S. Hrg. 108–473

U.S. TAX SHELTER INDUSTRY: THE ROLE OF ACCOUNTANTS, LAWYERS, AND FINANCIAL PROFESSIONALS

HEARINGS

BEFORE THE

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

OF THE

COMMITTEE ON GOVERNMENTAL AFFAIRS UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

NOVEMBER 18 AND 20, 2003

VOLUME 1 OF 4

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U.S. TAX SHELTER INDUSTRY: THE ROLE OF ACCOUNTANTS, LAWYERS, AND FINANCIAL PROFESSIONALS

TUESDAY, NOVEMBER 18, 2003

U.S. SENATE,
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS,
OF THE COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee met, pursuant to notice, at 9:02 a.m., in room SH–216, Hart Senate Office Building, Hon. Norm Coleman, Chairman of the Subcommittee, presiding.

Present: Senators Coleman, Levin, and Lautenberg.

Staff Present: Raymond V. Shepherd, III, Staff Director and Chief Counsel; Joseph V. Kennedy, General Counsel; Mary D. Robertson, Chief Clerk; Leland Erickson, Counsel; Mark Greenblatt, Counsel; Steven Groves, Counsel; Frank J. Minore, Detailee, GAO; Kristin Meyer, Staff Assistant; Steve D'Ettorre, Staff Assistant; Bryan Nelson, Intern; Elise J. Bean, Staff Director/Chief Counsel to the Minority; Bob Roach, Counsel and Chief Investigator to the Minority; Laura Stuber, Counsel to the Minority; Brian Plesser, Counsel to the Minority; Julie Davis, Professional Staff Member; Christopher Kramer, Professional Staff Member to the Minority; Beth Merillat-Bianchi, Detailee, IRS; Jim Pittrizzi, Detailee, GAO; Rebecca Dirks, Intern; Ken Seifert, Intern; Jessilyn Cameron, Brookings Fellow; Grant Bosser (Senator Sununu); Nate Graham (Senator Bennett); Kevin Carpenter (Senator Specter); Mimi Braniff (Senator Stevens); David Berrick (Senator Lieberman); Gita Uppal (Senator Pryor); Rudy Broiche (Senator Lautenberg); and Mandana Parsazad (Senator Dayton).

OPENING STATEMENT OF SENATOR COLEMAN

Senator COLEMAN. This hearing of the Permanent Subcommittee on Investigations is called to order.

I want to thank you for attending today's hearing. Today and Thursday we will focus on a set of issues developed by this Subcommittee's Ranking Member, Senator Levin. And, Senator Levin, I would like to commend you for your tireless efforts to prevent the abuse of our tax code by those willing to exploit loopholes and avoid paying legitimate taxes. You have done tremendous work in this area, and it is a pleasure for me to work with you.

In a bipartisan fashion, PSI has developed a deeper understanding of the history of individual tax shelters. PSI has uncovered how those shelters work, how they were marketed to potential investors, and how they were structured in order to avoid scrutiny by the Internal Revenue Service. Due to the complexity of these schemes, our hearings will focus only on a few of the shelters, but there are many others like them.

There is an old English proverb that says, "A clean glove often hides a dirty hand." Today we will hear firsthand how the ethical standards of the legal and accounting profession have been pushed, prodded, bent, and in some cases broken for enormous monetary gain. The fact is abusive and potentially illegal tax shelters sold to corporations and wealthy individuals rob the U.S. Treasury of billions of dollars in lost tax revenues annually.

Let me be clear: While some of the products we discuss today are not technically illegal, they are most certainly ethically questionable and demonstrate a deliberate effort on the part of the participants to fly underneath the regulatory radar of the IRS. This is not a victimless crime. It is not the government that loses money. It is the people of America, average working families who will bear the brunt of lost revenues so that a handful of rich lawyers, accountants, and their clients can manipulate legitimate business practices to make a profit.

According to the GAO, a recent IRS consultant estimated that for the 6-year period 1993 to 1999, the IRS lost an average of between $11 and $15 billion each year from abuse of tax shelters. The GAO reports that an IRS database tracking unresolved abusive tax shelter cases over a number of years estimates potential tax losses of about $33 billion from listed transactions and another $52 billion from unlisted abusive transactions, for a total of $85 billion.

As I said, this is not a victimless crime. To put this in context, if the IRS proactively shut down these abusive tax shelters and collected the diverted revenue, it would have helped to finance a substantial portion of our efforts in Iraq. Abusive tax shelters are fashioned in the likeness of legitimate transactions as permitted under the IRS Code. The transactions themselves are highly complex, involving accounting firms, major financial institutions, investment firms, and prestigious law firms. Not only are these participants necessary for the transaction, they provide the added benefit of making detection by the IRS difficult. Moreover, these entities provide a veneer of legitimacy, for abusive tax shelters are, in fact, illusory and sham transactions with little or no economic substance, driven primarily for favorable tax consequences.

There are three ovearching issues that these hearings will address. The first is the Internal Revenue Service's ability to enforce the Nation's tax laws. There is no doubt that our tax laws are very complex and give rise to different interpretations. The Service's interpretation is not legally controlling, and taxpayers have the right to ignore it if they think a court will uphold their reading of the statutes and regulations. But the IRS does have a right to challenge tax strategies it thinks are invalid. In order for the Service to challenge strategies and for the courts to rule, they must be aware of how taxpayers are applying the law.

The Subcommittee's investigation has uncovered evidence that the transactions studied here were deliberately designed to avoid detection by the IRS. Even an illegal strategy works if the government never finds out about it. Even more disturbing, the IRS has specific rules that require the promoters of certain tax products to notify the IRS whenever a taxpayer uses one of them. This gives the IRS the opportunity to review how the taxpayer has applied law to his or her specific situation.

Evidence suggests that the accounting firms knowingly evaded this requirement and that the IRS has not been as forceful in its administration of this registration requirement as it could be.

When transactions are hidden from the government, it loses its ability to enforce the law. The perception can quickly arise that fair application of revenue statutes is a sucker's game, that those who are rich and powerful ignore it or interpret it to their own benefit, and that only the average guy gets stuck with his full share. The system that relies primarily on voluntary compliance cannot afford to allow this perception to seem real.

Second, for a long time both the accounting and legal industries have been justifiably proud of their professions. Both have held themselves up to the public as practicing a high standard of professional ethics and giving the public honest access to a complex body of doctrine. Given the complexity of tax and accounting law, Americans with any wealth are increasingly dependent on professional advice in order to reconcile their personal interests with legal requirements. If clients cannot have absolute confidence in the accuracy of the advice they get, these professions no longer will merit the high standard we have previously given them.

This leads naturally to the third major theme of these hearings. We all know that an institution, especially one as large as the accounting firms appearing here today, cannot be held strictly responsible for every action of all their employees. Individual workers often have motives and take actions that are directly contrary to the intentions of a company's leaders. But because we foresee these conflicts, the existence of strong internal controls has become a key component of modern management practices. These controls are meant to ensure that no single employee or group of employees is allowed to subject the firm to a large amount of risk without the leadership's approval.

We will hear evidence that the internal controls that the accounting and law firms seem to have had in place did not work. The people responsible for ensuring firm quality often raise serious questions about the transactions we will discuss today. Yet it appears that their advice and recommendations were often disregarded in the effort to boost revenue.

These three issues—the ability of the IRS to learn of aggressive tax strategies, the possibility of misleading advice to taxpayers, and the breakdown of internal controls—all raise serious issues about future policy toward the tax industry. I am hopeful that the information Senator Levin has helped us uncover will lead to positive reforms.

I look forward to hearing from our panelists this morning, and I especially look forward to Senator Levin's questioning of the panelists. I know we will all learn a great deal today.

With that, I will turn it over to the distinguished Ranking Member, Senator Levin.

OPENING STATEMENT OF SENATOR LEVIN

Senator LEVIN. Thank you, Mr. Chairman, for your comments and for your support of this investigation that began a year ago when I was Chairman here, but has continued with the support of Senator Coleman. We are grateful for that and for what this is going to lead to, hopefully, as he points out. What we must point toward are a series of significant reforms if we are going to change the practices which we are going to hear described this morning.

My statement is something of a long statement because I do want to set forth what these shelters are in detail so that we can understand them. I know I have the understanding of our Chairman in proceeding this way. Normally I would try to limit an opening statement to 10 minutes, but this one could go 15 minutes or so, and I thank the Chairman for his understanding of that, even though we have a very difficult time schedule this morning.

Unlike legitimate tax shelters, abusive tax shelters have no real economic substance. They are designed to provide tax benefits not intended by the tax code and are almost always convoluted and complex. Crimes like terrorism or murder or fraud or 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 is also fundamentally different than it was a few years ago. Instead of individuals and corporations going to their accountant or law firm and asking for tax planning advice, the engine driving the industry is now a horde of tax advisers cooking up one complex scheme after another, so-called tax products, generally unsolicited by clients, 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 products, the Subcommittee conducted an in-depth case study 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, FLIPS, OPIS, and SC2.

We are releasing a 125-page Minority Staff Report today detailing what we found in these four case histories.[1]

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 e-mail by a top KPMG tax professional on whether KPMG should approve BLIPS for sale to clients illustrates the skewed priorities. He said that 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."

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[1] The Minority Staff Report appears in the Appendix on page 145.

Being paid a lot of money for a dubious tax scheme—that is 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 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 revisits 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 clean-ups, 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 boilerplate legal opinions to justify dubious tax schemes and to 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.

We are going to focus on two shelters, BLIPS and SC2. Let's first look at BLIPS. We have some charts here on the screens, and some of you have, hopefully, charts in front of you.[1]

BLIPS 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 to shelter that other income from taxation.

For this example, we will 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.

On the first slide, we will see the first step is the BLIPS taxpayer setting up a shell corporation called a limited liability com-

[1] See Exhibit No. 1a. which appears in the Appendix on page 371.

pany, or LLC. The taxpayer gives this shell company out-of-pocket cash equal to 7 percent of the $20 million paper loss that 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.

On the next slide, we will see what happens next, which 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 percent interest. 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 is, not coincidentally, 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 that it is repaid. The bank credits the taxpayer's account, which stays at the bank, with the $50 million so-called 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 the shell company have to agree to severe restrictions on how the loan proceeds can be used. And they must maintain collateral in cash or liquid securities in an account at the same bank equal to at least 101 percent of the loan and premium amount, meaning about $70.8 million.

Now, 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 percent means 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.

The next slide: Enter Presidio. They are the investment advisory firm that works hand in glove with KPMG and handles a lot of the legwork of the transaction. Presidio directs two companies it controls—Presidio Growth and Presidio Resources—to participate in the transaction.

Next, Presidio and the taxpayer's shell company form a partnership called a strategic investment fund or SIF. The taxpayer's shell company, that 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-percent interest and Presidio collectively has a 10-percent interest in the strategic investment fund.

The next slide: Here is the switcheroo. The shell company decides with the consent of the bank to assign or transfer the so-called bank loan to the fund.

Next slide: Here comes the fig leaf. The fund takes the money it has and supposedly engages in foreign currency transactions. The fund takes the so-called loan proceeds, the $70 million, and simply converts them into euros and puts the euros in what one bank calls a synthetic dollar account. The fund also signs a contract to guarantee that 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 bought it, 186 out of 186, pulled out early, as planned. They quit. They pulled out 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.

The last slide on BLIPS: Now we are at the unwind. At day 60, the taxpayer pulls out of the partnership. The partnership, the fund, repays the so-called 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 gone, mostly in fees, but that is a price that he is more than willing to pay for the $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.

Now, if this does not make much sense to you, it is because the whole transaction is an elaborate concoction to create the impression of economic substance. The taxpayer did not 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 1 year, KPMG obtained at least $53 million in fees, making BLIPS 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.[1]

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.

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, assuming that the S corporation had, let's say, 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

[1] See Exhibit No. 1b. which appears in the Appendix on page 379.

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, which KPMG has made a major effort to identify, 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.

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 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.

On the next slide, we will see that 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 percent of its net income to the charity and 10 percent to the individual shareholder.

The difference between "allocation" and "distribution" 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 percent of company income allocated to the charity is tax-exempt, while the individual has to pay taxes on only the 10 percent allocated to him. That is true even though the charity often never sees a nickel of the money supposedly allocated to it and agrees, indeed, to forego that income.

On the third slide, we will see the following: We are 2 or 3 years down the road after significant net income has been accumulating inside the company, when the charity's redemption rights kick 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.

Now the payout, the fourth slide. This is where the individual shareholder makes out.

The charity has sold back its shares and is no longer a shareholder in the S corporation. All of the income that has been 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 percent of the income allocated to the charity previously, 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 the years 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.

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 that we are releasing today depicts a powerful engine going at full speed, developing and selling 500 active tax products at KPMG as of February 2003. That was the response date for the subpoena of this Subcommittee.

Having claimed all during this year to my staff that these tax products are legitimate, KPMG's prepared testimony today is that the firm not only has turned off, but dismantled, that 500-cylinder engine.

List me as skeptical. I am simply afraid we cannot trust the 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 that 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. Pricewaterhouse Coopers 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 is a start.

The engine of deception and greed needs to be turned off, dismantled, and consigned to the junkyard where it belongs. That is 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 fly-by-night hucksters from whom such behavior is less surprising.

Again, my thanks to you, Mr. Chairman, for your great support of this effort.

Senator COLEMAN. Thank you, Senator Levin. Senator Lautenberg, would you like to make an opening statement.

OPENING STATEMENT OF SENATOR LAUTENBERG

Senator LAUTENBERG. Yes, thanks very much, Mr. Chairman, and I commend you for holding this hearing today and Thursday regarding the tax shelter industry. These are particularly timely subjects to review, and if Senator Levin had not so artfully described the way you do it—and maybe sent some people out of the room looking for a way to fulfill the pattern that you have described—I learned something this morning, and it is a very tough situation that we find ourselves in.

Over the past few years, our economy has been racked by corporate and accounting scandals so big and previously unimaginable, and I come out of the corporate world and remember expressions like the Big Eight, diminished to certainly lesser status and prestige and respect that these large firms had. But in many cases, they turned out to be conspirators with companies like Enron that have gone belly up. People lost their jobs, their life savings, their retirement savings, and their faith in the fundamental fairness of our stock market.

