Transfers to the Shareholder an Additional 900 Voting Shares and 7,000 Warrants
Shareholder "Donates" Non-Voting Stock to a Charitable Entity
**Step 1**
S-Corp. Creates and Transfers to the Shareholder an Additional 900 Voting Shares and 7,000 Warrants
Shareholder "Donates" Non-Voting Stock to a Charitable Entity

- S-Corp
- Shareholder 100 Shares Common Stock
- 7,000 Warrants
- 900 Non-Voting Shares
- Charitable Entity

Redemption right not exercisable until two or three years after contribution.
Shareholder guarantees redemption price at no less than FMV on date of donation.

**Step 2**
2-3 Year Period When Charity is Shareholder in S-Corporation

- S-Corp
- Shareholder 100 Shares Common Stock
- Charitable Entity

10% Allocation of Net income*
90% Allocation of Net income*

*Net income is allocated on a pro rata basis for tax purposes, but the distribution is suspended or limited as a result of amendments to S-Corp. Articles and By-laws.
**Step 1**
S-Corp. Creates and Transfers to the Shareholder an Additional 900 Voting Shares and 7,000 Warrants
Shareholder "Donates" Non-Voting Stock to a Charitable Entity

- S-Corp
  - Shareholder
    - 100 Shares Common Stock
  - 7,000 Warrants
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Redemption right not exercisable until two or three years after contribution
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  - Shareholder
    - 100 Shares Common Stock
  - Charitable Entity

*Net income is allocated on a pro rata basis for tax purposes, but the distribution is suspended or limited as a result of amendments to S-Corp. Articles and By-laws.

**Step 3**
Redemption

- S-Corp
  - Exercise Redemption 900 Non-voting Shares
  - Shareholder
    - 100 Shares Common Stock
  - Charitable Entity

The Greater of FMV at Contribution or FMV at Redemption
**Step 1**
S-Corp. Creates and Transfers to the Shareholder an Additional 900 Voting Shares and 7,000 Warrants
Shareholder "Donates" Non-Voting Stock to a Charitable Entity

- **S-Corp**
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      - Redemption right not exercisable until two or three years after contribution

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    - 90%
      - Charitable Entity
  - *Net income is allocated on a pro rata basis for tax purposes, but the distribution is suspended or limited as a result of amendments to S-Corp. Articles and By-laws.

**Step 3**
Redemption

- **S-Corp**
  - Shareholder 100 Shares Common Stock
    - Exercise Redemption 900 Non-voting Shares
  - Charitable Entity

**Step 4**
Distributions Reinstated

- **S-Corp**
  - Shareholder 100 Shares Common Stock
  - Distribution of income built up in corp. for 2-3 years (income taxed at preferential capital gains rate rather than ordinary income)

The Greater of FMV at Contribution or FMV at Redemption
Resolution of Recent Abusive Sheltering

"I'm afraid we cannot trust this industry to police itself. We need to take strong and forceful action to stop the pilfering of our Treasury and the damage to the credibility of our tax system. The engine of deception and greed needs to be turned off, dismantled, and consigned to the junkyard where it belongs."

-- Senator Carl Levin

KPMG Settlement

In late August of 2005, after much red tape, KPMG admitted involvement with a host of accusations against the firm in an effort to defer and ultimately escape criminal prosecution. In light of KPMG's testimony that since 2002 the firm has made sweeping changes in the way they do business, the Department of Justice nevertheless issued a battery of unique stipulations for KPMG to comply with.

First, KPMG was assessed a $456 million fine serving as a penalty for the following: failure to register utilized shelters in accordance with tax shelter list maintenance requirements, charging and accepting extravagant fees from clients, obstructing investigations causing the statute of limitations to run, and a large portion of the fine was based on lost taxes as a result of KPMG's orchestration of the abusive shelters. The $456 million fine is the largest U.S. imposed tax fine in history and proved to be the most widely publicized stipulation of the case. However, if during the years of sheltering abuse, promoters caused substantially more damage to the tax system than $456 million, one has to wonder what else the government could enact in order to supplement restitution.

It was not feasible to issue a fine larger than $456 million because the firm has no rational means to pay a larger amount in such a short period of time. The fine was issued in August of 2005 and KPMG has until December 31st, 2006 to comply. Instead, the Department of

Justice ordered the termination of functions relating to KPMG's wealthy individual tax advising, which then reduced the earnings potential of KPMG's tax practice. The termination order targeted the disbandment of the practices that were most directly involved with the fraud. This included Stratecon and Innovative Solutions, two groups who's main function was to engineer abusive shelters, as well as National Deployment Champions and Area Deployment Champions, two groups who's main function was to provide extensive resources in the active marketing and sale of abusive shelters. Further, KPMG is not allowed to sell pre-packaged tax products or accept commission based fees. The agreement also forces KPMG to implement an ethics compliance program.71

Finally, after the reorganization of the tax practice KPMG has to allow one final condition, the direct oversight of progress. According to the Department of Justice, the condition includes, "the installment of an independent, government-appointed monitor who will oversee KPMG's compliance with the deferred prosecution agreement for a three-year period..."

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."72 In effect, this serves as the equivalent of a parole officer. If KPMG tax does not maintain compliance with the agreement then the firm risks a prolonged monitoring period or possibly prosecution for conspiracy.

Reaction of Big-Four Accounting Firms

Ever since the IRS uncovered the widespread use of abusive tax shelters, the Big-Four accounting firms of KPMG, PwC, and E&Y, at some point, have made similar claims of

72 Ibid.
reformation from borderline illegal practices to that of the highest quality and professionalism. All three acknowledged that the regulatory environment was changing and that the market for such shelters was also changing. Although some firms appeared more remorseful than others by claiming that they issued a refund of certain fees, they all expressed that the abusive products sold in the past are no longer offered and that the business functions responsible for developing and marketing those tax products were dissolved.

Moreover, each firm claimed that they have reexamined their procedural policy, thus resulting in the implementation of a new approvals process for the introduction of new customer specific tax products. Also, some of the firms claimed that they replaced or introduced additional quality control functions. For example:

**E&Y**
- Established a new high-level and full-time position – Americas Director for Tax Quality – to help ensure that the firm maintains the highest possible standards of practice, policy, and procedures;
- Established Tax Technical Review Committees for each of our key functional areas in tax to provide detailed technical reviews of significant issues and help assure consistency in interpretation of the tax law;
- Established a new Tax Review Board, with members that include senior executives from outside the tax practice, to provide a firm-level view with respect to tax practices, services and relationships; and
- Established a new tax practice “hotline” to allow employees to provide anonymous input about any tax-related matter.73

**PwC**
- Developed a comprehensive quality review program to prevent our participation in abusive tax shelters and to ensure that we provide the highest quality advice to our clients.
- Significant resources have been committed to a quality and risk management group that is independent of any business unit and reports directly to the leader of the Tax practice. This group is centralized with representatives embedded throughout our organizational levels (national, regional, and business unit). The function includes six full-time partners, supporting staff and an additional eight partners spending significant amounts of time in this activity.74

KPMG

- Over the past three years, KPMG has developed an increasingly more rigorous and formal review and oversight procedure within our tax practice. All tax strategies must undergo three levels of review and approval.
  - The new position of Partner in Charge of Tax Risk and Regulatory Affairs is responsible for analyzing each tax strategy proposed by the firm to determine if it could put KPMG and our clients at risk.
  - The Partner in Charge of our Washington National Tax practice must sign off on the technical merits of all significant tax strategies.
  - The Department of Professional Practice – Tax reviews all strategies to ensure that they are in compliance with the firm’s policies and procedures.
- We have also revised our procedures with respect to list maintenance and registration obligations under the Internal Revenue Code.
- In 2002, KPMG implemented a firm wide Compliance and Ethics Hotline.
- We have put in place more stringent rules about offering tax services to executives at our SEC-audit clients.75

There appears to be a correlation between a firm’s level of conflict over the abusive shelters and its level of change. KPMG, who finally agreed to a $456 million dollar penalty, enacted more quality control initiatives than PwC who quietly settled with the IRS and quickly returned engorged fees. Surely, these new quality control procedures have substance in their organization, but are they anything more than window dressing to the IRS, clients, and general public?