The situation worsens as we look at other organizations getting into places like the mutual fund industry, the New York Stock Exchange itself, all talking about concealing the truth from the public, hiding things. And that is where we are when we look at what has happened here with tax sheltering.

The marketing, the use of questionable, even abusive tax shelters for individuals with very high incomes evolved, and many of the questionable tax shelters at issue today were created during the biggest, longest economic expansion in our Nation's history. I will assume that the witnesses will confirm that the economic good times during the mid and late 1990's created such wealth that there was enormous pressure to find new ways to shelter that wealth. So a veritable army of the best and the brightest accountants, lawyers, and investment bankers went to work on behalf of their high net worth clients.

I was a corporate Chief Executive Officer for many years, and my company, ADP, did very well, but I am a bit old-fashioned because I believe that the better you do, the more taxes you should pay, not less. So much for progressivity.

How much money are we talking about? According to the General Accounting Office and the Internal Revenue Service database, tracking unresolved abusive tax shelter cases over a number of years, estimates potential tax losses at about $33 billion from listed transactions, and another $52 billion from non-listed but questionable transactions. That is $85 billion. I want to put it in perspective. We just borrowed $87 billion from future generations to pay for the ongoing war and reconstruction in Iraq. It may be said that these tax shelters complied with tax laws and IRS regulations, but I think there is something inappropriate, to say the least, about how much time, energy and expertise is helping to save some of our very richest to hide more of their multimillion dollar income from taxation when we are notably short of funds to meet our national obligations, especially with young men and women in harm's way who do what they do regardless of some of the economic loss that they experience as a result of being away from their jobs, away from their community, and away from their families.

A few weeks ago I participated in a panel discussion in New York City hosted by *Atlantic Monthly Magazine* on the future of corporate America. There were two current CEOs also on the panel, and they complained about the burdens imposed upon them by the Sarbanes-Oxley Corporate Accountability Bill that Congress passed last year. My response was simply: If you tell the truth, then it would not have been necessary to develop the strict regime that says everybody has to report along the way about what the results were. The fact of the matter is that if industry and the professionals associated with it outside of the companies, outside of the firms that are creating and marketing these tax shelters, if they will not police themselves, then the Congress is going to do it for them. They will not sit by while greed-fueled corporate malfeasance wipes out jobs, savings, and lives.

Today's hearing raises questions about the accounting industry's role in devising and peddling tax shelters, and I hope that it is going to shed some light on the useful things that Congress might do with regard to definitions, disclosure requirements and increased penalties. Clearly though, the primary responsibility for cracking down on abusive tax shelters rests with the accounting profession itself, and I am heartened by the response of some firms, particularly Ernst & Young, to this scandal. But we have a long way to go to fix this mess.

I thank you, Mr. Chairman, for holding the hearing.

Senator COLEMAN. Thank you, Senator Lautenberg.

I would now like to welcome our first panel to today's important hearing. Debra Petersen, tax counsel with the California Franchise Tax Board; Mark Watson, a former partner with KPMG's Washington National Tax Practice; and finally Calvin Johnson of the University of Texas at Austin's School of Law. For the record, let me mention that Mr. Watson is appearing before the Subcommittee this morning under Subcommittee subpoena.

I thank each of you for your attendance at today's hearing and look forward to hearing your testimony.

Before we begin, pursuant to Rule 6, all witnesses who testify before this Subcommittee are required to be sworn. At this time I would ask you to please stand and raise your right hand.

Do you swear that the testimony you are about to give before the Subcommittee will be the truth, the whole truth, and nothing but the truth, so help you, God?

Ms. PETERSEN. I do.

Mr. WATSON. I do.

Mr. JOHNSON. I do.

Senator COLEMAN. I would note that we are using a timing system today. When you see the lights go from green to yellow, yellow means getting close to quitting and red means that it is time to quit. I would like to limit the testimony to 5 minutes, but your entire prepared testimony will become part of the official record.

So with that, Ms. Petersen, we will have you go first this morning, followed by Mr. Watson, and finish up with Mr. Johnson. After we have heard all the testimony, we will turn to questions.

Ms. Petersen, you may proceed.

TESTIMONY OF DEBRA S. PETERSEN,[1] TAX COUNSEL IV, CALIFORNIA FRANCHISE TAX BOARD, RANCHO CORDOVA, CALIFORNIA

Ms. PETERSEN. Thank you, Mr. Chairman. I am testifying today on behalf of Controller Steve Westly and the California Franchise Tax Board. On their behalf, I would like to thank you for this op-

[1] The prepared statement of Ms. Petersen appears in the Appendix on page 275.

portunity to give testimony on some of the most egregious tax scams that we have ever seen.

In recent years the Franchise Tax Board has seen a gross proliferation of abusive tax schemes and tax shelters that have been aggressively marketed to taxpayers. We have been appalled at the positions taken to justify these transactions and schemes. These are designed and sold as tax-saving strategies and are veiled with a limited technical reading of the tax law and a flimsy excuse for a valid business purpose. The transactions are designed to create artificial losses and to make use of losses and deductions a second time.

Based on the GAO's report that you have mentioned, the $85 billion report, we estimate that California's share of that $85 billion is $3.5 billion. So California is very concerned about abusive tax shelters, and we are dedicated to cracking down on tax sheets and abusive tax shelters.

In the words of Controller Steve Westly, "California loses hundreds of millions of State tax dollars each year as a result of these sophisticated tax schemes. This is legitimate tax money owed to the State of California that funds our schools, helps our elderly, and fuels our emergency and transportation services. With a record deficit currently plaguing our State, we are very motivated to pursue these cases."

We have already taken a number of steps to curb the promotion and use of these tax avoidance schemes. First of all, in 1998 we rolled out a computer program system that would help us to trace the flow-through of pass-through entity income to the ultimate person that should be reporting that income.

Then on September 13, 2003, the State of California, along with 33 other States, signed a memorandum of understanding with the Small Business Self-Employed Operating Division of the Internal Revenue Service. We have been, and will continue to cooperate with the Internal Revenue Service in the identification and audit of tax shelters.

In October 2003, the Governor of California signed into legislation a bill that provides for reporting requirements, increases existing penalties, and imposes new penalties for tax shelters. Our new law provides for a voluntary compliance initiative, wherein taxpayers who voluntarily file amended returns and pay the full amount of the tax and interest related to tax shelter benefits claimed on their return can avoid the new and increased penalties. We are hoping that many taxpayers will be wise and take advantage of the voluntary compliance initiative, especially since we plan not to settle tax shelter issues. Our bill was modeled after the Tax Shelter Transparency Act, and we hope that Congress will pass this legislation at the Federal level in the near future.

We also passed legislation that would shut down one of the most egregious tax avoidance scams that we have ever seen. We saw banks form solely-owned registered investment companies for the purpose of paying no State income tax on their earnings on their loan portfolios. Contrary to the spirit and the intent in the Investment Act of 1940, they have registered these companies solely to avoid State income tax. We worked in cooperation with the Securities and Exchange Commission on that issue.

Our Executive Director, Gerald Goldberg, chairs the Corporate Income Tax Shelter Working Group of the Multistate Tax Commission. Some of the goals of the working group is to share information among the States regarding tax shelters and abusive tax transactions, and to develop anti-abuse legislative tools. Apart from the MTC, the State of California has been working directly with several States to coordinate information about State level tax shelters that we have encountered.

While we are pleased with the progress that we have made to identify and close down tax shelters, we think that more needs to be done in order to prevent creative minds from formulating new shelters and schemes that circumvent tax laws. We need to focus more on promoters and tax return preparers who sign tax returns without proper disclosure, and in some cases attempt to bury transactions on tax returns. Imposing penalties, however stiff, is not good enough. The preparers count on the audit lottery. Even disgorgement of the profit made on the transaction is not enough to discourage these practices. If the preparer is caught 1 in 10 times, then 9 out of 10 times they win. So even if they have to pay back $1 million out of $10 million that they earned on the promotion of a shelter, they still come out $9 million ahead. In addition, the firms very often have insurance to cover themselves on these transactions.

Second, we would like to see the registration exemptions be examined to see whether they should be removed for these types of transactions. Requiring registration of the 1933 Act and other acts will provide disclosure of more information about the transactions and will cost the promoter more. The fact that the tax laws required registration under the Investment Act of 1940 in order to conduct the scam that they were trying to do with their loan portfolios enabled us to see that transaction at an early stage, and were able to shut it down.

Senator COLEMAN. Ms. Petersen, I ask if you could summarize here.

Ms. PETERSEN. Sure. We would also like to see some whistleblower statutes to encourage good and honest people to come forward with information that would help us to find these shelters.

Finally, we need to beef up the enforcement agencies. We had one prominent California tax litigator note that the reason that we were seeing so many shelters is that "the enforcer had backed off." Clearly we need to have enforcement activity in order to encourage self-compliance.

Senator COLEMAN. Thank you, Ms. Petersen. Mr. Watson.

TESTIMONY OF MARK T. WATSON,[1] FORMER PARTNER, WASHINGTON NATIONAL TAX PRACTICE, KPMG, LLP, WASHINGTON, DC

Mr. WATSON. Chairman Coleman, Senator Levin, and Members of the Subcommittee, good morning.

My name is Mark Watson. I am here today to provide information to the Subcommittee regarding my experience working at KPMG. In particular, I understand that the Subcommittee wants

[1] The prepared statement of Mr. Watson appears in the Appendix on page 285.

me to address certain tax strategies that were approved and implemented during my tenure at KPMG.

Before answering the Subcommittee's questions, please let me give a brief description of my background and my role at KPMG. I am a graduate of Texas A&M University, where I received a bachelor's degree in finance and a master's degree in tax.

In 1992, I joined KPMG as a staff accountant in their personal financial planning practice, and I was located in the Houston, Texas office. In 1994, I came to Washington on a 2-year rotation in KPMG's Washington National Tax Practice, which was the group responsible for providing technical tax support to KPMG's field offices. In 1996, I moved to KPMG's Dallas Field Office, where I continued to work in the personal financial planning practice. KPMG promoted me to partner in 1997.

I returned to Washington in 1998 as the partner in charge of the Personal Financial Planning Group within the Washington National Tax Practice. I developed significant experience in the areas of individual income tax, fiduciary income tax, and estate and gift taxes, as these were the areas of focus for the Personal Financial Planning Group at that time, and that group provided technical tax support to KPMG's field offices regarding those matters.

Also at around this time, KPMG's Washington National Tax Practice assumed the additional role of participating in the review and analysis of potential tax strategies that were to be sold and marketed to KPMG clients and others.

When I was in the Washington National Tax Practice I reported to Phil Wiesner, who was the partner in charge of that practice at that time. I also reported to Doug Ammerman, who was the partner in charge of KPMG's Personal Financial Planning Practice. During this time the Personal Financial Planning Group of the Washington National Tax Practice was comprised of approximately eight individuals, and I was responsible for supervising those individuals.

In the summer of 2000, KPMG transferred me out of the Washington National Tax Practice on a 2-year overseas assignment. After I completed that overseas assignment, rather than return to a position in the Personal Financial Planning Practice, I decided to leave KPMG. Today, I continue to work in the tax area, focusing on estate planning.

I would now be happy to address any questions that the Subcommittee may have.

Senator COLEMAN. Thank you. Mr. Johnson.

TESTIMONY OF CALVIN H. JOHNSON,[1] ANDREWS & KURTH CENTENNIAL PROFESSOR, THE UNIVERSITY OF TEXAS AT AUSTIN SCHOOL OF LAW, AUSTIN, TEXAS

Mr. JOHNSON. My name is Calvin Johnson, and I teach tax and accounting at the University of Texas in Austin.

My general conclusion is that tax shelters have done real damage to the national tax system. Former IRS Commissioner Charles Rossotti, said that the IRS is losing the war on tax compliance. Some 80 percent of the most sophisticated taxpayers are avoiding

[1] The prepared statement of Mr. Johnson appears in the Appendix on page 286.

their share of tax, he said. And I think that the figures support that assessment. Real or effective tax rates are running at a maximum of 10 percent for corporations and investors, and these are the people that Congress wants to and needs to tax at 35 percent. The tax system is not in healthy shape.

Every day a cadre of well-trained, well-paid, highly-motivated tax professionals have been launching vicious attacks on the tax base, and they have done considerable damage. KPMG charged over $80 million for its BLIPS and SC2 shelters. We can be confident that they destroyed many times that in terms of tax. Uncle Sam seems to be losing the war against tax shelters.

I have two short comments on remedies. The first one is on retroactivity. KPMG sold a shelter called BLIP or Son of Boss, which depended upon the creation of artificial accounting losses by having real liabilities, real economic liabilities assumed, be ignored for tax purposes. The tax law was said to be blind to the assumption. Congress fixed the problem by retroactive amendment of the Internal Revenue Code, and then Treasury fixed the specific problems of BLIPS with a retroactive amendment to the regulations going back for 4 years.

I applaud the retroactive cure. The statute that BLIPS attacked was drafted by the best minds in the country right before the Internal Revenue Code of 1954, spending a lot of time and deliberation on this system. Sometimes a vicious attack like BLIPS opens up a hacker's windows in the best-designed system in the world. Sometimes it does not, but the litigation is required and the long war of litigation prevents full enforcement of the law. Congress has to react by fixing the hole retroactively.

I hope that the Treasury and the Congress will also fix the so-called SC2 shelter retroactively to deny all of KPMG's customers any tax benefits. SC2 creates a second class of stock which sub-S corporations are prohibited to have because it tries to separate the tax on the income from the ownership of the underlying capital. SC2 also separates the tax from the real economic ownership of the income.

Going beyond the specific shelters, I would hope that the IRS and Congress would set up a joint institution to conduct legislative audits. The office would have the duty of fixing the tax law when the shelters have ripped it open. Litigation is a long and ugly process. Far better to cure the rips the shelters have caused by retroactive fixes.

My second comment is on auditor independence. An auditor, a CPA, has to have an attitude of extraordinary skepticism, even hostility, to the firm that it is auditing. Nothing else will satisfy the zealous loyalty to investors and to the capital markets that CPAs must have. In this post-Enron world, CPAs cannot be offering tax shelters or business advice. The CPAs are trying to be both the cop, the FBI Task Force, and also the consigliore to the very same don, to the very family at the very same time, and it does not work. They are not helping the public investors in the capital market.

The remedy is simple. Firms auditing SEC statements need to separate their auditing and advising functions into two unrelated companies by spinoff or sale. In fact, I believe that under current law, the Sarbanes-Oxley Act, accounting committees may not approve for the sale, the purchase of a tax shelter from their auditing CPA. It is a violation of their duty to ensure independence and none of them should ever be approved. I think the auditing committees are going to face personal liability every time they say yes to these under any circumstances.

Thank you very much.

Senator COLEMAN. Thank you very much, Professor Johnson.

Professor Johnson, my first question will be to you. How would you grade Senator Levin's description of BLIPS? [Laughter.]

Mr. JOHNSON. I thought it was superb. This man can come down and teach my class, and bump me for a while.

Senator COLEMAN. Thank you.

Senator LEVIN. I was going to say thanks for asking, but I was not sure what the answer was.

Mr. JOHNSON. I'm on your side.

Senator COLEMAN. Ms. Petersen, in your prepared testimony you talked about BLIPS transactions lacking economic substance. Can you further explain that? What does it mean to lack economic substance?

Ms. PETERSEN. Economic substance has a number of tests that you look at. One is that there are no economic advantages other than the tax savings. The tax benefits outweigh the economic risks and the potential profit, and third, that there's no business purpose separate from the tax consequences. So usually there's just no justifiable business purpose for the transaction other than to reduce taxes, and the transaction usually lacks the potential to generate a profit.

Senator COLEMAN. We focused today on BLIPS and SC2. Clearly though there are a range of these schemes that are out there: COBRA, which was marketed by Ernst & Young; Son of Boss, which was marketed by Pricewaterhouse Coopers. Do they all bear the general characteristics that you testified to today?

Ms. PETERSEN. Yes. In each of those cases you can see where they're trying to create an artificial or non-economic loss, and very often they will use different mechanisms to be able to inflate, in those situations, the basis of a pass-through entity, so that the owner gets a higher basis than they should normally be entitled to without any risks, and then they go and claim that as a loss when they dispose of the——

Senator COLEMAN. So you have it within the industry—first, let us back it up. People made a lot of money in the 1990's.

Ms. PETERSEN. Yes.

Senator COLEMAN. There is a lot of cash out there. And you have within the industry, either a loophole in the law or blinders on the law enforcers. A whole industry is saying, we can come up with ways in which there is very little risk, but an opportunity to write off massive loss. Would that be an accurate assessment?

Ms. PETERSEN. That is correct.

Senator COLEMAN. Aside from holding the tax preparers accountable, how do we prevent this? Many of these firms have come and said, we do not do this any more, they have acknowledged this as headed down the wrong path—but how do we stop this tomorrow? What is it that we need? You talked about a Taxpayer Transparency Act. Would it be your testimony that a Taxpayer Transparency Act are things that we can do to prevent this in the future?

Ms. PETERSEN. Yes, very definitely that would help, but we would also like to see—I think Mr. Johnson may have touched upon this—Sarbanes-Oxley Act, that same concept, extended to tax return preparers, to say, if you're going to sell and market these shelters, then you cannot sign the tax return for the taxpayer investor that's claiming those. You need to send them to another firm. Let another firm take an independent look at the transactions and make the adequate disclosures on there.

We would like to see some sort of a licensing or registration of tax return preparers, because until you are able to take away their ability to do their profession, if you're only looking at penalties, they're going to continue to do what they do as long as economically it makes sense to do that.

And we would like to see the ethical standards raised for tax preparers. Right now they have this idea that as long as it's not illegal or there's nothing that blatantly tells them you cannot do this particular thing, they're going to go ahead and try and take those positions, and so we really need to have them come up on their standards and try to support the whole spirit and the purpose of the laws.

Then we'd like to see publication of a list of opinion providers, whose opinions are really inadequate. Sometimes these opinions mislead the person that they're giving the opinion to, to think that they're going to be able to avoid penalties, when the reality, they're kind of circular. They rely strictly on the taxpayer making representations. And that's how the opinion is given. So we would like to see, as we find these firms that give faulty opinions, to publish that, let the public be put on alert that they can't rely on those opinions issued by those firms.

We also see great abuse with the fee structure. Some of the firms use contingency fees, meaning up front they'll go in and sell the work that they're going to do and say, we'll take a percentage of the benefits that you get derived from that——

Senator COLEMAN. You have any problem with firms marketing SC2? I mean my sense is that with SC2 in particular, they are doing cold calling out there to Subchapter S corporations. You have a concern with that?

Ms. PETERSEN. Yes. You're talking about companies that probably wouldn't otherwise be looking to get in these types of investments, now feeling the pressure that everybody's doing this, that they ought to take advantage of this, and they might not have otherwise thought of this.

Senator COLEMAN. Let me ask you one other question. What is the culpability to the taxpayer in these schemes?

Ms. PETERSEN. Well, the taxpayer is going to have to pay back the amount of tax that they sheltered, that was incorrectly sheltered, and then they're going to also be subject to potential penalties. Right now California probably has stiffer penalties than the Feds do because we enacted our legislation and you haven't enacted that yet.

Senator COLEMAN. But do you absolve them of culpability if they have an opinion from their accounting firm, they have a legal opinion, typically from a law firm in these cases—and we are going to examine that more on Thursday—in spite of that, do they still have culpability?

Ms. PETERSEN. They may, because even though they might try to rely on the opinions, if the opinion is faulty or if it is issued by someone that has promoted that particular shelter, we're going to look at it and say that your reliance is invalid and that you can't do that.

Senator COLEMAN. Mr. Watson, I want to focus a little bit on your knowledge of and involvement in dealing with BLIPS in particular. Did you have a chance to review the BLIPS transactions when this concept was being developed?

Mr. WATSON. Yes, I did.

Senator COLEMAN. Who was responsible? I presume there had to be some discussion, when you were establishing something like BLIPS, somebody had to be saying, well, is it legal? Is it not legal? Can you talk to me how that worked within the firm?

Mr. WATSON. Sure. Perhaps I should just overview the process that we went through to review and approve BLIPS. BLIPS was one of the first tax strategies that was put through KPMG's newly-structured review process, and that new review process was implemented probably in the fall of 1998. The review process involved KPMG's Washington National Tax Office, the Tax Innovation Center, which was recently created, and KPMG's Department of Professional Practice.

The Washington National Tax Office's role was to review, and if possible, approve a tax strategy based on the applicable tax law. So that's where the legal analysis was made.

The Tax Innovation Center was there to really facilitate the review process in the sense of making sure that adequate resources were available and then participating or helping with the development of marketing materials and the deployment of approved strategies.

And finally, the Department of Professional Practice's role was to determine that, if a tax strategy was approved by the Washington National Tax Office, whether the business risks associated with that strategy were appropriate for KPMG to be involved with, and they also made sure that the auditor independence rules were sufficiently addressed.

So that's how we went through the review process. We really had three different groups looking at the various issues, both from a tax standpoint and from a business risk standpoint. And to answer your question, yes, these issues were debated, they were examined at some length. And in fact, the review process with BLIPS officially started on February 11, and after numerous meetings, numerous e-mail messages and hundreds of hours of tax research, it was finally approved around May 10, 1999.

Senator COLEMAN. According to judicial precedent, there must be reasonable opportunity to earn pre-tax profit. Do you believe that the BLIPS transaction allowed for this, and if not, why not?

Mr. WATSON. That was my primary concern with the BLIPS transaction. I was never comfortable that BLIPS provided a reasonable opportunity to make a reasonable pre-tax profit, and I didn't believe that it could make a reasonable pre-tax profit primarily because of what Senator Levin disclosed in his opening statement, that very little of the proceeds were going to be invested in a manner that could generate a sufficient rate of return.

Senator COLEMAN. And you in fact sent out an e-mail raising this issue; is that correct?

Mr. WATSON. Yes, sir, that's correct.

Senator COLEMAN. I have a copy of it. It is Exhibit 80,[1] and if staff could give Mr. Watson a copy. It is an e-mail dated Wednesday, May 5, 1999, 9:21 a.m. In that you say, "According to Presidio, the probability of making a profit from this strategy is remote, possible but remote. Thus, I don't think a client's representation that they thought there was a reasonable opportunity to make a profit is a reasonable representation. If it isn't a reasonable representation, our opinion is worthless."

Can you talk to me about Presidio's role? Did you have an opinion from Presidio as to what they thought of this transaction?

Mr. WATSON. Yes. This e-mail message was the result of a meeting that I attended on April 30 and May 1, 1999, where Presidio, members of Presidio, were present to explain the investment strategy, in essence, to the partners who were going to be selling this transaction.

Senator COLEMAN. Can you explain again Presidio's involvement in the transaction?

Mr. WATSON. Presidio was the investment adviser. They arranged for the investment side of this transaction to take place.

Senator COLEMAN. In the KPMG tax opinion that I have had a chance to review, Presidio represents there is a reasonable opportunity for pre-tax profit. My question is, does this representation seem credible based on the May 5 e-mail?

Mr. WATSON. It did not seem credible to me, no.

Senator COLEMAN. Can you explain how they got there?

Mr. WATSON. Senator, I don't know how they go there on this issue. This was my primary concern and the reason I continually raised the issue with Mr. Wiesner and Mr. Smith, but they decided that this was a reasonable representation and that the opinion letter could be issued.

Senator COLEMAN. I also understand that you were concerned about who was the borrower in the BLIPS transaction and the fact that the bank required the loan to be paid in 60 days. Can you explain the significance of these issues and why you feel they negatively impacted KPMG's ability to issue an opinion to its clients?

Mr. WATSON. Well, the who's the borrower issue really related to whether you could get the basis with respect to the premium, in other words, the $20 million loss that Senator Levin described. We were concerned that the individual taxpayer would not be treated as the true borrower, but rather the investment fund itself would be treated as the true borrower, because the bank really had significant restrictions on the use of the money. It was just really transferred from one account at the bank to another account at the bank in a very short period of time. So we feared that an easy at-

[1] See Exhibit No. 80 which appears in the Appendix on page 664.

tack on this transaction was for the IRS to just argue that the taxpayer never really borrowed the money, and therefore there is no basis for which to claim a loss.

Senator COLEMAN. Were these concerns ever resolved to your satisfaction?

Mr. WATSON. Not to my satisfaction, no, and nor to Mr. Rosenthal's satisfaction, who expressed some significant concerns specifically on who's the borrower issue.

Senator COLEMAN. Two other questions, three questions. Who is Larry DeLap?

Mr. WATSON. Mr. DeLap was the partner in charge of KPMG's Department of Professional Practice for the tax practice at that point in time.

Senator COLEMAN. Do you recall a telephone conversation with Larry DeLap, during which you indicated to him that all of your concerns were resolved regarding the BLIPS transactions?

Mr. WATSON. I don't recall that conversation, Senator. It may very well have taken place, and in fact, I will assume that it took place, but I'm quite certain that I did not tell Mr. DeLap that I was comfortable with the BLIPS transactions or that all my concerns had been resolved, and in fact that's completely inconsistent with the e-mail messages that I wrote both before and after the date of this purported conversation.

Senator COLEMAN. The last question, and we will do another round. Do you consider it unusual for KPMG to go forward with the strategy despite the fact that several technical partners, yourself, apparently Mr. Rosenthal, had significant problems with it, and if so, why do you believe they went forward with it anyway?

Mr. WATSON. Well, I was disappointed with the decision, but again, a lot of people were involved in this review process, a lot of smart partners with significant experience, including Mr. Wiesner, Mr. Smith, Mr. DeLap, and Mr. Eischeid. And so, when they decided that, despite our reservations, despite our concerns, to move forward, there was really nothing left for me to say.

Senator COLEMAN. Senator Levin.

Senator LEVIN. Let me go through some of those e-mails with you. On May 7 and May 10, you and Mr. Rosenthal, that is Steve Rosenthal, met with Mr. Wiesner and Mr. Smith to discuss your concerns. Mr. Wiesner announced apparently at that point that the decision was made to move forward with BLIPS. What took place at those meetings? Did you express your problems with this BLIPS deal?

Mr. WATSON. I recall that we met to discuss my concerns and Mr. Rosenthal's concerns regarding economic substance and who was the borrower. I wouldn't describe the meeting as a substantive conversation, but we did lay out our concerns, and Mr. Smith and Mr. Wiesner did respond with why they thought it was not a problem, cited some cases, which Mr. Rosenthal later researched and replied that he was still not comfortable with the who's the borrower issue.

Senator LEVIN. There are two distinct problems that you had, is that correct? One was who was the borrower.

Mr. WATSON. Correct.

Senator LEVIN. It was your conclusion that there were grave doubts that the borrower here was the taxpayer; is that correct?

Mr. WATSON. I was concerned about that, yes.

Senator LEVIN. When you say you were concerned, you indicated in your e-mails and otherwise, as I understand it, that the borrower here was really effectively the partnership if there was any loan at all. Is that correct?

Mr. WATSON. That's what I was afraid of, yes, that the conclusion would be that the partnership borrowed the money and not the individual taxpayer.

Senator LEVIN. That would be because?

Mr. WATSON. That would be because the bank controlled the funds and the taxpayer actually never received the funds.

Senator LEVIN. There was, in addition to that question—assuming there was a loan, who was the borrower—there was the underlying question of whether or not there was a loan at all. Is that correct?

Mr. WATSON. Yes. That was a concern as well, whether this was truly a bona fide loan.

Senator LEVIN. The reason that you had doubts about that was because?

Mr. WATSON. Again, because of the significant restrictions placed on the loan proceeds.

Senator LEVIN. Would you list those restrictions?

Mr. WATSON. I think you adequately listed it. It was the collateral requirement that was contained in the loan documents that in essence prohibited those loan proceeds from being invested in any manner other than money market type instruments.

Senator LEVIN. The collateral requirement was for how much?