Prior to conflict with the IRS, each of these firms already had quality control functions serving as rigorous review processes and approval processes. Now, they simply have more of the same type of review functions, none of which have addressed the fundamental aspect that firm culture is often passed down from top to bottom. These new divisions only make it necessary to involve a few additional tax minds to approve an abusive tax product. The above improvements negate the fact that each firm is still open to the potential of high level collaboration over the next amazing opportunity that evolving market conditions will produce.

Previous conspiring approval groups based their decision on whether or not a product will pass scrutiny. It remains to be proven that since a few additional approval processes were

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created, firm wide culture will eliminate the possibility of risky practices on behalf of a few. This raises the speculation of whether or not these new initiatives hold a hidden agenda.

Undoubtedly firms want to offer the highest quality services to clients while maintaining the greatest degree of professionalism. But, were these quality improvements also intended to decrease the chance of getting caught when they promote such ambiguous and complex types of strategies in the future? If so, it makes sense to bulk up areas of guidance that were responsible for forecasting whether or not problems would arise as a result of direct involvement in potentially abusive tax shelters. Increased resources should lead to more in-depth and better reports on what products should be issued with such a high degree of intensity.

Firms should introduce a more diverse type of oversight control, such as an ethics division, instead of additional quality control groups that serve the same function as the previous control groups that they replaced or are complimenting. The new groups may be just as susceptible to the same type of top-down abuse by a few as the previous control divisions were. Fraud may be just as likely to run its course whether there are 15-20 tax partners collaborating and approving shelters as it is if there are 30-35 partners working the same managerial, oversight function. A profitable new opportunity to serve an expanding market is likely to appear just as tempting to the additional approval officers as it did to the pre-existing approval officers.

Likewise, some of the Big-Four accounting firms have asserted that as an extra layer of control, in-charge or executive partners from outside the tax practice will assume the responsibility of reviewing tax products or strategies. Though this type of control is beneficial in that persons unrelated to the tax function may be better able to form an overall opinion of the legitimacy of a particular tax strategy and determine if the strategy meets regulatory requirements, it still does not establish true independence. The additional executive partners are
still proponents of the firm's success, only they work in audit or consulting. The above descriptions of this type of "independent" quality control failed to include why a scenario will not occur where the market will again present an incredible opportunity to the tax function, and due to a lack of expertise in tax, the audit and consulting executive partners responsible for outside guidance take the word of their tax expert colleagues and join the bandwagon of support for an unknowingly abusive product. After all, the success of a firm's tax function is sure to benefit the firm as a whole. The outside executive partners have little incentive to act otherwise.

Increasing diversity between control functions will help increase independence by attacking the problem from a different angle. Instead of implementing new or additional tax product approval groups, firms should first fix existing approval groups and secondly create an ethics support or advisory service. The main concern of this group should be to determine whether the tax function is operating with legitimate intent. Thus, the ethics advisory group would be able to access all documents to determine the following: if compensation is commission based, if tax clients are properly independent from audit clients, if tax professionals are in collusion with a myriad of other financial and legal professionals in order to serve an individual client, if tax professionals are issuing boilerplate opinions, and overall if tax professionals are acting in everyone's best interest by issuing tax advice with clear purpose other than to benefit clients and themselves at the expense of the United States Treasury.

This type of control should also differ on the basis of incentive. Where previous approval controls were open to intra-firm competition of earnings figures, the ethics advisory group should operate on a slightly different incentive with monetary compensation based solely on the goal of exposing and reporting firm-wide those who are not adhering to a publicly established ethics framework. The long list of corporate scandals has created opportunity for professional
services groups to begin marketing ethics framework advice. One such organization whose purpose is to create ethics framework awareness is the non-profit Open Compliance & Ethics Group.\textsuperscript{76}

**Reaction of Governing Agencies**

One of the first initiatives resulting from the discovery of flagrant tax abuse was a 120-day grace period for taxpayers. In 2002, taxpayers who bought abusive tax shelters were able to come forward and pay back taxes, interest, and certain penalties in order to forgo more onerous civil penalties. The IRS made it clear to the public that those who have purchased and used abusive tax shelters and have not come forward will be sought after and thoroughly prosecuted. Mark Everson, IRS Commissioner, had the following to say, "Those who elected to settle did the right thing. We have already begun to contact the taxpayers who didn't take us up on the offer and expect to begin enforcement action soon."\textsuperscript{77} In order to show magnitude and make use of fear tactics, Everson continued, "We will vigorously pursue all those who participated in Son of Boss deals but did not take advantage of the settlement initiative."\textsuperscript{78} "If you're thinking about cheating on your taxes, think twice. The IRS is ramping up its enforcement efforts, particularly for high-income individuals and corporations. Where we need to, we turn to the Justice Department to take people to court."\textsuperscript{79}

Although, Son-of-Boss deals were primarily sold by PwC, information gained from taxpayers who did come forward proved to be the underlying motivation for such encouragement from the IRS. Though it was important to collect from honest and willing taxpayers, the IRS


\textsuperscript{78} Ibid.

was exceptionally interested in the disclosure of information about the practitioners who sold these products.

This type of investigation and pursuit parallels that of the controlled substance industry. The IRS interrogated taxpayers to learn which firms and partners were involved based on the same principle that the DEA interrogates street-level drug dealers in order to obtain information on the drug boss. With willing taxpayers coming forward, the IRS would have information to increase control over the sheltering industry, and with a turnout of roughly 1,500 taxpayers this proved to be a good start for the IRS.

Next, a list of legislation proposals accumulated in response to the tax abuse. Carl Levin, Michigan Senator, proposed the Auditor Independence and Tax Shelters Act. In a report to the Senate, Levin proposed the following, “the Auditor Independence and Tax Shelters Act would bar an accounting firm from auditing the books of any publicly traded company to which it has sold a tax shelter.”

Senator Levin specifically targeted the unethical practice of accounting firms recruiting audit clients to sell shelters to. He acknowledged the severe lack of independence that such a relationship creates. Auditors would, in effect, audit the work of tax partners from their own firm. Once this type of relationship is established, the auditor’s opinion becomes less credible.

Moreover, this act was also aimed at decreasing an accounting firm’s market for appropriate tax shelter clients. As described above, certain KPMG practitioners and others had set criteria that were necessary for potential clients of the abusive tax shelters. It is much easier for a financial services firm to determine whether or not a client meets the criteria if they have been auditing the client for the past four or five years.

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As a compliment to this type of proposed legislation, the IRS plans to be pro-active in notifying the public of new rules, guidelines, and listed shelters. As a type of “good cop - bad cop” strategy, versus the aforementioned fear tactics, the IRS also intends to create a friendly and permissive atmosphere to encourage taxpayers and promoters to come forward with sheltering inquiries. “Published guidance of abusive transactions” as termed by Everson, is based on the following theory, “Our willingness to indicate transactions that the Service believes are permitted under the tax law should encourage promoters and taxpayers to come to us with transactions that they believe are technically sound.”81 The IRS intends to make the public more aware of the risks involved with abusive tax sheltering activity in hopes of curbing the market of taxpayers eligible for the high income abusive shelters.

These statements proposed by Everson bring up the topic of how his good cop - bad cop attitudes will affect self-assessment. Clearly Everson’s goal is to increase social responsibility and create higher standards for taxpayers who are valid clients to tax shelters as well as tax practitioners who possess the skill to promote tax shelters. But, there isn’t much reason to believe that a few motivational comments will do the trick. Sure, for the next few years those who were borderline involved or wholly involved in abusive tax practices will be deterred by Everson’s bad-cop, vigorous prosecution comments. And, those who can present significant proof for a “more likely than not” opinion on the legality of their shelters will come forward for Everson’s good-cop blessing on their efforts to shelter taxes within the legal limits. Yet, the future problem may arise when five to ten years down the road tax practitioners once again become increasingly bold with their intentions and loose with their interpretations.

Therefore, IRS has two particular strategies to create sustainability in the deterrence of abusive tax sheltering. Unfortunately, due to the nature of intricate abusive sheltering and an inability to forecast the next miracle shelter, both strategies are after-the-fact solutions and can only benefit the tax system after a shelter has surfaced. First, the IRS can petition for forward looking legislation that pinpoints exact flaws in current law and attempts to curtail additional fraudulent activity in the future. Secondly, the IRS can petition for backward looking legislation that retroactively fixes flaws and thus holds newly established abusive shelter participants liable for past actions based on the premise that current law was intended to bar such activity and was inadequate in doing so.

Among expected benefits of $137 billion for corporations and businesses, a recent bill signed into law on October 22, 2004 provides for a crackdown on abusive tax shelters by imposing tougher penalties and expanding or creating new laws in the major problem areas of shelter fraud. The American Jobs Creation Act of 2004 (P.L. 108-357) is an example of forward looking legislation that created stiffer penalties for the following acts:

- taxpayers' failure to disclose reportable (including listed) transactions;
- taxpayers' understatement of tax where the understatement is attributable to a reportable tax avoidance transaction;
- taxpayers' failure to report transactions or accounts maintained with a foreign financial entity;
- material advisors' failure to comply with new information return requirements or existing regulations requiring that investor lists be maintained and provided to IRS; and
- tax shelter promoters' making or furnishing false statements in connection with the organization or sale of abusive tax shelters.  

The act also introduces the following:

- extends the statute of limitations for taxpayers who fail to disclose listed transactions;
- expands IRS ability to take civil injunction action against persons promoting tax shelters or aiding and abetting the understatement of tax liability;
- enables the Treasury Department to use censure and monetary fines as additional sanctions against practitioners who fail to comply with Circular 230 rules governing practice before IRS;
- provides an exception to confidentiality privileges for all tax shelter transactions; and
- requires taxpayers subject to SEC filing rules to disclose certain tax shelter related penalties.83

The American Jobs Creation Act was directed towards preventing the continued abuse of the tax system by substantiating penalties of existing laws. One additional penalty was in the area of tax shelter list maintenance and presumably was enhanced due to the nature of its ability to expose potentially abusive products. Stiffer penalties increase the incentive for honesty in self-assessment. The IRS hopes that as a result, taxpayers will become more aware of listed transactions and will be more likely to clear transactions with the IRS before taking the risk of using them intentionally or even haphazardly.

A second major change dealt with the practice of issuing boilerplate opinion letters. Again, stiffer penalties are now in place to encourage honesty and restore the professionalism of an important liability practice among lawyers and accountants. The very basis of opinion and engagement letters is to establish the terms of services provided and to state on paper the practitioner’s belief of what is to result if the client undertakes certain transactions or practices. These statements are worthless without a solid ethical and legal reputation of the issuing firm to accompany them.

Moreover, without an impeccable reputation, a firm would virtually operate without the means to accomplish the function of opinion and engagement letters, which ultimately would lead to that firm’s demise. Arthur Andersen serves as a great example as to the damage that can

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result from a panicking market’s lack of trust. The entire firm dissolved in a matter of months stemming from the actions of a few. With potentially increased penalties for boilerplate opinion letters, it is the government’s intent to preserve the jobs and well being of the other 100,000 employees who do attest to the highest level of ethical and professional standards on a consistent basis, while penalizing those who attempt to take advantage of the system and firm’s reputation for a short period of time. The government’s intent does not stop at the firm level, but extends to preserve the well being of clients, creditors, and all other parties who hold a business relationship with these firms. A tax client should be able to rely on a professional’s opinion that they are dealing within the boundaries of the law. If not, the client does not receive what they are paying for, which is world class service from a world class organization.

The American Jobs Creation Act also intends to prevent the continued abuse of the tax system by creating new laws that specifically target newly exposed weaknesses from the abusive activity recently disclosed through settlements between the IRS and various accounting firms. For example, since KPMG was successful in obstructing access to pertinent documents in the past and causing the statute of limitations to run, the new legislation extends the statute of limitations to assess taxpayers who do not comply with list maintenance registration. In the future this will allow more time for the authorities to figure out what the specific crimes are and who is responsible. This is an important addition to current law since abusive tax schemes are becoming more and more complex. In the event of another abusive sheltering ring, a lengthened statute of limitations may lead to the direct prosecution of certain tax practitioners.

The act also allows the IRS to make greater use of temporary and permanent civil injunctions against those who aid and abet tax sheltering or create an illegal decrease in tax liability. This law establishes a powerful threat to those who contemplate tax abuse because the
IRS can now take away their means for a living. Currently it is unclear how inclusive this piece of legislation will be. The context of the KPMG scandal involves investment bankers, lawyers, investment advisors, and accountants as parties who aided and abetted tax sheltering. Services provided from those four functions necessarily combined to create specific and well defined abusive tax products. It will be interesting to learn whether or not injunctions will be applied to professionals outside the accounting industry.

Although, since the act’s inception injunctions have only been issued on the part of tax abuse promoters, tax return preparers, and employers who failed to pay correct amounts of withholding tax. Nevertheless, to show the effect of new legislation on the rates of injunctions issued, from 2000 through 2004 the government has issued roughly 103 injunctions to abusive promoters and roughly 17 injunctions to abusive preparers with approximately 49 of the 120 injunctions being issued in 2004, the same year that the American Jobs Creation Act became law.84

A second and less frequently enacted option available to the IRS for creating sustainability in the deterrence of abusive tax sheltering is to petition for backward looking or retroactive legislation. According to Wikipedia, “A retroactive law changes the legal consequences of acts committed or the legal status of facts and relationships that existed prior to the enactment of the law.”85 A typical and more well known term for this principle is “Ex Post Facto.”

Calvin H. Johnson, a law professor at the University of Texas-Austin, provided in his expert testimony before the Senate a description of the Congressional attitude towards the

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retroactive principle, "Congress adopts retroactive amendments only when in its judgment the misinterpretation is both shocking to ethical norms and substantial in amount and because the misinterpretation is not what the tax law intended to do."\textsuperscript{86} Therefore, it is most likely tougher for the IRS to get Congress’ approval on retroactive legislation as opposed to new legislation because it presents a potentially dangerous slippery-slope. Even though it proves to be a very effective tool for the IRS in tax collection since at Congress’ decision, taxpayers who previously found ways to avoid tax liability suddenly have a re-emergence of the same liability. Retroactive law changing needs to be reserved for extreme cases such as the FLIP and BLIPS schemes.

Section 358 is an example of the retroactive principle in action to fix flaws that accommodated BLIPS and Son of BOSS. The Community Renewal Tax Relief Act, enacted on December 22, 2000 made the effective laws applicable by more than a year prior, to October 19, 1999. Originally, section 358 of the Internal Revenue Code provided that basis in shares of stock is reduced by liabilities assumed. The amendment changed this assumption of liabilities provision in order to take away cost basis when corporations acting in the BLIPS scheme assumed the future obligation of the co-conspiriting shareholder.\textsuperscript{87} Thus, the amendment to section 358 fixes the unintended loophole that FLIP and BLIPS previously legally took advantage of by recognizing the intent of the shelter promoters and realizing that such complex transactions, including the transfer of shares and loans between taxpayer and s-corporation, did not hold merit.

Analysis of Expert Recommendations

There have been many additional recommendations proposed to increase the integrity of the tax profession and help prevent future abuse of the United States taxation system. Some recommendations are simple logical responses to the underlying problems, while others are more involved. All of the following recommendations intend to decrease the attractiveness of and opportunity for abusive sheltering. Nevertheless, some may present negative implications.