Mr. WATSON. At least 101 percent, if I recall correctly.

Senator LEVIN. Ms. Petersen, let me ask you about both BLIPS and SC2. Before I do that, let me just go back.

Is it fair to say, Mr. Watson, without going through all of the e-mails, that you expressed your problems with BLIPS on a number of occasions in a number of ways to Mr. Wiesner, Mr. Eischeid, and Mr. DeLap?

Mr. WATSON. Yes, sir, it is, numerous times.

Senator LEVIN. Now let me go to Ms. Petersen.

I want to get yours and the other witness's quick assessments of the two tax products that we are focusing on here today, BLIPS and SC2. In your opinion, do these two tax products comply with Federal tax law?

Ms. PETERSEN. No.

Senator LEVIN. Mr. Watson.

Mr. WATSON. I think they comply with a technical reading of Federal tax law, yes. I did not think these were fraudulent transactions. But as to BLIPS I did not believe that it met the standard of more likely than not primarily because of the economic substance issue.

Senator LEVIN. And more likely than not would mean that you did not believe it was more likely than not that they would be sustained in a court?

Mr. WATSON. Correct, that they would be—that the tax results would be sustained by a court of law if challenged by the Internal Revenue Service.

Senator LEVIN. Mr. Johnson, in your judgment were these two tax products in compliance with Federal law?

Mr. JOHNSON. I think the IRS can beat them.

Senator LEVIN. Should they beat them?

Mr. JOHNSON. Oh, absolutely.

Senator LEVIN. If we look at the chart with the three mass marketing quotes on them, I think this is Chart 3. I am sorry, it is Chart 1c.[1] I gave the wrong number.

The first line is from a KPMG e-mail: "Look at the last partner's scorecard. Unlike golf, a low number is not a good thing. A lot of us need to put more revenue on the board." This is talking about tax shelter sales.

Another internal KPMG e-mail: "Sell, sell, sell."

A third KPMG e-mail: "We are dealing with ruthless execution, hand-to-hand combat, blocking and tackling. Whatever the mixed metaphor, let's just do it."

Professor Johnson, what is your reaction to that kind of culture?

Mr. JOHNSON. Certainly not surprise. KPMG's assessment is they're making a lot of fees and that the penalties that will be incurred on them are not high enough going to stop them. Oliver Wendell Holmes said that it's a case of holding in the bad man. You simply can't rely on an ethical role. The penalties of money or maybe a little bit of jail time are the only thing that are going to do it.

Senator LEVIN. Ms. Petersen, what is your reaction to those kind of comments?

Ms. PETERSEN. I think it is just reflective of the greed of the firms, the desire to make as much money at any cost that they possibly can.

Senator LEVIN. I want to get a little more detail from you, Ms. Petersen, about the BLIPS shelter. You testify about it in your written testimony, but you did not get into it in any detail. You did in response to the Chairman's question a bit, and I want to press you a little more on that. In your review of BLIPS, would you go into the question of whether or not there was economic substance in a little more detail than you did to the Chairman's question?

Ms. PETERSEN. I think you described in great detail of how the transaction is put together.

Senator LEVIN. Would you describe it in your words though, whether or not you believe there was economic substance?

Ms. PETERSEN. I don't think there is economic substance to that transaction. Again, the only way that they are creating that loss is not because the investor or the taxpayer was out $20 million, because they borrowed everything. They only got there as a phony paper loss. So they inflated the basis of the partnership or pass-through entity's based and then took that as a loss. It had nothing to do with the amount of money that was invested by the taxpayer.

Senator LEVIN. You have done some examinations, I believe, of the BLIPS transactions; is that correct?

[1] See Exhibit No. 1c. which appears in the Appendix on page 384.

Ms. PETERSEN. I've looked at the BLIPS transaction, yes.

Senator LEVIN. Have you seen any taxpayers who made a profit as an investment? In other words, putting aside the tax benefit here, the tax loss, which was created by this shelter, did you see any taxpayers who made a profit on that small investment portion that they put in?

Ms. PETERSEN. I don't recall. I can tell you that these things were very short-lived and came and went over maybe a 60-day period of time.

Senator LEVIN. Was the loan ever at risk here, the so-called loan ever at risk?

Ms. PETERSEN. Looking at the terms of the loan and the restrictions on that loan, no, I don't think so.

Senator LEVIN. Also looking at the collateral requirement?

Ms. PETERSEN. The collateral requirement, that's right.

Senator LEVIN. Where was that loan? Was that not retained in the bank?

Ms. PETERSEN. I don't know.

Senator LEVIN. Was the loan needed for that small investment that was there? I know it was needed obviously to create the tax loss, but in terms of the small investment portion of this deal?

Ms. PETERSEN. No. It was only there just to create the loss.

Senator LEVIN. It was what?

Ms. PETERSEN. Only there just to create the loss.

Senator LEVIN. Did you have a chance to review the opinions that were issued by KPMG relative to this shelter?

Ms. PETERSEN. Yes, I did.

Senator LEVIN. Based on that review, do you think that the KPMG BLIPS opinion letter was one that a client could gain some assurance from?

Ms. PETERSEN. The difficulty I found with that opinion letter is that it relied very heavily on representations, and in particular on a representation made by the taxpayer, that they had reviewed the economics of the transaction, and they made a statement that they were going to be able to make a profit. But you have to question whether the taxpayers themselves really understood the complexities of these transactions to be able to make that determination. In that opinion, there's about 16 pages discussing economic substance, and the conclusion of it is strictly based on the representation that was made by the taxpayer.

Senator LEVIN. On the SC2, you mentioned in your written testimony that the SC2 opinion letters that you reviewed were "grossly deficient."

Ms. PETERSEN. Yes.

Senator LEVIN. Can you elaborate on that point, to be my final question for this round?

Ms. PETERSEN. Well, the opinion letters that I saw dealt with some of the code sections, but failed to really address any of the tax doctrines that we look at in these cases. So they didn't talk about step transaction. They didn't talk about assignment of income. They didn't talk about those doctrines which is what you have to look at to say, does this thing hang together or not? They didn't address economic substance. They didn't address any of those types of things, just went down through a series of code sections. Well, we can do this here. Here's a case that we think we don't meet the facts of those cases, and we think we're clean on this transaction.

Senator LEVIN. In your judgment were they grossly deficient?

Ms. PETERSEN. Yes.

Senator LEVIN. Thank you. My time is up.

Senator COLEMAN. Thank you, Senator Levin. Senator Lautenberg.

Senator LAUTENBERG. Thanks, Mr. Chairman.

I am a little bit more interested in how we got to where we are because of the criticism I hear from my former colleagues in the corporate world, that the government is complicating life so much and interfering in many ways with their ability to make forecasts, etc., all of which I consider as part of an incredible conspiracy to deceive the public and the government.

I am kind of curious about how were colleagues of yours in the accounting world seduced into cooperating with these deceptions we saw out there? What kind of devices were traditionally used to say, to exchange it for simply a pat on the back as it used to be for a good job? How much of this was affected as a result of the division of the firm into essentially two principal parts, one the auditing side and the other the consulting side?

Mr. WATSON. First, with respect to your question about the auditing and consulting side, I had no involvement with the audit practice so I can't answer what kind of activity was taking place in the audit practice. My experience was solely limited to the tax practice.

With respect to your question about how professionals were seduced, I don't know that professional were seduced, per se. There certainly was a tremendous amount of pressure being applied from the leadership at KPMG to review, and if possible, approve these transactions, because they had tremendous marketplace potential to generate revenue for KPMG. Nonetheless, I feel, at least based on my experience, that, with the exception of economic substance in the case of BLIPS, a thorough review was applied and the professionals did act in a professional manner to reach their conclusion.

Senator LAUTENBERG. Mr. Johnson, do you have any knowledge or observation about what it is, what happened when the accounting firms split their business? Was that then a lead in to sharing the profits more directly, as opposed to simply the audit function which made sure the books were presented honestly? We saw a huge change in character during this period of time, and I am wondering where it went wrong. I did a lot of work for the accounting firms in my former corporate life.

Mr. JOHNSON. I think the bottom is obviously money. There is an awful lot of money to be made by beating the IRS, and the IRS is perceived increasingly as being a paper tiger that doesn't have enough smarts, doesn't have enough ability to stop anything. If the IRS is going to leave millions of dollars hanging around on the table, then I think their perception is all they're doing is going in and picking it up.

There is no question that the accounting firms are now considerably compromised in their independence. They're supposed to be very skeptical about the firms that they're auditing. They are serving the investing public to ensure fair disclosure. I think the country was utterly shocked by Arthur Andersen, the one that had the best reputation of all, to find out that firm was teaching Enron how to make their financial statements absolutely meaningless by guiding them through the elaborate mine field set up by accounting standards to protect investors.

I don't think the accountants understand the degree of righteous anger that investors have against firms like Arthur Andersen. Enron went from the 7th largest company in the country to overnight being absolutely worthless, and all who touched Enron lost their nest eggs, lost their life savings. And Arthur Andersen helped them do it. They were supposed to be the cops. They were supposed to be somebody that you could depend on. They were supposed to be the sign of absolutely moral rectitude, and it turns out that they were co-conspirators. They had been co-opted and captured in full. There is no question that this making a lot of money, giving advice, selling sleazy tax shelters to the client is utterly inconsistent with their cop role, and I think the cop role has been utterly compromised. I think that accountants simply have no business having that business advisory function and the cop function within the same firm. They've got to split up, they've got to spin off or sell. We depend on the accountants' credibly to ensure that we're getting good financial statements, and those people are turning out to eat too many donuts. The cops are eating too many donuts.

Senator LAUTENBERG. There is a lot of slippage here, and it is discouraging and demoralizing for the public. What do they do? They see their pension fund evaporating in front of their eyes, and much of that is caused by this incredible greed culture which has developed in the country, where a CEO comes in and signs a 5-year contract, and is forced emotionally and financially to say, if you do not join in you are kind of maybe stupid. Join in. Get your stock price up. Forget about what the company is going to look like 5 years, 10 years from now, what you turn over to a successor when that happens, because inevitably it does, and the bonuses are in the so many millions that it is hard to conceive that that could be created without permanently damaging the companies, and it has in many instance.

There was a comment made about board members. I predict that one day you will see a class of professional that works exclusively boards, because otherwise you cannot get someone to leave their regular business responsibilities, come over, join in, take a hit if one occurs by permitting something to sneak through, and I think that that cozy cooperation between a board and the CEO or the chairman or whomever makes these recommendations for board memberships is going to find that there are not people around who they can be so proud of to come along and join their boards unless the protections are so high that it alters the thinking function of the board member.

What do we think about expanding, as Ms. Petersen said, the Sarbanes-Oxley Act requirements to the accounting function? Is it a good idea for government to get more involved at this juncture. How do we cure the problem that we have? This is not simply the tax shelters, and that is what I said initially, and that is to make sure that the public is getting a fair shake on the information on the data they receive.

Mr. JOHNSON. I think separating the auditing function and business advising functions is a first step, an absolutely mandated first step, that you can't be simultaneously trying to help and trying to be a cop against an audited firm.

Senator LAUTENBERG. Ms. Petersen, do you have a view?

Ms. PETERSEN. I think I gave my comments, but I think you need to remember that the firms have a tax preparer side, so there's the tax side, there's the auditing side. They may have business consulting. And what we're missing is looking at the tax return preparers, and that's the concern we have, is what are those preparers doing? What are their duties? What are the requirements on them?

Senator LAUTENBERG. What are their opportunities? That is the question, you see.

Ms. PETERSEN. Their opportunities are great.

Senator LAUTENBERG. Yes. The opportunities for deception, there is almost a demand out there to see how clever you can be and avoid paying tax, and I find it irritating. Again, having spent 30 years of my life in the corporate world gives me a little bit different insight, and I believe that if you make it, you pay, and that is the way it ought to be, fairly straightforward. I see the Center for Budget Policy Priorities, a research group, said preliminary tax for this year indicate corporate taxes account for just 7.4 percent of total tax receipts, down from in the 1960's when it was 21 percent of total receipt. I do not say that 21 percent should be the mark we are trying to toe, but there has been far less required of wealth taxpayers now than there perhaps has ever been. It is not fair and deprives us of revenue opportunities.

The fact is that my time has expired. [Laughter.]

Thank you very much.

Senator COLEMAN. Thank you, Senator Lautenberg.

Mr. Watson, I think you indicated in response to Senator Levin's question that you thought the BLIPS was thoroughly reviewed?

Mr. WATSON. With the exception of the economic substance issue, yes.

Senator COLEMAN. I am trying to understand how we get from a thorough review of very bright professionals, where there clearly—I am not an accountant. I did not do too well in math—and as I look at this, I ask where is the substance? Where is the risk? I am trying to understand how we got there. In fact, let me direct this question to Mr. Johnson. I will come back to you, Mr. Watson.

Professor Johnson, is it your sense, Professor, that what you have here is kind of a risk versus benefit kind of analysis. The risk is a buck, the benefit, whether caught or not caught is 10 bucks. So why not do it? Is that your sense?

Mr. JOHNSON. Absolutely. Phil Wiesner is not a rogue elephant. He's not an unusual member of this community. He is core to management. This is a KPMG official decision by the core of management, and it's really unfair to consider this to be an aberration. It's not an aberration. It is a system, people reacting to the system in places in which the penalties are very low, trivial, nonexistent, and the rewards of not paying tax are very high. I'm not sure we should get moralistic. It's just a matter of creating the right system incentives and throwing some people in jail.

Senator COLEMAN. But is this because the law allows it? I mean, again, this is not just KPMG, it is all the firms. Ms. Petersen talked about a variation of these, opportunities for folks to wipe their loss off the books and avoid paying taxes. Is it because the law allows it or because the IRS does not catch it?

Mr. JOHNSON. Well, it's a combination of both. They're finding—they're creating hacker's windows. The tax law looked like it was beautiful and a good safety net, and worked and fully described, and then—these are very highly motivated, very well trained, very well paid professionals who are sitting there in a skunk works full time. The best minds of our generation are now spent in skunk works tax shelters. Sometimes they work, or at least they appear to work.

Senator COLEMAN. What is a skunk works? I am sorry, I missed that.