One common recommendation among the experts was to create greater degrees of independence among tax service professionals. The Minority Staff of the Permanent Subcommittee on Investigations previously asserted that the AICPA, American Bar Association, and American Bankers Association, all of whom are industry oversight bodies, should enhance professional standards by outlawing the issuance of opinion letters by tax professionals who have a conflicting interest with the tax advice or product.\(^8^8\) Conflict of interest includes practitioners who have provided support in the form of accounting, legal, design, sales, and implementation services of a product. Most importantly, conflict of interest covers practitioners who have a financial tie to particular tax advice or to a product.\(^8^9\)

Creating independence between the practitioners who create, sell, and directly profit off of tax shelters and practitioners who draft opinion letters is, to a lesser degree, preventing tax practitioners from auditing their own work. As described above, an opinion letter is a firm's stance or legal position on the specific advice or product offered to a client. Thus, firms want to issue quality, legal advice and are reluctant to label their own advice as sub-par or even inadequate. Practitioners that experience a direct correlation between developing a

\(^{8^8}\) The American Institute of Certified Public Accountants is the largest professional accountancy organization in the U.S.

lucrative new tax product and bending the rules on drafting an opinion are tempted to issue statements that may be technically accurate but do not fully serve their purpose. Even if the practitioner’s intent is legitimate, he or she will still be influenced by the potential economic benefits of using his or her own product. Therefore, the Minority Staff of the Permanent Subcommittee on Investigations argues that having colleagues within the firm review new tax advice or products can establish an additional layer of independence by preventing egotism.

Further, Tax Counsel Debra Petersen of the California Franchise Tax Board suggested a very similar upgrade in accordance with the independence initiative:

Extend Sarbanes-Oxley to tax return preparers. If a return preparer or related party has marketed, sold, or recommended a tax shelter, the firm and related parties should not be allowed to sign the return for that year or any year in which the taxpayer benefited from the shelter. Another return preparer would be required to prepare and sign the return. The other preparer would then need to independently review the transaction to determine if the position is appropriate under the tax laws and to include disclosure statements in order to avoid liabilities.90

This recommendation proposes that a higher level of independence can be achieved by shifting liability within the firm from the practitioners who develop tax advice or tax products to colleagues who were not involved in the developmental processes, thus forcing the colleagues to heavily scrutinize the product before endorsing it with their own signature. Fear tactics serve as this recommendation’s basis. First, tax partners should be skeptical about signing something they have had no involvement in, and secondly they do not want to take the blame for issuing incorrect advice on a return, as the preparer’s signature establishes.

However, the principle of both recommendations creates superficial assurance. These recommendations may better be implemented as internal controls at professional service firms, aimed at catching honest mistakes instead of preventing large scale abuse. These propositions are insignificant to the possible widespread collaboration between intra-firm colleagues. The

KPMG scandal resulted due to daring culture that was passed down from a few firm-wide leaders and in turn managers were pressured to play ball. The independence measures listed above would be very easily circumvented by a group of ten highly motivated partners who all share the same goals and experience. They would simply set up an assembly line for these three newly independent functions of tax shelter engineering, opinion letter producing, and tax return preparing. After a few months they would rotate duties.

Next, the Minority Staff proposed that the AICPA, American Bar Association, and American Bankers Association should heighten professional standards by preventing their professions from practicing aggressive sales tactics such as cold calling, telemarketing, setting explicit revenue goals, and accepting commission fees based on planned tax savings.91 Petersen seconded this recommendation by stating, “The AICPA should prohibit all contingency fees and fixed fees not based upon actual hours incurred for tax services. Use of contingency fees results in aggressive positions being taken and over inflation of the benefits.”92

This type of recommendation directly attacks the motivational component of the fraud triangle. Commission based fees act as a triple-dog-dare to tax professionals and encourages them to push the legal and ethical envelope. It makes sense that a tax professional would not spend extra time and effort researching possible customer specific tax strategies if they were not going to receive adequate compensation. Some practitioners at KPMG, PwC, and E&Y all marketed generic shelters anyways. Their shelters were not customer specific products, instead the only requirement to become eligible for these services was an enormous tax burden and a willfulness to complete each transactional task asked of them by their tax advisor. Practitioners

involved were greedy to the point that charging commission based fees were not enough to lead them to decrease a client’s tax burden ad hoc, rather they created a product that could be mass produced and sold to each customer, creating enormous economic benefits. Mass production is not often a term that surfaces in the context of highly respected professional services firms.

An interesting recommendation proposed by Petersen was to create a whistleblower provision that offers economic incentive. Anyone with knowledge of an abusive sheltering operation could receive cash in return for disclosing valuable information to the authorities. This idea is on the right track since cash incentives play an enormous role with financial types. But, one’s desire to blow the whistle comes from other pressures that naturally surround illegal activity. Allegedly Michael Hamersley spoke out because he was experiencing pressure to participate in tax fraud, but maybe, he wanted to save his own reputation and avoid indictment. Others speak out because they acknowledge that criminal activity is occurring and they feel it is their moral duty to intervene. Ethical employees most likely would not be concerned with a $5,000 or $10,000 bonus for turning in their boss when it is their duty to do so anyway.

This recommendation also draws the question of who would provide the award and whether or not the award would be material in respect to any risks assumed by whistleblowing. Potential risks include: losing one’s job, losing friends and colleagues, damaging one’s reputation, and losing professional licenses for partial involvement in illegal activity. Surely an economic award alone would not be great enough to influence a professional’s decision to blow the whistle.

Petersen’s next recommendation serves as an extension of the already advantageous practice by the courts of issuing injunctions. She proposed the requirement of licensing tax

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return preparers so that if preparers file abusive returns, the authorities can suspend or revoke indefinitely their right to prepare returns. This recommendation is reasonable because the practice of licensing would enable the IRS to maintain tighter control of practitioners who exhibit the expertise to implement abusive shelters. Each practitioner could receive an identification number that would be disclosed on each return prepared. Returns found to be altered by abusive shelters could be traced back to the practitioner allowing the court system to deal with the situation accordingly. The courts could decide upon a specific time period to revoke the practitioner’s right to prepare returns, much like the courts are able to revoke a person’s right to drive after traffic violations. Simple computer programs could disallow returns prepared under revoked license numbers.

While the idea of issuing preparation licenses seems like a satisfactory alternative to cash fines for the deterrence of fraud, Petersen introduced yet a more intriguing possibility through the following:

Publish a list of firms that issue tax opinions that fail to properly analyze the tax consequences of the transactions so that the public can be put on notice that they cannot rely on opinions of that firm. The firm would remain on the list for that period of time (say one year) and would be added and remain on the list for that period of time each time it is determined that an improper opinion has been issued.

This would most definitely encourage firms to issue correct advice and legal products as often as possible in order to maintain their reputation. It is common knowledge in the financial industry that a firm’s reputation for expertise is often its most valuable asset. This might also increase competition between firms, resulting in cheaper and better quality service for clients. In addition, the preparation licenses recommendation can tie together with the transparency recommendation through the public disclosure of licenses that have been revoked in the past.

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94 Ibid.
year. The same computer program that identifies and disallows specific preparers could also periodically update a publicly accessed website by adding and removing identification numbers.

On the other hand, this type of regulation could bring a few negative effects as well. Firms might extensively try to distance themselves from any liability resulting from their advice, which subsequently would make their opinions less effective. They may also be more reluctant to issue quality and beneficial advice to clients because it is complex and uncertain in the scope of the law. Firms would have less encouragement to challenge the law on behalf of their clients. An ideal solution to abusive tax sheltering will prove to be less overkill and will allow firms to operate under less stress and provide the best service possible to clients.