Mr. JOHNSON. A skunk works is——

Senator COLEMAN. We do not have those where I grew up in Brooklyn.

Mr. JOHNSON. A skunk works is a factory that creates dirty tricks in the middle of war. It's the creative people who figure out how to do nasty things to the Nazis or Commies or the IRS, one or the other its kind of the same view. They are the high-tech people that are going to do a whole bunch of dirty tricks. Sometimes those people win, even against a well-designed tax system.

Sometimes we have to have extensive litigation to fix these. The only justification for litigation is that it's a little bit better than the trial by combat that it replaced. After 10 years of litigation, sometimes the IRS wins. So a lot of it is that they're very creative destroyers, and they succeed in destroying stuff. Then sometimes it's just that the IRS doesn't have as much talent, doesn't have as many resources. Everybody kind of hates the IRS, so they sit there being held back, and they don't compete as well. They don't wake up in the morning with that same sense of viciousness that the skunk works people do. You've got to give the skunk works credit. There are times in which in this war over money the most talented lawyers win it. Is it compliance or is it illegal? The answer is, well, sometimes their schemes are so brilliant they in fact—work. They created a loophole. They really did create it. They won. And you can take it all the way to the Supreme Court and they've still created the loophole.

Senator COLEMAN. One last question. One of your recommendations of action for the Federal Government, allow the government to turn over the suit for damages to aggressive plaintiff lawyers for a reasonable fraction of the return. Can you discuss that?

Mr. JOHNSON. Yes. In fact, the plaintiffs' lawyers are starting to get active in this stuff. They think that there is a breach of contract action. You know, you promised to save me $10 million worth of tax and the IRS caught me, and I want my $10 million from you. And that is kind of a regular contract.

I will say if there is anybody who is as talented, vicious, hard-driving, and smart as the skunk works tax shelter people are, it is the plaintiffs' bar. The plaintiffs' bar are very talented people, and in some sense, if we want our tax enforced, maybe we ought to put talent against talent.

There is a lot of damage that has been done, just pure uncompensated damages to Uncle Sam, to our country, and it seems to me quite ordinary law to say if you have done damage, then you ought to be obligated in a civil court of law to make amends, pay compensation for the damage that you have done. The system works in other areas. I think it might work here.

Senator COLEMAN. Thank you, Professor. Senator Levin.

Senator LEVIN. Thank you. Sometimes these very creative schemes that the skunk works produce are found to be legal. Is that correct? They have created a loophole, as you put it.

Mr. JOHNSON. Yes.

Senator LEVIN. Is it also true that sometimes they are found to be illegal?

Mr. JOHNSON. Yes.

Senator LEVIN. So when you say it is a combination of both, there are some that turn out that will be found not to be illegal, and there are some that will be found to be illegal. Is that accurate?

Mr. JOHNSON. Yes. Jerome Kurtz, who was Commissioner of Internal Revenue Service some years ago, had to define a tax shelter as those that did not comply with the law because the IRS function is to force compliance with the law. But a tax shelter goes way beyond that.

There are a lot of cases in which you rip the fabric apart of a perfectly good system and make it into jelly, make it into Alzheimer's networks or something completely dumb, completely paralyzed, completely open and unable to collect tax. That is why I think you need a legislative audit, a combination of Congress and IRS who can go back and say, no, maybe that was the interpretation, but it is a bad interpretation, that is not what we intended to do. We intended to write a beautiful tax system that worked. The Supreme Court often says the taxpayers should win on an interpretation that is outrageous, and those things need to be fixed retroactively very fast. You need to repair your tax base.

The tax base is sacred. Countries decline and disappear when their taxpayers get in bad shape, and ours is in awful shape and it needs to be defended against this crap.

Senator LEVIN. I could not agree with you more, but also, I think part of that is that some of the tax shelters which have been created are "abusive but found to be illegal." Is that correct?

Mr. JOHNSON. Absolutely. I hope all these get found to be, but, it is——

Senator LEVIN. Found to be illegal?

Mr. JOHNSON. Yes, found to be illegal. But it is still——

Senator LEVIN. All right. Let me now go——

Mr. JOHNSON. It is still up in the air. You know, on some of these you have not decided.

Senator LEVIN. I think they were, and I hope they are found to be.

Now let me go back to Mr. Watson. If you would, would you turn to Exhibit 88?[1] I want to go through this with you.

These are a series of e-mails, and if you look at the one from you to a bunch of folks, Eischeid, Ammerman, relative to BLIPS on May 5, and these two dots—do you see those two dots there? OK. Now, I want to read these to you because it seems to me these are very significant and come to the heart of the matter as to what your reaction was to BLIPS.

"According to Presidio, the probability of making a profit from this strategy is remote, possible but remote. Thus, I don't think a client's representation that they thought there was a reasonable opportunity to make a profit is a reasonable representation. If it isn't a reasonable representation, our opinion letter is worthless."

Now, when you said that, "according to Presidio," that is what Presidio told you at a meeting, which is where you got started really worrying about this BLIPS thing. Is that correct?

Mr. WATSON. Yes, Senator, that's correct.

Senator LEVIN. Because what they told you at that meeting was different than what you had previously understood. Is that correct?

Mr. WATSON. That's correct.

Senator LEVIN. All right. Now, the next dot: "The bank will control via a veto power over Presidio how the 'loan' proceeds are invested. Also, it appears that the bank will require this 'loan' to be repaid in a relatively short period of time, e.g., 60 days, even though it is structured as a 7-year loan. These factors make it difficult for me to conclude that a bona fide loan was ever made. If a bona fide loan was not made, the whole transaction falls apart."

Now, those were your words, right?

Mr. WATSON. Yes, sir.

Senator LEVIN. And in your judgment—you have given us your judgment already here this morning—you had doubts that a bona fide loan was made.

Mr. WATSON. Yes.

Senator LEVIN. And if it was not, this whole transaction, in your words, falls apart. Correct?

Mr. WATSON. It would not produce the tax results desired.

Senator LEVIN. All right. Now, if you were told by—it would not produce it.

Mr. WATSON. It would not produce the desired tax results.

Senator LEVIN. In other words, the IRS would not allow it because it was not consistent with the tax code. Is that another way to say that?

Mr. WATSON. Well, if there was no bona fide loan, then there was never any basis to claim a loss for.

Senator LEVIN. And, therefore, they could not properly claim the deduction.

Mr. WATSON. That's correct.

Senator LEVIN. All right. Now, Presidio told you, as I understand your e-mail, that the probability of making a profit from this strategy is remote, possible but remote. Is that correct?

Mr. WATSON. That's correct.

[1] See Exhibit No. 88 which appears in the Appendix on page 677.

Senator LEVIN. And then when you stated your concerns to the folks that you talked to, they said we are going to get some additional representations from Presidio. Is that correct?

Mr. WATSON. That's correct. This problem was cured through representations.

Senator LEVIN. Just representations, which they obtained from Presidio. Correct?

Mr. WATSON. Correct.

Senator LEVIN. And here is one of the representations that was made to "cure the problem." Presidio has represented to KPMG the following—this is dated December 31, 1999. It is not in the exhibits. "Presidio believed there was a reasonable opportunity for an investor to earn a reasonable pre-tax profit, in excess of all associated fees and costs, and without regard to any tax benefits that may occur." That was exactly the opposite of what Presidio acknowledged to you, wasn't it?

Mr. WATSON. It was, yes.

Senator LEVIN. And yet after you told the folks at KPMG that Presidio told you that, in fact, there was little probability of making a profit, or to put it differently, it was remote, they made a representation that Presidio said the opposite, and this came after you told them what Presidio had told you. Is that correct?

Mr. WATSON. That is correct, yes.

Senator LEVIN. All right. My time is up. I had one more subject.

Senator COLEMAN. Senator Levin, do you want to pursue one more subject?

Senator LEVIN. Just one more quick subject, if I can, and that has to do with the issue of grantor trusts, and this is something of a separate issue.

The Subcommittee has come across some material suggesting that with respect to OPIS and BLIPS, grantor trusts were used to net out gains and losses and to obscure reporting at the individual taxpayer level. Can you explain—well, let's go to Exhibit 10[1] because I think time-wise we are going to have to cut through a little quicker.

In Exhibit 10, you appear to be expressing your views that, with regard to your own analysis of the use of grantor trusts relative to the OPIS transaction, that those grantor trusts, in your words, "Notwithstanding the conclusion reached in the 'grantor trust memo,' I don't think netting at the grantor trust level is a proper reporting position. Further, we have never prepared grantor trust returns in this manner. What will our explanation be when the Service and/or courts ask why we suddenly changed the way we prepared grantor trust return/statements only for certain clients? When you put the OPIS transaction together with this 'stealth' reporting approach, the whole thing stinks."

That is in Exhibit 10. Those are your words?

Mr. WATSON. Yes, sir.

Senator LEVIN. And is that what the firm was doing?

Mr. WATSON. That was my understanding, yes, that the grantor trusts were being used to disguise the OPIS and perhaps the BLIPS transactions.

[1] See Exhibit No. 10 which appears in the Appendix on page 428.

Senator LEVIN. And then you also wrote in January 1999 a memo in which you said the following: "You should all know that I do not agree with the conclusion reached in the attached memo that the capital gains can be netted at the trust level. I believe we are filing misleading, and perhaps false, returns by taking this reporting position."

Was that your position then?

Mr. WATSON. Yes, it was.

Senator LEVIN. Is it your position now?

Mr. WATSON. Yes, it is.

Senator LEVIN. All right. And then, finally, in Mr. Eischeid's memo, which appears at the top of the page, he writes, relative to a conference call, "We concluded that each partner must review the WNT memo"—and WNT stands for Washington——

Mr. WATSON. Washington National Tax.

Senator LEVIN. National Tax, which is part of KPMG, right?

Mr. WATSON. Correct.

Senator LEVIN. ". . . memo and decide for themselves what position to take on their returns—after discussing the various pros and cons with their clients."

Therefore, your conclusion was essentially ignored. Is that correct? It was left up to each of the partners?

Mr. WATSON. Yes, Senator, it was.

Senator LEVIN. Thank you.

Senator COLEMAN. Senator Levin, I am going to follow up with one question just based on that last line of questioning that you had, the issue of grantor trusts here. IRS Notice 2000–44, according to that notice, using a grantor trust is criminal activity?

Mr. WATSON. They threatened criminal penalties in that notice, yes, sir.

Senator COLEMAN. Can you give me a sense of the time sequence of that memo versus your communications here? Did the memo come out before or after?

Mr. WATSON. The notice came out in, I believe, August 2000. These e-mail messages were taking place in January 1999. So this actually related to the OPIS transaction, but the desire was to use that same reporting position with respect to the BLIPS transaction.

Senator COLEMAN. Thank you, Mr. Watson.

This panel is excused. We thank you very much.

I would now like to welcome our second panel to today's hearing: Philip Wiesner, Partner in Charge of KPMG's Washington National Tax Client Services, Washington, DC; Jeffrey Eischeid, a partner in KPMG's Personal Financial Planning Office, Atlanta, Georgia; Richard Lawrence DeLap, a retired National Partner in Charge of KPMG's Department of Professional Practice-Tax, Mountain View, California; and, finally, Larry Manth, the former West Area Partner in Charge for KPMG's Stratecon, Los Angeles, California.

I want to thank you all for your attendance at today's hearing, and I look forward to your testimony. Before we begin, pursuant to Rule VI, all witnesses who testify before the Subcommittee are required to be sworn. At this time, I would ask you to please stand and raise your right hand. Do you swear that the testimony you are about to give before the Subcommittee will be the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. WIESNER. I do.
Mr. EISCHEID. I do.
Mr. DELAP. I do.
Mr. MANTH. I do.

Senator COLEMAN. Again, as I noted with the other panel, we will be using a timing system. I would like you, if you are going to make prepared statements, to limit them to 5 minutes. We will enter your entire written testimony into the record.

Again, I am going to give an opportunity for opening statements, starting with Mr. Wiesner, Mr. Eischeid, Mr. DeLap, and Mr. Manth.

TESTIMONY OF PHILIP WIESNER, PARTNER IN CHARGE, WASHINGTON NATIONAL TAX, CLIENT SERVICES, KPMG, LLP, WASHINGTON, DC

Senator COLEMAN. I understand, Mr. Wiesner, that you will not be making an opening statement?

Mr. WIESNER. That is correct, Senator.

Senator COLEMAN. Mr. Eischeid.

TESTIMONY OF JEFFREY EISCHEID,[1] PARTNER, PERSONAL FINANCIAL PLANNING, KPMG LLP, ATLANTA, GEORGIA

Mr. EISCHEID. Mr. Chairman and Members of the Subcommittee, on behalf of KPMG there are four main points that I would like to call to your attention:

One, the tax strategies being discussed today represent an earlier time at KPMG and a far different regulatory and marketplace environment. None of the strategies—nor anything like these tax strategies—is currently being presented to clients by KPMG.

Today, KPMG advises our clients on the enormous range of potential outcomes under the tax laws and how to achieve the best outcomes in their individual cases. We have provided the Subcommittee with materials that describe hundreds of these approaches. None of these are aggressive tax strategies like FLIP, OPIS, BLIPS, and SC2.

Two, the strategies presented to our clients in the past were complex and technical, but were also consistent with the laws in place at the time, which were also extremely complicated.

Three, the strategies did undergo an intensive and thorough review, a process that resulted in vigorous, sometimes even heated, debate.

Four, KPMG understands that the regulatory environment and marketplace conditions have changed. This has led to significant changes within KPMG over the past 3 years.

We would like to elaborate on each of these points.

First, the tax strategies under review were all presented under regulatory and marketplace conditions that do not now exist. Today, KPMG does not present any aggressive tax strategies specifically designed to be sold to multiple clients, like FLIP, OPIS, BLIPS, and SC2.

These strategies were presented at a time when the U.S. economic boom was creating unprecedented individual wealth and a

[1] The prepared statement of Mr. Eischeid appears in the Appendix on page 298.

demand for tax advice aimed at achieving tax savings. All major accounting firms, including KPMG, as well as prominent law firms, investment advisers, and financial institutions gave tax advice, including presenting these types of tax strategies to clients.