Finally, one of the most promising recommendations to the U.S. Senate Permanent Subcommittee came separately from both Debra Petersen and Calvin H. Johnson. They both contend that the IRS has been weaker in the past compared to the mighty accounting firms who at the time were in the business of testing the agency. Petersen stated:

A gentler, kinder Internal Revenue Service has contributed to the perception that tax professionals can get away with just about anything because the watch dog is asleep. The IRS and other tax enforcement agencies need more resources to audit taxpayers who engage in abusive tax transactions.96

Johnson’s comments build on this statement by offering:

The alternative (to imposing extensive economic penalties) is to increase the audit rate, and to increase the education and talent of IRS auditors and lawyers. We should be increasing the salaries of IRS officials to match those of the private sector against whom they are competing and we need more IRS officials. . . . Still, the government should be able to collect its auditing, litigation and collection costs if the promotion of the opinion caused it that unnecessary expense. A possible remedy, approaching the level required by the bad man or neutral economic theory level, would be to collect the tax lost from the opinion writer and promoter on failed shelters, even when the IRS collects the tax by deficiency against the client. That money would be a proxy for all the cases that the IRS did not catch the client, but should have.97

New control procedures are an improvement to be sure, but are they fail-safe? They can still be circumvented by smart well-paid tax professionals. Thus, one extremely effective solution to curbing tax abuse would be to increase penalties to the point that the risks of this type of activity outweigh the benefits. Certain practitioners at the Big-Four firms ventured into this risky activity based on the fact that they could charge a premium that far outweighed the potential risk. And, had it not been for Michael Hamersley and a handful of other indicators, these risk takers might have succeeded.

Johnson established an important point. The IRS has less talented resources to compete with the expertise of the Big-Four. An increase in funding would enable them to attract more talented individuals out of college and from the experienced workforce resulting in better quality audits and a quicker realization of fraud. Highly talented individuals will be more able to focus on problem areas of a return and provide better scrutiny. Due to a level playing field, shelter promoters would not be as confident that they could disguise an abusive shelter. It is likely that the risk to practitioners would be high enough to cancel any temptation.

Johnson also proposed a catchy way to fund the remodeling of the IRS, make firms who are guilty of implementing abusive tax shelter promotions pay the amounts lost to the IRS as a result of the promotion. Since the taxpayer also would have to pay back taxes the government would realize additional punitive amounts equal to the intended tax savings. However, this funding mechanism may also lie vulnerable to the overkill criticism. Again, firms might decide that even acting as an advisor to legal tax sheltering brings too great of a risk and that it would be best to exit the tax sheltering industry all together. As a result of the potential widespread conservatism among firms, clients would lose the available quality of service that prominent
firms have proven that they can provide, and would have to settle for second rate practitioners who are willing to accept the risk.
Ethics

"The bad news is that painless lessons tend not to stick."
-- Jesse Eisinger

"Not only does one have to know the right thing to do – one must have the moral fortitude to do it."
-- Anonymous

Role of Ethics

The first annual Ethics Day at Northern Illinois University was held on October 18, 2006. Amidst the free hot dogs and ethics handbooks was the College of Business’s intent to create awareness of the topic and how it will affect the lives of students, both in the classroom and eventually on the job. Even though many rarely take the time to stop and look, ethical dilemmas, big and small, are everywhere. The decisions to give a fellow peer insight to their upcoming quiz, peek at a neighbor’s test, take an extra half hour for lunch, and to do personal work on company time are a few seemingly insignificant decisions compared to the decisions to pay a peer to do homework, use a cheat sheet, routinely defer tougher assignments to coworkers, and to lie about experience or qualifications. But, these are all decisions that people make everyday at school or in the office and regardless of their insignificance they are all unethical choices. In fact, most people do not even think about the ethical dilemma that any of the previous decisions present because they are used to making routine, split-second ethical decisions. But, what happens when the ethical dilemma is multiplied in scale?

The racecar analogy proposed by Scott Mitchell98 provides a conceptual correlation between a racecar without brakes and a profitable corporation without an ethics framework. Just as the goal of racecar drivers is to push their car to the limit to win races, the goal of many CEOs is to push their company to the limit to achieve internal earnings goals or the expectations of

98 Scott Mitchell is Chairman and CEO of Open Compliance and Ethics Group.
Wall Street. But, suppose the high performing racecar does not have brakes and the Fortune 500 company does not have an ethics framework. What happens when these two very determined leaders approach a turn in the road? The driver risks an accident and the CEO risks undetected fraud, both of which can be disastrous. Where getting into a racecar without brakes obviously appears unattractive, becoming a stakeholder in a company that does not have an adequate framework for ethics should appear equally as unattractive. Although they may have a pit crew or a board of directors, both the racecar driver and the CEO are often times in complete control. Just as brakes allow the driver to maneuver the car around turns, an ethics framework allows for more control over a company and decreases the chances of unchecked and potentially fraudulent activity during a time of growth.  

Further, like racecar drivers, CEOs instinctively do not want to slow down and in turn may make decisions that are not in the company’s best long-term growth interest. CEOs often times want to expand a company to the degree of their ego, but future problems may result from fast, unnecessary growth. Similarly, earnings management can be an unethical practice that some leaders are guilty of. Although this practice sometimes has the power to meet earnings goals, often it does not result in the true disclosure of where a company stands. Moreover, pressure to meet earnings goals might make other leaders turn towards increasingly unethical and potentially illegal strategies. Thus, a strong component of ethics in a company serves the purpose of maintaining quality growth. When problems arise the company will be in a stronger position to deal with them as opposed to in the fast paced, earnings driven growth that was common throughout the late 1990s. In the late 90s problems grew as they went unnoticed and

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100 Earnings management most commonly refers to management’s decision to manipulate asset and liability timetables in the current year, which then either has positive or negative effects the following year (deferring liabilities and prematurely recording assets).
the company continued to expand. Therefore, in the past when the ethical dilemma was multiplied in scale it resulted in an alarming number of corporate scandal headlines. Hopefully ethics awareness can lead to the acknowledgement by many firms that a solid core of ethics can prevent disaster when intense ethical dilemmas present themselves, all while helping trim and guide business.

**Ethics v. Law**

It is important to differentiate between morals, ethics, and law. Morals are composed of one’s values and beliefs formed over time and are the basis for ethical conduct. According to *Merriam-Webster*, ethics refers to the discipline dealing with what is good and bad and with moral duty and obligation. However, *Encyclopedia Britannica* describes law as referring to rules of conduct of a community that are recognized as binding by the community and carry enforcement through a controlling authority. Therefore, the fundamental difference between morals or ethics and law is that law is enforced by the endorsing community. Ethics, as in what is good and bad behavior may also be supported by the community, but unless unethical practices coincide with law, perpetrators cannot be legally penalized. Some acts may be considered ethical and legal or unethical and illegal, while others may be considered unethical but legal, or ethical yet illegal. It is a person’s moral beliefs that lead to assuming an illegal act is ethical, whereas it is the intent of law makers and theoretically the overall sentiment of society that determines whether an act is legal.

In addition, the topic of tax sheltering, in its many forms, fits perfectly with the various combinations between ethics and law. Assume taxpayer A holds personal beliefs and values that lead him or her to think that the very purpose of tax sheltering is to shield one’s income from taxes to the state, and therefore is wrong. Hence, all forms of tax sheltering are wrong, including
the use of legal tax planning shelters endorsed by the IRS and upheld by Tax Courts. This person then believes that all tax shelters are unethical, but also acknowledges that some are legal.

Suppose taxpayer B holds beliefs and values that lead him or her to think that the purpose of tax sheltering is to shield one’s income as intended by Congress and that it is right to take advantage of shelters offered as incentives to act or donate in a certain fashion. Hence, taxpayer B believes all shelters endorsed by the IRS and upheld by Tax Courts are ethical and legal. Also, if according to taxpayer B’s values and beliefs he or she thinks it is not ok to embellish the interpretations of Congress by taking part in potentially abusive tax shelters, then he or she believes that abusive shelters are unethical and illegal.

Finally, taxpayer C holds beliefs and values that lead him or her to think that the purpose of tax sheltering should be to limit a taxpayer’s vulnerability to tax burden, regardless of Congress’ intentions. Therefore, taxpayer C believes that all tax shelters, including potentially abusive shelters, are ethical on their fundamental basis to protect from tax liability. Even though taxpayer C recognizes that there is a boundary between legal and illegal sheltering, he or she still believes all tax shelters are ethical.

The dilemma among beliefs in line with those of taxpayer C, presents a dangerous combination if held by tax practitioners among the most prominent accounting firms in the world. By definition a person’s beliefs can not be wrong, and therefore taxpayer C can not be sanctioned for thinking in such a manner. Nevertheless, this is precisely where law comes into focus. The law clearly states that taxpayers can hold any array of beliefs, views, morals, and complaints over the tax system, as long as they pay their legal tax liability. Legal enforcement of tax laws is the answer to taxpayer C’s beliefs. There is no telling what specific views on the tax system many of those involved in creating, marketing, and implementing abusive tax shelters
had in the past or will have in the future. But, one thing remains clear, the ethical dilemma presented to those professionals was too great for their own set of morals to establish the necessary ethical guidelines, and instead the law imposed a different boundary.

**AICPA Code of Professional Conduct**

The American Institute of Certified Public Accountants is the largest professional organization of CPAs in the United States and primarily serves as a self-regulator of the profession. Professional standards of conduct set by the AICPA are applicable to accountants of all disciplines as according to the following statement published on the AICPA website, "The AICPA Code of Professional Conduct was adopted by the membership to provide guidance and rules to all members—those in public practice, in industry, in government, and in education—in the performance of their professional responsibilities." Further, the AICPA discusses some principles of professional conduct:

The Code of Professional Conduct provides general guidance on professional responsibilities, the public interest, integrity, objectivity and independence, due care, and the scope and nature of services without establishing specific standards. Nevertheless, they should be read by every practitioner. An understanding of the difference between independence and objectivity is important particularly when consulting services are being provided to attest service clients. The AICPA standards for independence relate only to the performance of attestation services. The standards for objectivity apply to all services. It is important, however, that the practitioner adhere to all the rules that are appropriate for the particular service being provided.

The Code of Professional Conduct establishes five main areas of guidance: Section 100 – Independence, Integrity, and Objectivity; Section 200 – General Standards Accounting Principles; Section 300 – Responsibilities to Clients; Section 400 – Responsibilities to Colleagues; and Section 500 – Other Responsibilities and Practices.

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Relevant to abusive sheltering is Section 300 of the Code of Professional Conduct discussing responsibilities to clients and specifically, contingent and excessive fees. As already established, certain tax practitioners were charging “value added” fees that were only collected if a client was able to take advantage of the marketed tax results and secure a certain amount of tax savings. AICPA rule 302 states:

.01 Rule 302—Contingent fees.
A member in public practice shall not
2) Prepare an original or amended tax return or claim for a tax refund for a contingent fee for any client.
Interpretation under Rule 302—Contingent Fees
.02 302-1—Contingent fees in tax matters.
This interpretation defines certain terms in rule 302 and provides examples of the application of the rule.

Definition of Terms
(a) Preparation of an original or amended tax return or claim for tax refund includes giving advice on events which have occurred at the time the advice is given if such advice is directly relevant to determining the existence, character, or amount of a schedule, entry, or other portion of a return or claim for refund.
(b) A fee is considered determined based on the findings of governmental agencies if the member can demonstrate a reasonable expectation, at the time of a fee arrangement, of substantive consideration by an agency with respect to the member's client. Such an expectation is deemed not reasonable in the case of preparation of original tax returns. 104

Therefore, the efforts of certain tax professionals to charge fees contingent upon tax savings is highly unethical. Implications resulting from charging contingent fees include excessive marketing and implementation of tax shelters that at the time were viewed as borderline legal, but in hindsight are now known to be illegal. Contingency fees are unethical because they take away from the true task at hand, which is to provide the highest quality advice and service to the client. However, when the possibility exists to cash in on lucrative contingency fees the temptation also exists to offer advice that plainly maximizes profit potential.

Moreover, unethical contingency fees allegedly shifted hands when certain KPMG professionals screened for potential shelter clients. The professionals in question promised to pay a fee to their sources for every client who actually purchased a tax product. Many times sources of potential clients were investment banks where KPMG served as the SEC registered independent auditing firm. According to the Minority Staff report, the following was found in an email from Tom Newman, a First Union employee, to multiple other First Union employees, “Fees to First Union will be 50 basis points if the investor is not a KPMG client, and 25 bps if they are a KPMG client.”105 In this case First Union was one investment bank that took part in the contingency compensation plan created by the involved tax practitioners. Although it is unclear exactly how much economic compensation correlates with basis points, there was a clearly outlined compensation system acting as incentive for the involved investment banks to refer clients to the sheltering services.

Many believe utilizing this type of method to attract clientele effectively cheapens the profession much in the same way as purchasing another firm’s contact list or cold calling. As a result, the profession of accounting has outlawed the practice. Still, there is an important distinction to be made. Standards set by the AICPA are professional standards and in some cases rise above legal standards imposed by the SEC or the PCAOB106. Thus, some conduct that is frowned upon by the AICPA may be legal. For example, it is common in the marketing function to circulate customer contact information for compensation.

Moreover, Just because professional organizations and fellow colleagues declare an act unethical does not mean legal sanctions can be imposed, except when the unethical act aligns

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106 The Public Company Accounting Oversight Board was created by the Sarbanes-Oxley act of 2002 and carries the responsibility of overseeing audits of public companies in order to protect the interests of stakeholders.
with the law. During the late 90s and first few years of the new millenium there might not have been laws prohibiting contingency fees in the accounting profession. Generally the extent of power of the AICPA is to suspend indefinitely a member's license and to publicly display the suspension online, whereas the SEC and PCAOB are full legal arms of the United States Government that have authority to facilitate law suites against those who cross legal boundaries.

Also relevant to the KPMG scandal is Section 100 of the Professional Code of Conduct targeting independence. As established, certain practitioners at KPMG worked with numerous investment banks, who were also SEC audit clients, during the orchestration of many abusive shelters. The Code of Professional Conduct states:

ET Section 100.01 - Conceptual Framework for AICPA Independence Standards 06

*Independence* is defined as:

a. *Independence of mind*—The state of mind that permits the performance of an attest service without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.

b. *Independence in appearance*—The avoidance of circumstances that would cause a reasonable and informed third party, having knowledge of all relevant information, including safeguards \(^{m2}\) applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or a member of the attest engagement team had been compromised.\(^{107}\)

Independence of mind and independence in appearance were both at risk during the abusive sheltering period. By recruiting SEC audit clients to provide the investment banking function of the transactions in the shelters, those involved at KPMG had established a basic partnership with those banks. The banks took part by processing hundreds of separate transactions for different clients in conjunction with KPMG practitioners who orchestrated the shelters. Both the AICPA and the SEC established that there cannot be independence between un-official partnerships with

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the following, "The SEC considers independence to be impaired when the firm has a direct or material indirect business relationship with an SEC audit client."\textsuperscript{108}

\textbf{Sarbanes-Oxley}

The fairly recent unraveling of numerous corporate scandals prompted Congress to create Sarbanes-Oxley, which is considered the most sweeping piece of financial litigation since the 33 and 34 acts.\textsuperscript{109} The fostering of a corporate environment or principal-agent relationship that allows for gross information asymmetry between officers and stakeholders provides for rampant corporate scandal. Although it is illegal under SEC regulations to plainly fabricate optimal assertions to stakeholders, Sarbanes-Oxley increased the responsibility, on behalf of CEOs and CFOs, for representational and transparent financial reporting. Under Sarbanes-Oxley CEOs now have to sign off on the financial statements, asserting that the statements are correct.

Subsequently, the law enforces fines and jail time for the highly unethical and illegal abuse of managerial position, stemming from the principal-agent relationship. Sarbanes-Oxley is aimed at decreasing the disparity of knowledge-based power between management and stakeholders by designating legal responsibility of assertions to officers and the board of directors.

Further, the extensive complexity of tax law made the KPMG scandal difficult to render as illegal. The act of decreasing the tax liability of a client for the sake of not paying taxes is unethical by taking advantage of the tax system and client’s responsibility to state. Wealthy individuals and select corporations were circumventing their own tax liability, thus shifting the tax burden to the remainder of society. In other words, taxpayers involved were not paying-in their fair share. Recall that loopholes sometimes allow breaks in tax and unless investigators can


prove that certain professionals incorrectly exploited a loophole, they would not be able to prosecute those persons according to legal penalties. After investigation it is likely that a handful of KPMG tax professionals, among many in the tax community, were profiting off of the very unethical and illegal practice of abusive tax sheltering.