In KPMG's case, other firms often provided investment advisory and other non-tax services in connection with these transactions. All of these relationships were consistent with KPMG's legal and professional requirements.

Second, it is true that these strategies were complicated and that the tax consequences turned on careful and detailed analyses of highly technical tax laws, regulations, rulings, and court opinions. But all of these tax strategies were consistent with the laws in place at the time.

It is important to note that no court has found them to be inconsistent with the tax laws. In some cases, the IRS has agreed that taxpayers should be allowed to retain a portion of the tax benefits they claimed as a result of implementing a strategy.

For all of the strategies being reviewed by the Subcommittee, KPMG provided our clients with a "more likely than not" opinion as to their tax consequences. In other words, we informed our clients that, based on the facts and actions they took, they would have a "more likely than not"—or a greater than 50 percent—chance of prevailing if the IRS challenged the transaction.

The tax laws are complicated and often ambiguous and unsettled. As a result, KPMG's opinions regarding these tax strategies were long, detailed, and technical. Our clients were told that, in addition to a possible tax benefit, the law required a transaction to have a business purpose, profit, charitable, or other non-tax motive. They were required to provide us with representations to that effect. Our clients were sophisticated and typically had their own attorneys, accountants, and investment advisers. Throughout the process, KPMG made it very clear to clients that they were undertaking complex transactions on which the law was ambiguous and often had not been clarified by either the IRS or the courts.

Our third point is that because we understood that these tax strategies might be subject to an IRS challenge, KPMG put them through a rigorous review process before they were approved for presentation to multiple clients. The tax strategies also underwent very careful analysis of the IRS requirement for registering tax shelters in effect at the time.

Many tax partners with different areas of expertise participated in the review process. That, combined with the fact that we were dealing with a "more likely than not" opinion, is the reason there was a lively and often lengthy debate among partners over the interpretation and application of tax laws, regulations, rulings, and opinions. Many of the materials provided to the Subcommittee document this internal debate.

Finally, KPMG has changed. We learned a number of important lessons from our previous tax policies and practices. As a result, KPMG has made substantial improvements and changes in our practices, policies, and procedures over the past several years. My colleague, Richard Smith, will describe these in greater detail.

In the practice I head, Personal Financial Planning, we have shifted our approach from one focused on taking solutions to clients to one that works with clients to address their individual situations. This is consistent with KPMG's current leadership philosophy and more conservative approach to the tax service practice.

We understand that simply being technically correct is not enough. We know we need to respond better to the continuing changes in the tax laws and regulations and the needs of our clients. We also need to ensure that no action taken will call into question the integrity, reliability, and credibility of KPMG.

Thank you.

Senator COLEMAN. Thank you, Mr. Eischeid.

TESTIMONY OF RICHARD LAWRENCE DELAP, RETIRED NATIONAL PARTNER IN CHARGE, DEPARTMENT OF PROFESSIONAL PRACTICE-TAX, KPMG LLP, MOUNTAIN VIEW, CALIFORNIA

Senator COLEMAN. Mr. DeLap, I understand that you will not be making a prepared statement.

Mr. DELAP. That is correct.

Senator COLEMAN. Thank you. Mr. Manth.

TESTIMONY OF LARRY MANTH, FORMER WEST AREA PARTNER IN CHARGE, STRATECON, KPMG LLP, LOS ANGELES, CALIFORNIA

Mr. MANTH. Mr. Chairman and Members of the Subcommittee, I had not planned to make a statement at today's hearing, but simply to appear here to answer the Subcommittee's questions regarding a tax strategy known as SC2, a tax strategy for which I was primarily responsible during a portion of my time as a partner there. But I have seen some press articles on today's hearing, and I note that they contain some misstatements about SC2. I wanted to take this opportunity to set the record straight, and I appreciate the Subcommittee allowing me to do so.

First and foremost, there is no question that there was a real donation of S corporation stock to a tax-exempt organization. The tax-exempt organizations involved received real and quantifiable benefits from these donations. Tax-exempts that redeemed their S corporation stock have received literally millions of dollars in cash which have directly benefited thousands of police and fire fighters. Almost all the press reports state that under SC2, the charity sells back its shares to the S corporation for fair market value. This is true. But it doesn't tell the whole story.

One key element of SC2 is that the charity does not, in fact, have any obligation to sell the shares back to the S corporation. A number of tax-exempt organizations have not redeemed their shares after 2 years. Some are actually seeking a better valuation or waiting for a greater return from their stock at some future point. Basically, the charity controls the stock and does not have to sell it back to the S corporation.

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

Some articles reported that S corporations that implemented SC2 passed resolutions to limit or suspend dividends or other distributions to shareholders, basically to keep the charity from getting any share of earnings. So far as I know, a resolution limiting or suspending distributions was not an element of SC2. In fact, KPMG recommended that S corporations make distributions during the period tax-exempts held their stock. Such payments made the S corporation stock even more attractive to the charity, while still allowing substantially more income to be reinvested in the S corporation than before the stock was donated to the charity. There are tax-exempt organizations that have received hundreds of thousands of dollars in distribution income while they were holding S corporation stock.

Finally, some articles referred to pledges that individual S corporations made to guarantee that charities would receive at least the original value of their stock at the time it was redeemed. It was my experience that some SC2 transactions involved such a pledge, but that in most transactions, no pledge was offered or even requested.

Essentially, SC2 was a strategy that involved a gift to a charity, a tax-free build-up of income, and a deferral of income so that it could be subject to capital gains tax in the future. This is virtually identical to another tax strategy that is still widely available to taxpayers. It is called the charitable remainder trust, and Congress wrote it into the tax laws many years ago so that it is not only legal but encouraged by law.

I note this because, along with all the factors I have described, it further supports KPMG's position that SC2 was consistent with the law and regulations governing charitable giving and S corporations. Thank you.

Senator COLEMAN. Thank you, Mr. Manth.

Mr. Manth, let me just follow up as I recall listening to Senator Levin's testimony and talking about distribution of income. I believe his testimony was that there was not distribution of income. This was one of the concerns. And your testimony is to the contrary.

Do you know—and I do not have the information in front of me. Is there a percentage of the times in which there was distribution versus non-distribution?

Mr. MANTH. I don't know. We recommended that the S corporations make dividend distributions.

Senator COLEMAN. Do you have any information as to whether, in fact, that was practiced?

Mr. MANTH. I know it was done, but I don't have that in front of me.

Senator COLEMAN. OK. Can I ask you about registration of this product with the IRS as a tax shelter? Do you know whether it was registered?

Mr. MANTH. I do not believe it was registered.

Senator COLEMAN. Can you help me understand that? I think that is one of the concerns here about not registering. It would appear to me obviously if you register something and the IRS knows it is there, they have got a better shot at taking a look. Here it is not registered. Can you talk to me, tell me the reason for that?

Mr. MANTH. Well, I have been out of the business for a while, and my recollection in the registration there are two types of registrations. There was what we referred to as the old 6111(c) registration, which was really if there were significant deductions created in excess of an investment, then you would have to register. And then there were the new regulations that came out on registration, and I believe that a thorough review of registering SC2 was done on both. And it was concluded that it was not a registerable transaction.

Senator COLEMAN. And I would ask any of the individuals from KPMG about BLIPS. Was that registered?

Mr. EISCHEID. No, sir, it was not.

Senator COLEMAN. And as a result of not registering, I would take it, then, the IRS would not know if an individual taxpayer had gotten a certain amount of gain, if they had made a lot of money on some business transactions.

My sense with BLIPS is that, in fact, by setting BLIPS up, the IRS would not know that information.

Mr. EISCHEID. Senator, that is not my impression or understanding; that, in general, and specifically with respect to BLIPS, the taxpayers would report on their income tax returns their taxable income, including the income from sales of stock or the businesses that they owned as well as the tax effects of the BLIPS investment transaction that they entered into.

Senator COLEMAN. Mr. Wiesner, were you in charge of resolving the issues associated with economic substance?

Mr. WIESNER. Yes, Senator, I was.

Senator COLEMAN. And then did you ultimately approve the BLIPS transaction despite the concerns raised by Mr. Watson and perhaps others?

Mr. WIESNER. Yes, Senator, I did. It was after about a 5-month review process in which we very intensively reviewed every issue that our whole team of professionals would raise with respect to the transaction.

Senator COLEMAN. One of the things, though, that concerns me here regards the exchanges between Watson and Presidio and then the ultimate opinion by Presidio, which seems to contradict an earlier representation.

Did Mr. Watson ever inform you that he had met with Presidio and that they had indicated to him the chance of making a profit from a BLIPS transaction was—I think his words were "possible but remote"?

Mr. WIESNER. Yes, Senator, I believe—I don't know if he sent me the e-mail or just informed me about it. But when he did, we would have looked further into the issue and examined it in greater detail in order to make ourselves comfortable that, in fact, there was an economic profit potential in the transaction.

Senator COLEMAN. And then Presidio comes back—and Senator Levin went into this in a little more detail—with a representation saying that there was a reasonable opportunity to earn a pre-tax profit. Is that correct?

Mr. WIESNER. Yes, sir, that's correct. When they came—after we had met with Presidio and gotten comfortable with additional information that we could then rely upon their representation.

Senator COLEMAN. What kind of additional information did they give you to reverse their sense about the possibility of pre-tax profit?

Mr. WIESNER. Senator, at this point I do not have a specific recollection of it. I don't know if Mr. Eischeid has a more specific recollection.

Mr. EISCHEID. Senator, actually, in terms of the referenced meeting, I believe Mr. Watson spoke to April 30 and perhaps May 1, I was physically present at that meeting, and I came away with a distinctly different impression with respect to the investment program outlined by the Presidio investment advisory firm. And it was not that the possibility of obtaining a profit from entering into those transactions was remote.

Senator COLEMAN. BLIPS was at least represented as a 7-year investment strategy, marketed as such. I understand that all 66 deals in 1999 closed after the first phase of 60 days, and few of the other remaining deals actually transitioned to stage two. Can you help me understand how you market something as a 7-year strategy and yet all the transactions close out in the 60 days?

Mr. EISCHEID. I think, Senator, as Presidio articulated the investment program, it was a multi-stage investment that took on varying degrees of risk as the strategy matured and progressed. And at any point in time, the investors had a choice as whether to contribute additional equity to the investment program and to continue their investments in these foreign currencies and the like. And certainly one of the considerations that those investors undertook was what was going to be the income tax consequences of their adoption of this investment strategy, and, importantly, as was discussed earlier, what would be the consequences that were anticipated when they terminated their investment in this strategic investment fund.

Senator COLEMAN. We had a 15-minute vote posted. What I am going to do, Senator Levin, is I am going to finish my questioning in just a couple of minutes, and then we will adjourn the hearing and come back after the vote. The other possibility is I could finish my questioning quickly, go vote, you continue, and I will come back. Do you want to keep it going?

Senator LEVIN. Are there two votes or one, do we know?

Senator COLEMAN. Could we check to see whether there are two votes or one?

We touched upon, Mr. Eischeid, the concept of netting at the grantor trust level, and it was just touched upon by Mr. Watson at the end. Has KPMG engaged in transactions with clients or provided the clients with the option of netting?

Mr. EISCHEID. The netting issue was, I think, discussed at some length within KPMG, and there was, as you can tell from some of the documentation, a rigorous debate and disparate views expressed. And from that documentation, you can see that my primary objective was to make sure that our professionals were not doing something that I would term wrong, that proper reporting was occurring.

When it comes to that type of tax return preparation issue, historically our firm has approached that with respect to relying on our partners, the individual tax return preparers, to analyze the law and to make the proper determination with respect to the returns that they are preparing to ensure that they are complete and accurate.

Senator COLEMAN. Exhibit 38,[1] Are you the author of a memo labeled "PFP Practice Reorganization, Innovative Strategies Business Plan"? Can we show the witness a copy of the memos? I just want to know if you are the author. The piece that I have, it talks about history, and in the last paragraph, the fiscal 2001 IS revenue goal was $38 million, the practice is to have $16 million through period ten, the shortfall from plan is primarily attributed to the August 2000 issuance of Notice 2000–44. This notice specifically described both the retired BLIPS strategy and the current SOS strategy. Accordingly, we made the business decision to stop implementation of SOS transactions and stay out of the loss generator business for an appropriate period of time. In addition, there is no word that the softening in the overall economy, e.g., the decline in new IPOs, the devaluation of technology stock valuations, adversely affected our ability to broadly sell our modernization tax advisory services suite of solutions.

Do you recall whether you—is that your memo?

Mr. EISCHEID. I believe that it was, Senator. It was a draft that I put together as I was contemplating what business plan that I would put forth for the innovative solutions practice.

Senator COLEMAN. Let me see if I can kind of sum up the environment, because you talk about that in your statement. There was a lot of cash being generated and a lot of profit in the 1990's, and I take it that you are out there, and Ernst & Young and Pricewaterhouse, and everybody is out there and coming up with, "creative solutions in which folks who are generating profits, it would mean they pay taxes on that, can minimize their tax liability." A fair statement?

Mr. EISCHEID. Yes, Senator, I think that our profession was actively engaged in reviewing and evaluating and creating what we termed solutions or strategies to help our clients minimize their tax liability.

Senator COLEMAN. And there is nothing illegal about helping folks minimize their tax liability.

Mr. EISCHEID. Correct.

Senator COLEMAN. But help me understand. As I listened to Senator Levin's description of BLIPS and listened to the witnesses, it does not seem to be economic substance in there. There does not seem to be much at risk. And so help me understand how, with all this rigorous review, you in effect have these transactions in which there is no real risk, there is very limited potential to make real profit, and folks have the capacity to write off $20 million, $30 mil-

[1] See Exhibit No. 38 which appears in the Appendix on page 528.

lion, or $40 million. Help me understand how it got to that place and why folks think it is OK or thought it was OK.

Mr. EISCHEID. Well, Senator, I think that, first of all, we are talking about a period that was several years ago, and we are talking about transactions that are admittedly, quite aggressive in terms of the application of the tax laws. I think that our firm, myself included, believed that those transactions were legal and that they met the literal requirement of the Internal Revenue Code and the regulations and so forth.