Prior to Sarbanes-Oxley, Rule 501 of the Professional Code of Conduct had clearly established that employee harassment was unethical. The code states:

501-2—Discrimination and harassment in employment practices.
Whenever a member is finally determined by a court of competent jurisdiction to have violated any of the antidiscrimination laws of the United States or any state or municipality thereof, including those related to sexual and other forms of harassment, or has waived or lost his/her right of appeal after a hearing by an administrative agency, the member will be presumed to have committed an act discreditable to the profession in violation of rule 501.110

Sarbanes-Oxley merely broadened the scope of this unethical practice to make such behavior applicable to legal sanctions. Sarbanes-Oxley enacted the following whistleblower provisions:

Sec. 1514A. Civil action to protect against retaliation in fraud cases
(a) WHISTLEBLOWER PROTECTION FOR EMPLOYEES OF PUBLICLY TRADED COMPANIES- No company with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l), or that is required to file reports under section 13(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d)), or any officer, employee, contractor, subcontractor, or agent of such company, may discharge, demote, suspend, threaten, harass, or in any manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee--

(1) to provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders, when the information or assistance is provided to or the investigation is conducted by--

(A) a Federal regulatory or law enforcement agency;
(B) any Member of Congress or any committee of Congress; or
(C) a person with supervisory authority over the employee (or such other person working for the employer who has the authority to investigate, discover, or terminate misconduct); or

(2) to file, cause to be filed, testify, participate in, or otherwise assist in a proceeding filed or about to be filed (with any knowledge of the employer) relating to an alleged violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders.111

Circular 230

Where the AICPA Code of Professional Conduct is applicable to all practicing accountants, the Department of Treasury created Circular 230 as a code of conduct targeting tax practitioners. Moreover, Circular 230 tries to ensure that tax opinions and tax advice is correct and has been put through the appropriate due diligence before being passed on to taxpayers. Overall, Circular 230 sets up professional standards to govern practitioners who wish to practice before the IRS. All tax practitioners must adhere to these standards, according to law. Similar to the AICPA’s Code of Professional Conduct, Circular 230 includes ethical and professional responsibility rules that every professional should take into account because they are a consensus of standards among tax professionals. This meaning that since Circular 230 sets a good example for tax practitioners, professionals in different functions can still benefit from the principles it provides.

Relevant to abusive tax sheltering, Circular 230 underwent revision by the Department of Treasury on December 17, 2004, which strengthened and clarified many aspects of the document. The IRS released the following in conjunction:

WASHINGTON — As part of an ongoing effort to improve ethical standards for tax professionals and to curb abusive tax avoidance transactions, the Treasury Department and the Internal Revenue Service today issued final regulations amending Treasury Department Circular 230.

Circular 230 is applicable to attorneys, accountants and other tax professionals who practice before the IRS. The revisions to Circular 230 provide standards of practice for written advice that reflect current best practices and are intended to restore and maintain public confidence in tax professionals. These revisions ensure that tax professionals do not provide inadequate advice, and increase transparency by requiring tax professionals to make disclosures if the advice is incomplete.

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Also, the IRS intends not to impose sanctions lightly or without merit. But, where practitioners have acted reckless in failure to comply with Circular 230 the IRS plans to hold them accountable.\textsuperscript{114}

In the past, the guidelines of Circular 230 have been relatively vague. Now, in response to the need expressed by abusive sheltering, the revision to Circular 230 creates clearly spelled out guidelines. For example, steps have been taken to reveal the completeness of due diligence when writing an opinion. These clearly defined steps intend to facilitate opinions that taxpayers can rely on. Accordingly, sanctions for not following these steps include revocation of a practitioner’s right to practice before the IRS.\textsuperscript{115}

Generally, practitioners have responded positively to the increased guidelines. According to Harvey Coustan, a retired CPA from Ernst & Young, many practitioners have published lists of best practices under Circular 230 as reference material for their firm. Others have published required steps in forming a covered opinion, and the steps necessary when only issuing advice.\textsuperscript{116}

However, some practitioners have reacted negatively to the additional Circular 230 requirements. Their argument follows the “If it ain’t broke, don’t fix it” theory and contends that some of the new requirements are unnecessary.


\textsuperscript{115} Harvey Coustan, “Circular 230 Overview,”

\textsuperscript{116} Ibid.
Some claim that the new requirements change the way they do business and how they interact with their clients, while others claim that their clients were perfectly happy with their work before the revision. Complain against Circular 230 parallel those of Sarbanes-Oxley, asserting that this legislation is ahead of its time and somewhat overkill to the situation at hand. However, only time will tell as to the effectiveness and applicability of this new legislation to future ethical and fraudulent issues.

Interestingly enough the AICPA has made it clear that they hold a negative stance on the Department of Treasury's amendment to Circular 230. In a letter addressed to the Honorable Mark Everson, the AICPA outlined several concerns over the new amendment. The following illustrates the AICPA's concern:

While the AICPA supports the goals of the Treasury and IRS in revising practitioner standards, the proposed changes in REG 122380-02 raise some general concerns that we believe are held by a large segment of the practitioner community. Unfortunately, many of the proposed Circular 230 revisions appear to reflect a lack of balance that may undercut both the goal of enhanced standards and compromise fundamental fairness. The proposed regulations also create additional grounds for sanction without any explanation of why the additional provisions are necessary or when they might be satisfied in a particular case. The net effect of these changes, if adopted without elaboration or examples, unfortunately may be to unnecessarily subject practitioners to discipline and sanction. Our attached comments detail our concerns and recommendations on these and other issues.

The most significant concern of the AICPA and many others in the tax community is the wrongful or unnecessary subjection of small firm tax practitioners to new sanctions. Although the larger accounting firms may have the resources to change their practices in a relatively short period of time, smaller partnerships may be adversely affected when trying to conform to new standards. Alan Einhorn, a CPA from Deloitte & Touche, offered the following concern relating

to the new amendment, "It doesn't matter what size practitioner there is they need to understand these rules and the firm has to have the process and procedures in place to indicate that they are trying their best to comply with these rules." Einhorn was referring to the inadequacies or lack of awareness, present at certain small accounting firms, of the need to conform to the new standards. For example, section 10.37 of Circular 230 applies to all tax practitioners and all written tax advice they offer. The AICPA's remedy to this concern is to publish extensive resources on their website including slide shows, memos, and practice aides, etc.

The general sentiment of the IRS opposes the concerns of the AICPA. Stephen Whitlock of the IRS contends that if tax practitioners have been issuing independent, competent, and diligent advice in the past then Circular 230 only introduces a new format for issuing such advice. Hence, if the new Circular 230 guidelines are too great of a burden, then practitioners need to assert more due diligence and re-visit and re-assess their approach to tax issues. In turn, the answers issued to clients need to be revised.

Open Compliance & Ethics Group (OCEG)

As referenced earlier, Scott L. Mitchell, CEO of Open Compliance & Ethics Group, gave a presentation to Northern Illinois University College of Business students and faculty on the first annual Ethics Day in Barsema Auditorium. His presentation was awareness based and
discussed the importance of establishing an ethical framework in any given organization. The purpose of his presentation was to describe what the non-profit organization does.

OCEG's mission is to help organizations align their governance, compliance, and risk management activities to drive business performance and promote integrity. To do this they provide a framework for clients to think about, which is an ethics model similar in principle to a business model. Termed GRC+C for governance, risk management, compliance, and culture, the framework is a process to track and identify risks that lead to crossing boundaries while creating and maintaining a solid culture in a belief initiative. Presumably GRC+C is a new business fad much like ERP, JIT, or Six Sigma.

The OCEG website defines each component of GRC+C. First, Governance sets and evaluates performance against objectives. Governance also includes the power to authorize business strategies and models to achieve objectives. Secondly, Risk Management proactively identifies and rigorously assesses and addresses potential obstacles to achieving objectives. Risk Management also identifies and addresses risks that lead the organization to step outside of mandated and voluntary boundaries. Next, Compliance proactively encourages and requires compliance with established policies and detects noncompliance and responds accordingly. Finally, Culture establishes an organizational climate and mind-sets of individuals that promote ethical behavior, trust, integrity, and accountability.

There is a clear need for such consulting that OCEG provides since business models do not always coincide with desirable ethics models. For example, assume XYZ Company, a chemical manufacturer, currently operates towards the objective of producing chemical A at the cheapest price. In addition, assume that the consequences of breaking applicable pollution laws

123 Ibid.
are less than the benefits of complying with them. XYZ Company's business model operates only with mandated legal boundaries, pollution laws for example. After consulting with OCEG, XYZ company would be likely to implement additional voluntary boundaries in response to harmful pollution output levels. In the long run this ethical strategy is likely to preserve the chemical company by establishing forward looking goals that will be less negatively affected by adversely shifting mandated boundaries. In the future when pollution laws become more stringent, XYZ will be in a better position than competitors to deal with the tougher laws.

Moreover, as mentioned earlier, scandal is perpetrated by an individual, not a company as a whole. This important distinction offers another internally based reason why corporations should establish an ethical framework. Structured and methodical companies are more likely to catch ethical breaches by a handful of fraud perpetrators than a company that has no straightforward set of guidelines to ensure proper compliance with applicable laws and codes of conduct. It can be exponentially damaging to a company the longer unethical or fraudulent practices go unnoticed. Worst case scenarios need no introduction, Enron, WorldCom, and Arthur Anderson. But, consider breaches of ethics at firms that still have a going concern. KPMG, PwC, and E&Y, as a result of the actions of a few, have been withstanding the worldwide embarrassment of tax scandals that were perpetrated by a very select group. Even though 99.9% of the remaining employees at these global firms had no part in the incident, they are, nonetheless, connected with the wrongdoing of a few.

Touching on a previous analogy, an ethics framework acts as a tool to control growth and better guide a company. When things go slightly wrong the company is able to catch the mistakes in a timely manner. Without the control that an ethics framework provides, mistakes will amplify and cause exponential damage. OCEG is working towards implementing a culture
where their clients are protective against fraud. But also, when fraud does occur, their clients will be better prepared to deal with it.

Deloitte & Touche serves as an example of a firm that has been changing their culture from top down. Recently the U.S. member firms have been making tremendous efforts to diversify their employees. On July 14, 2006 Barry Salzberg, Managing Partner of Deloitte America, gave a speech to roughly 500 college students at the closing ceremony of their Deloitte National leadership Conference discussing their women’s initiative and general importance of diversity. This initiative most likely was not based on strengthening ethics and deterring fraud, but was probably based on projecting a politically correct image. In the professional services industry it is becoming increasingly important to maintain a quality image. As such, Deloitte believes that it is important for their employees and consultants to “look” like their clients. As the market becomes more diverse, Deloitte attempts to become more diverse.

Nevertheless, the diversity initiative likely has had a positive impact on the deterrence of ethical breaches and ultimately fraud. As seen with KPMG, PwC, and E&Y a culture was created by a small group of professionals, who presumably thought alike and came from strikingly similar backgrounds, where it was ok for certain tax groups to manipulate the intentions of Congress. Deloitte’s diversity initiative attempts to create a situation where everyone in the room has different capabilities and comes from differing backgrounds and as a result, coincidentally forms functional groups that may react strongly to an array of motivational sources instead of a single source. Where a handful of tax practitioners at other Big-Four and Mid-Tier accounting firms were heavily swayed by contingency fees and exorbitant wages, it

125 Peter Kaplan, Internal Audit Manager, Deloitte & Touche USA LLP. Interview by author. Chicago, IL, October 27, 2006.
may be more likely that at Deloitte half of the group would not be as inclined to accept unethical practices based on a single type of motivation. To clarify, this is not to say that professionals from certain backgrounds and ethnicities are invincible to perpetrating fraud, rather additional types of motivation, other than economical, would have to be present to sway a diverse group to unethical and fraudulent practices.

The diversity initiative represents a partial solution to preventing fraud. Previous portions of this paper discussed the frequent response to fraud of developing and implementing additional review processes or partially independent review processes that are eerily similar to control processes already in place. The true answer is to think outside of the box and create change in areas other than hard process controls. Areas such as ethics awareness and culture also play a role in determining how prone a firm is to fraud. In the context of the fraud triangle, process controls only work to reduce opportunity, whereas a diversity initiative may work to reduce motivation. It is by thinking in other than a strictly control based mindset that a firm will realize other potential weaknesses. Process controls will always have a fundamental weakness illustrated by the saying, “rules were meant to be broken.” Talented, resourceful, and motivated individuals will find a way to circumvent process controls. Therefore, Deloitte’s diversity initiative may have inadvertently insulated the firm from one-third of the fraud triangle, thus effectively eliminating the firm’s participation in the industry’s latest scandals. When was the last time you heard Deloitte’s name mentioned in connection with a breach in ethics, misrepresentation, or fraud?
Three Relevant Codes of Ethics

I  Code of Ethics of the National Association of Tax Consultants
Each member shall conduct himself according to the highest standard by:

- Obeying all laws governing the practice of tax preparation as regulated by the legislative bodies of the member's state and the federal government;
- Maintaining the highest standards of honesty, integrity and confidentiality in all relationships with clients, keeping as the utmost concern the client's best interest;
- Treating statutory educational requirements as the minimum, while maintaining current knowledge in all areas of a member's practice;
- Extending professional courtesies to all colleagues in the tax preparation field while maintaining respect for a colleague's practice and area of specialty; and
- Working to further the goals of the National Association of Tax Consultants by setting the example for professional standards and working to improve education throughout the tax profession.

Further, each NATC member understands that if enjoined from practice or convicted of a felony, membership in NATC will be suspended, pending review of the proper NATC committee.  

II  Subsection of the KPMG Global Code of Conduct: MANAGEMENT RESPONSIBILITIES

It is of particular importance that those with management responsibilities lead by example and act with integrity, making ethical behavior a cornerstone of conduct at KPMG. If you lead or manage others you should:

- Be a positive role model by showing what it means to act with integrity.
- Ensure that others have the knowledge and resources they need to adhere to KPMG's standards.
- Set clear, measurable, and challenging goals that promote ethical behavior.
- Enforce KPMG's standards consistently and fairly, and promote compliance with those you lead.
- Respond appropriately to those who raise questions and concerns in good faith.
- Be prepared to be held personally accountable for your own integrity shortcomings as well as those of the people you lead.

III Northern Illinois University College of Business Student Code of Ethics

As a student at Northern Illinois University’s College of Business, I understand that it is my duty to behave in a courteous and ethical manner at all times. The attitudes and habits I develop as a student form the core of my professional behavior. As such, I will set an example of the highest caliber for those that work with me.

To promote these behaviors within the student body, I will use the principles of honesty, respect, integrity, and professionalism as my academic and professional guide.

HONESTY:

- Understand the College’s policies on academic conduct, and practice them as part of my life
- Honor my personal obligation to be sincere and forthright by dealing fairly and truthfully with others

RESPECT:

- Embrace the diverse perspectives and accomplishments of others, knowing that it is the personal and cultural variations among people that enrich us individually and as a society
- Take pride in my College and University by protecting our facilities and their surroundings

INTEGRITY:

- Maintain my beliefs and values despite changing circumstances and challenging environments
- Respect my reputation and that of my university by avoiding unethical behaviors and the circumstances that encourage them

PROFESSIONALISM:

- Maintain the highest standards of performance, conduct, and cooperation with my fellow students, faculty, and co-workers
- Perform my duties with due diligence and make a continuous effort towards improvement

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128 Building Ethical Leaders, Northern Illinois University College of Business Ethics Handbook (United States of America, August 2006), p.27.