I will tell you here today that our firm would not approve that type of transaction to be introduced to our clients, that we have made the determination that it is too close to the line, so to speak, as to what is more likely than not ultimately going to prevail once it is judicially determined.

Senator COLEMAN. Thank you.

We have a vote. What I am going to do is I am going to adjourn the hearing for approximately 10 minutes until the return of Senator Levin. He will then continue his questioning. There are two stacked votes. I will not be back for that since I will do the second vote, too, but then I will come back.

The hearing then will stand adjourned for approximately 10 minutes until the return of Senator Levin.

[Recess.]

Senator LEVIN [presiding]. We are going to proceed now, and Senator Coleman will be back a little later. There is a second vote going on, and he is going to wait there for the second vote to begin.

Let me start with you, Mr. Eischeid. Three of the four products that we are looking at—FLIP, OPIS, and BLIPS—operate in a similar way, and my question to you is this: Isn't it the case that all of these are primarily tax-reduction strategies that have financial transactions tied to them to give them a colorable business purpose?

Mr. EISCHEID. Senator, I am not sure that that would be how I would characterize those transactions. I certainly viewed them as investment strategies that certainly had a significant income tax component to them.

Senator LEVIN. My question to you, though, is: Are these not primarily tax-reduction strategies?

Mr. EISCHEID. I think you would have to speak to each individual taxpayer to ascertain their primary purpose for entering into the transaction, and I think you would get different answers, depending on which taxpayer that you spoke to. I suppose I would also just simply point out that, not to get overly technical, but primarily it tends to be a term of art in sort of the tax professional world that is very difficult, frankly, to pin down.

Senator LEVIN. Is it not the case that these were designed and marketed primarily as tax-reduction strategies?

Mr. EISCHEID. Senator, I would not agree with that characterization.

Senator LEVIN. All right. Now, let's look at what other parties involved in transactions said about that issue. If you look at Exhibit

1d.,[1] this is a compendium of how other parties involved in these shelters characterized them, and it is pretty clear what the consensus is here.

First is a UBS Bank memo regarding FLIP. "The principal design of this scheme is to generate significant capital losses for U.S. taxpayers which can then be used to offset capital gains which would otherwise be subject to tax."

Then there is the memo of one of the investment advisory firms involved in FLIP, which was Quadra: "KPMG approached us as to whether we could effect the security trades necessary to achieve the desired tax results. The tax opportunity created is extremely complex."

Then at First Union, now Wachovia, regarding FLIP: "Target customers. Who are the target customers? Capital gain of $20 million or more. Potential benefits: Individual capital gain elimination." You do not see anything in there about investment, do you?

And then you have got an HVB employee—HVB is a German bank—regarding BLIPS: "Seven percent is the fee equity paid by investors for tax sheltering." That is the way that particular bank employee looked at it.

And then you look at a Deutsche Bank internal memo: "It is imperative that the transaction be wound up due to the fact that the high-net-worth individual will not receive his or her capital loss or tax benefit until the transaction is wound up."

Now, do you still claim that these tax strategies were primarily investment strategies and not tax-reduction strategies? Is that your testimony under oath here that they were not designed primarily as tax-reduction strategies?

Mr. EISCHEID. Senator, my testimony is that these were investment strategies that were presented to individual taxpayers that had tax attributes that those investors found attractive.

Senator LEVIN. Well, let me ask my question again, then. Is it your testimony that these were not designed and marketed primarily as tax-reduction strategies?

Mr. EISCHEID. Senator——

Senator LEVIN. I am talking now about designing and marketing. Were these designed and marketed primarily as tax-reduction strategies?

Mr. EISCHEID. Senator, I can't speak to any and all of the marketing activities. You know, for example, you read——

Senator LEVIN. Well, just speak to what you know.

Mr. EISCHEID. Thank you——

Senator LEVIN. From what you know, were these designed and marketed primarily as tax-reduction strategies?

Mr. EISCHEID. And what I know is that they were not, that I personally had a number of conversations with clients and prospective clients, and they were always characterized as investment transactions with a significant pre-tax economic purpose that was embedded in the overall transaction.

[1] See Exhibit No. 1d. which appears in the Appendix on page 385.

Senator LEVIN. All right. Now, look at what the professionals at KPMG said about the purpose of the transactions. Take a look at Exhibit 32.[1]

When KPMG and the financial advisory firm Quadra pitched FLIP to that UBS Bank, this is how the product was presented. Here is the title: "Generating Capital Losses." That is the title of the presentation.

If this is an investment strategy, why does KPMG describe it and pitch it to potential partners as a product designed to generate capital losses?

Mr. EISCHEID. Senator, I don't believe I've ever seen this document before.

Senator LEVIN. Well, now that you look at it, can you give me an explanation?

Mr. EISCHEID. I don't know what purpose this document might have been used for.

Senator LEVIN. This was the pitch of FLIP to a potential partner bank, UBS.

Mr. EISCHEID. OK.

Senator LEVIN. That is the purpose.

Mr. EISCHEID. I'll accept your statement, sir. I have no——

Senator LEVIN. Now that you know, can you explain why it is characterized the way it is?

Mr. EISCHEID. No, sir, I cannot explain why someone used that phrase, sir.

Senator LEVIN. All right. Now let's look at the strategy that you were involved with, Exhibit 41.[1] This is the presentation of BLIPS prepared by Carol Warley. Do you know who she is?

Mr. EISCHEID. Yes, Senator.

Senator LEVIN. All right. She is the BLIPS regional deployment champion, is she not? Or was she not?

Mr. EISCHEID. I don't remember her being the regional deployment champion, but she may have been, yes.

Senator LEVIN. She was intimately involved with BLIPS?

Mr. EISCHEID. Yes, Senator.

Senator LEVIN. Now, look at the chart on page 4 of that exhibit, if you would.

"BLIPS Benefit: Avoid all of the capital gains and ordinary income tax. Net benefit to client—effective tax rate less after tax cost of transaction of approximately 5 percent."

Are you familiar with that?

Mr. EISCHEID. No, Senator, I'm not.

Senator LEVIN. Well, this is BLIPS. You were intimately involved with BLIPS, weren't you?

Mr. EISCHEID. Yes.

Senator LEVIN. Well, this is your document, isn't it? This is a KPMG document.

Mr. EISCHEID. It appears to be a document prepared by Carol Warley, yes, sir.

Senator LEVIN. She works for KPMG?

Mr. EISCHEID. Yes, she does.

[1] See Exhibit No. 32 which appears in the Appendix on page 505.
[1] See Exhibit No. 41 which appears in the Appendix on page 536.

Senator LEVIN. Was she wrong? Was she wrong that was the purpose of BLIPS? That is the only purpose stated: Avoid all of the capital gains and ordinary income tax. Do you see anything there about this investment you made reference to?

Mr. EISCHEID. Senator, I have no knowledge of what Carol Warley was trying to communicate——

Senator LEVIN. Have you ever seen that document before?

Mr. EISCHEID. No, I have not.

Senator LEVIN. Is this a KPMG document? Do you know that much?

Mr. EISCHEID. It appears to be, yes, Senator.

Senator LEVIN. All right. But you don't—you think that is inaccurate, that statement?

Mr. EISCHEID. If the statement is that that is the sole benefit of BLIPS, then, yes, Senator, I would say that is inaccurate.

Senator LEVIN. Does BLIPS avoid all of the capital gains and ordinary income tax? Is that a benefit of BLIPS?

Mr. EISCHEID. A potential benefit of BLIPS, sir, would be the reduction of one's income tax liabilities, yes, Senator.

Senator LEVIN. Well, is this accurately stated that a BLIPS benefit is to avoid all of the capital gains and ordinary income tax? Is that accurate or not? It is a KPMG document. Is it an accurate statement or not?

Mr. EISCHEID. When you say a KPMG document, it certainly appears to be—to have been prepared by a KPMG professional——

Senator LEVIN. It says here KPMG 0049642, proprietary material, confidentiality requested. Are you denying this is a KPMG document?

Mr. EISCHEID. Senator, at least in terms of your reference, I think that's an indication that it is a document that KPMG produced, and as you indicated, the cover seems to indicate that it was prepared by Carol Warley. I have no indication as to what purpose she might have intended to use this document for. It does not appear to me, at least on cursory review, that it would have been prepared for use in a discussion with a client of KPMG.

Senator LEVIN. Take a look at Exhibit 18.[1]

Now, this is a document that you signed, and this says, "A number of people are looking at doing BLIPS transactions to generate Y2K losses." That refers to year 2000 losses. Are you familiar with that document?

Mr. EISCHEID. Yes, Senator.

Senator LEVIN. Is that accurate?

Mr. EISCHEID. I believe it was.

Senator LEVIN. "We currently have bank capacity to have $1 billion of loans outstanding at 12/31/99. This translates into approximately $400 million of premium. This tranche will be implemented on a first-come, first-served basis until we fill capacity. Get your signed engagement letters in!!"

Are those your words?

Mr. EISCHEID. I believe they were, yes, sir.

[1] See Exhibit No. 18 which appears in the Appendix on page 459.

Senator LEVIN. And then take a look at Exhibit 16.[2] This is from you to Michael Comer. It says here at the top, look at the last line in that first paragraph, "Innovative Strategies is a portfolio of value-added products that are designed to mitigate an individual's income tax as well as estate and gift tax burdens. BLIPS is just one of the products in the innovative Strategies portfolio."

So BLIPS, according to your memo, was "designed to mitigate an individual's income tax as well as estate and gift tax burdens." Is that true? Was that true when you wrote it?

Mr. EISCHEID. Yes, sir, I believe that one of the attributes of the BLIPS strategy was the income tax mitigation.

Senator LEVIN. Well, I know you are trying to make it one of the attributes, but in your words, it was that this was a product "designed to mitigate." Was BLIPS designed to mitigate an individual's income tax and estate and gift tax burdens? Yes or no.

Mr. EISCHEID. Senator, as I previously testified, I think that is one of the attributes that was designed into the strategy, both the income tax consequences as well as, as we've heard previous testimony on, the economic investment attribute.

Senator LEVIN. Do you see anything about investment attributes in your memo here as to what it was designed to do? Now, you can't blame this on Carol Warley. She wrote the other thing. You said, well, you are not familiar with that KPMG document, but this one you are familiar with. And here you are saying it was "designed to mitigate." My question is: Do you see any reference here to investment strategy on that memo of yours?

Mr. EISCHEID. No, Senator, I don't. I think that you are somewhat reading "designed" out of context.

Senator LEVIN. Give me the whole context.

Mr. EISCHEID. Well, I think my intention here was to reference the innovative strategies in general as a portfolio of value-added products——

Senator LEVIN. Which are? Keep finishing the sentence.

Mr. EISCHEID. In the aggregate, in general, are designed to help mitigate an individual's income as well as estate and gift tax burdens. So that the——

Senator LEVIN. That is the purpose——

Mr. EISCHEID [continuing]. Entire portfolio and the purpose of that portfolio was to aggregate in a sense in a place a number of different strategies that taxpayers might be interested in discussing that have some significant income tax consequence associated with them.

Senator LEVIN. When it says BLIPS is one of the products in that portfolio, now look at the context. Is there any doubt in your mind that it is, according to that previous sentence, therefore, a value-added product designed to mitigate an individual's income tax as well as estate and gift tax burden?

Mr. EISCHEID. Senator, I don't know how to change my answer to——

Senator LEVIN. Well, try an honest answer. Just give me a direct answer to this. You are making a reference here to a portfolio whose purpose is to mitigate on individual's taxes. That is what

[2] See Exhibit No. 16 which appears in the Appendix on page 453.

your own memo says—the other ones you said you weren't familiar with. They were all KPMG stuff, but you are not familiar with that. Now it is yours. You are Jeff. Now, how do you avoid looking that straight on and saying, I did say that, BLIPS is a product designed to mitigate an individual's income tax because it is part of Innovative Strategies portfolio?" Why not just give us a straightforward answer?

Mr. EISCHEID. I'm trying my best, sir.

Senator LEVIN. Why isn't that the straightforward answer?

Mr. EISCHEID. I think the straightforward answer is that that was one of the attributes of the BLIPS products——

Senator LEVIN. One of the attributes.

Mr. EISCHEID [continuing]. And that we certainly recognized that and that was one of the factors that our clients were quite interested in.

Senator LEVIN. Take a look at Exhibit 16—well, let me just ask you about the fees. How were the fees priced for BLIPS? What fee did you charge your customers?

Mr. EISCHEID. Our fees would vary depending on the circumstances. We would negotiate a fee with our clients, determine an amount, and put that in——

Senator LEVIN. Wasn't it based on the tax loss?

Mr. EISCHEID. I don't believe that we looked at our fee in that way, no, Senator.

Senator LEVIN. Take a look at Exhibit 16,[1] near the bottom. BLIPS contact, you are the contact here, too. Here is the fee. "BLIPS is priced on a fixed-fee basis which should approximate 1.25 percent of the tax loss." Are those your words?

Mr. EISCHEID. Well, my only hesitation is really to try and refresh my recollection with respect to this e-mail. It very well may have been my words. I don't recall writing that.

Senator LEVIN. Is it true?

Mr. EISCHEID. That would not be my view or my testimony, sir.

Senator LEVIN. It is not your testimony. That is the whole point. Was it true or not? Was BLIPS priced on a fixed-fee basis approximating 1.25 percent of the net tax loss?

Mr. EISCHEID. In a very indirect way, yes, sir. The fee that we would typically use as the starting point of our negotiation we developed a shorthand around, which we used as 1.25 percent of what we referred to as the loan premium amount. And as you indicated earlier, that loan premium amount translated into tax basis for the investor.

Senator LEVIN. And that was the intent, was it not, of that premium?

Mr. EISCHEID. I'm sorry. I don't understand the question, sir.

Senator LEVIN. Was that the intent of the premium, to be approximately the net tax loss that the investor would gain from this whole transaction?

Mr. EISCHEID. We believed that that was the appropriate tax treatment of that loan premium, yes, sir.

Senator LEVIN. Was that the tax loss which you told taxpayers that they could expect, approximately, from this transaction?

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[1] See Exhibit No. 16 which appears in the Appendix on page 453.

Mr. EISCHEID. We generally told taxpayers, I believe, that the tax treatment of that loan premium, whatever that amount would be, should translate into tax basis for them, yes, sir.

Senator LEVIN. Tax basis which would be then deducted from any capital gain or income that they had?

Mr. EISCHEID. Depending on what ultimately happened with that tax basis, yes.

Senator LEVIN. Was it the intent to be something which would be a deduction from their income?

Mr. EISCHEID. I think the answer would generally be yes, that the taxpayers would anticipate using that tax basis at some point in time and reflecting that on their income tax.

Senator LEVIN. They were so informed of that, were they not?

Mr. EISCHEID. Yes, sir. I mean I believe they were informed as to the tax consequences of their participation in the BLIPS investment program.

Senator LEVIN. My time is up. Thank you.

Senator COLEMAN. Mr. DeLap, because you did not give an opening statement, I just want to do a little background here. Can you tell us what position you held at KPMG during the period that FLIPS, BLIPS, OPIS and SC2 strategies were being developed and marketed?

Mr. DELAP. In February 1997, I became a partner in charge of a newly-created Department of Professional Practice Tax, and I held that position until June 30, 2002, at which time I turned it over to my successor, and then I retired from the firm on September 15, 2002.

Senator COLEMAN. Could you tell us what your responsibilities entailed?

Mr. DELAP. The responsibilities generally related to seeing that firm personnel complied with various regulatory rules, Internal Revenue Service, SEC, AICPA, and State accountancy boards. It entailed helping set policy, recommending policy changes to leadership, involved making revisions as necessary to the firm's tax services manual, involved an annual quality performance review of the tax personnel in the various operating offices relative to compliance with firm policies and procedures. It included review of all contingent fee engagement letters to determine whether they complied with rules of the SEC, AICPA, and State boards accountancy.

Senator COLEMAN. Did you have any role in the approval of the aforementioned strategies, the FLIPS, the OPIS, or the BLIPS?

Mr. DELAP. With respect to tax strategies intended to be discussed with multiple clients, the rule was to review those strategies from a policy standpoint, to determine that the manner in which they were taken to clients, complied with the various regulatory rules and firm policy.

Senator COLEMAN. So you were involved then in the process, had a chance to raise concerns prior to approval?

Mr. DELAP. That is correct.

Senator COLEMAN. In regard to BLIPS strategy, during your review is it correct that you raised over 20 points that needed to be resolved prior to your approval?

Mr. DELAP. As I recall, I received a proposed pro forma—proposed model tax opinion regarding BLIPS that set forth the facts, discussion and technical analysis, I think, sometime in April 1999. I read that proposed opinion, and as I recall I had a list of 29 concerns that I sent back to Washington National Tax for further development.

Senator COLEMAN. Did you also share the concern about the couple mentioned before, the client ability to make a profit, and also I think the question of who is the borrower? Did you have concerns about those issues?

Mr. DELAP. Yes.

Senator COLEMAN. Do you recall whether those concerns were ever satisfied, were ever resolved to your satisfaction?

Mr. DELAP. Ultimately I determined that the analysis prepared by Washington National Tax, the final analysis, I thought addressed those concerns.

Senator COLEMAN. Help me understand, how do you get an opinion issued, a more likely than not opinion issued when—and it is easy in hindsight, we are looking back at this now, and I presume it is tough sitting down there, but we are looking back at this and we are seeing stuff that did seem to be substance, did not seem to be risk, did not seem to be profit, seemed to be transactions that you can lay out on a chart, but nothing you can put your hands around. How do you get to a more likely than not analysis based on that? I learned in law school not to ask more than one question, but I am asking more than one question. See if you can pull them together. Did you get to that more likely than not because folks simply thought the IRS would not know or did not have the resources or would not pursue it, or was there a valid intellectual basis for that more likely than not opinion?

Mr. DELAP. I believe, Senator, that it was based on a rigorous analysis of the technical rules. The analysis and the conclusion, from a technical standpoint was reached by Washington National Tax, so I might need to deflect that particular question to Mr. Wiesner.

Senator COLEMAN. Mr. Wiesner.

Mr. WIESNER. If I can supplement Mr. DeLap's answer. We came to the conclusion—we started in February 1999, and had intensive meetings with the Presidio people and their economic people. They laid out the transaction for us. At the end of the first meeting we had everybody around a table. We had the Presidio people leave, and put on a white board all the issues that we saw that were raised in the discussion, assigned those issues out to an appropriate technical resource within Washington National Tax, and then over a series of the next 2 months, 3 months, tried as best we could to resolve the issues that had been raised. And it was only after spending probably about 1,000 hours of time that we were able to arrive at our more likely than not conclusion.

Senator COLEMAN. From a lay person sitting here, the sense is that there is a lot of money to be made here, and revenues are driving outcome. How much of a factor did revenues play in these decisions?

Mr. WIESNER. Senator, from my point of view, money was not a consideration. We certainly were aware at Washington National Tax that this was an item of priority for the PFP practice, but the practice that we keep the resources assigned to the project and deal with the issues, and tell us sooner rather than later whether you can or cannot get to the more likely than not level of comfort.

Senator COLEMAN. You did on BLIPS though, $53.2 million in fees?

Mr. WIESNER. Being in Washington National Tax, which we are not in the operating office, I'm not familiar with the exact amount of fees, Senator.

Senator COLEMAN. I will go back to Mr. DeLap. This issue of registration, I need to understand that. We initially understand that you took the position that the BLIPS products should be registered as a tax shelter with the IRS, and I heard today and understand that BLIPS was never registered. Did you agree with the decision not to register?

Mr. DELAP. The registration statute left the implementation interpretation of the statutory words to regulations which were originally prepared in the 1980's in response to the syndicated tax shelters marketed generally by investment banks back in the early 1980's, and it was difficult to—or close to impossible in some cases to interpret those regulations as they might apply to the type of strategy like BLIPS. My view at the time was that it would have been—it would be preferable for Presidio to register the strategy, as I viewed Presidio as the organizer. I was told that Presidio declined to register. The Vice Chairman of Tax discussed the registration issue with the partner in charge of the Practice and Procedures Group in Washington National Tax, who is the firm's expert on procedural matters including registration. His conclusion was, at that time, that there was a reasonable basis not to register.

Based on that technical conclusion by the partner in the Practice and Procedures Group, I agreed to permit the strategy to go forward without registration.

Senator COLEMAN. What is the hierarchy here? What is your relationship with the partner in the PFP, Practice and Procedures? Do you have any authority over that person? Are you on an equal plane?

Mr. DELAP. I guess it would be parallel. Washington National Tax reported ultimately—I don't remember the exact layers, but ultimately to the Vice Chairman Tax. I reported to the Vice Chairman Tax.

Senator COLEMAN. There was a little discussion—I came in at the tail end of it—of confidentiality, having BLIPS clients sign a confidentiality agreement. Did you have any problem with that?

Mr. DELAP. At the time a nondisclosure agreement relative to tax strategies was common in the profession, so at the time I did not have a problem with that as such.

Senator COLEMAN. Let me just get to the termination of the marketing of BLIPS, which I believe was at the end of 1999?

Mr. DELAP. Yes, it was, I think in the fall of 1999.

Senator COLEMAN. Did you have any involvement with KPMG's decision to terminate the marketing of BLIPS?

Mr. DELAP. When I approved BLIPS from a policy standpoint, I set forth a list of conditions under which it would need to be offered. One of those conditions was that it would be offered to a limited number of individuals who were individuals who understood the investment and tax risk involved, and that Doug Ammerman and I would discuss at which point the marketing should be terminated. I believe that we had that discussion, I think in October 1999, maybe November 1999, and determined at that time there should be no further approaches to potential clients regarding BLIPS.

Senator COLEMAN. A cynic might say that the more transactions, the greater chance of being on the IRS's radar. Any substance to that cynicism?

Mr. DELAP. The way—I viewed it somewhat differently. I expected that the transactions, being large transactions, would be picked up on audit. My concern was that if there were an unlimited number of taxpayers entering into similar transactions, that the likelihood that a court would invoke the Step Transaction Doctrine, would go way up. So I thought it was important relative to the overall analysis that there be a limited number.

Senator COLEMAN. Thank you. Senator Levin, a short follow-up round.

Senator LEVIN. Thank you, Mr. Chairman.

I want to go back to the way KPMG's fees were tied to the targeted loss, Mr. Eischeid. Those fees were not tied, as I understand it, to the total amount of money managed or the amount of profit, if any, made by those investments. Is that correct?

Mr. EISCHEID. I suppose, Senator, in the same sense that it's referenced to the loan premium. You could use as an alternative reference the total amount invested in the strategic investment fund. You just really adopt a differing percentage to derive sort of the shorthand starting point for those fee negotiations.

But to the second point, there was no contingency around our fees. Once we had negotiated an amount with the client, it was a fixed amount that the client then agreed to pay us.

Senator LEVIN. Typically 1.25 percent of the targeted loss; is that correct?

Mr. EISCHEID. Generally, yes, sir.

Senator LEVIN. Now let us talk about the comments regarding netting and the grantor trust. Mr. Watson, who was one of the chief technical persons there, testified that netting gains and losses in a grantor trust would then allow individual gains and losses to be hidden, and that was not proper.

If you will look at Exhibit 10,[1] contains some internal KPMG e-mails on this matter. At this point KPMG was discussing whether its clients should use that method of netting, and Mr. Watson reacted strongly to it. If you look at the two comments that Watson made, "When you put the OPIS transaction together with this 'stealth' reporting approach, the whole thing stinks." And the last sentence of the second quote of this e-mail of Mr. Watson, "I believe we are filing misleading, and perhaps false, returns by taking this reporting position."

Do you agree with Mr. Watson's position, Mr. Eischeid?

Mr. EISCHEID. Senator, before I answer your question, I would like to, if I could, clarify the record. In your previous question I had agreed to your statement before you had I think completed it, and

[1] See Exhibit No. 10 which appears in the Appendix on page 428.

so I just wanted to clarify that my affirmative response is with respect to our fee calculation and the loan premium amount.

With respect to this question, no, I don't agree with Mr. Watson's characterization.

Senator LEVIN. Here is what you wrote in that Exhibit 10. "We concluded that each partner must review the WNT memo and decide for themselves what position to take on their returns after discussing the various pros and cons with their clients."

What I do not understand is why is the leader of the group, on an issue of this magnitude that is raised by the top technical professional on the issue, you tell your colleagues that they can do as they see fit. Should not a firm adopt a standard position on an issue as controversial as this one, and particularly one that results in potentially fraudulent returns? Why not a standard position in your firm?

Mr. EISCHEID. Senator, first of all, the reference memorandum, which I don't necessarily see here, was prepared by the head of the Personal Financial Planning Practice within National Tax at the time. And so sometime later Mr. Watson expressed his view with respect to the issues addressed in that opinion. So what you are witnessing here is really that spirited debate that I referenced in my initial comments about what is simply the right answer? What is the proper interpretation of the law? I don't think that any of the professionals viewed it as anything more than that, and that my partners are tax professionals, and I trusted their judgment to analyze the law and arrive at a correct determination.

Senator LEVIN. Did any KPMG clients who utilized BLIPS use grantor trusts to net out the losses that were received from those strategies?

Mr. EISCHEID. Senator, no, not to my knowledge.

Senator LEVIN. Did KPMG ever suggest this to them as a strategy? Did you ever sell BLIPS or OPIS on the basis of netting gains or losses in a grantor trust?

Mr. EISCHEID. Senator, as I indicated, I don't believe that any of our BLIPS clients prepared or had tax returns prepared that reflected any type of grantor trust netting.

I must also point out that when—the IRS's position with respect to grantor trust netting—emerged, as we discussed earlier, in August 2000, we endeavored to approach all of our clients to ascertain whether or not this type of netting might have occurred on one of their tax returns, and if so, we recommended to those clients, given the articulated position of the IRS, that they amend those returns.

Senator LEVIN. If you take a look at Exhibit 10 at the second from the last page, where it says "up in the Northeast," the third line there. "The short answer to your inquiry is," see that? "Up in the Northeast, at least, there is quite a bit of activity in the trust area where they used to not audit many of these kinds of trusts. They are now auditing quite a number of them because they have figured out that trusts are a common element in some of these shelter deals." Do you see that, "trusts are a common element?" Was that true in the case of BLIPS?

Mr. EISCHEID. Senator, I have no basis to answer that question.

Senator LEVIN. You are not familiar with this KPMG document?

Mr. EISCHEID. I have seen this KPMG document, yes, sir.

Senator LEVIN. Is it true that trusts are a common element in some of these shelter deals?

Mr. EISCHEID. That would not be my understanding, no, Senator.

Senator LEVIN. This was a call that you made, as I understand, asking a colleague if that colleague had spoken with a client whose name is redacted here; is that right?

Mr. EISCHEID. No, Senator, I don't think I had anything to do with this particular document.

Senator LEVIN. Take a look at the next page. It is a memo from you. "Did you have your 'netting' discussions with" blank and blank, redacted because they are clients, "I need copies of the memos of oral advice." That is your memo.

Mr. EISCHEID. Yes, Senator.

Senator LEVIN. This is the answer to it. So how can you say you are unaware of it?

Mr. EISCHEID. My impression, Senator, is that these are two totally unrelated documents, separated by 6 months or more.

Senator LEVIN. The memorandum here of May 24 is not a response to your October document; they are not related?

Mr. EISCHEID. No, Senator. I think the second memorandum that you are referring to——

Senator LEVIN. Which is the second one, the one on top of——

Mr. EISCHEID. October 20 is really referencing those kinds of client discussions that I just testified to. After Notice 2044 came out, and we went back to our clients to ascertain whether or not some type of netting activity had been undertaken.

Senator LEVIN. So whether or not the top document was a response to the earlier one or not, you were interested in knowing whether there were netting discussions; is that correct? And it related to FLIP; is that correct?

Mr. EISCHEID. This particular, the dialogue between myself and another of our partners related to a FLIP transaction, yes, Senator.

Senator LEVIN. The short answer is yes. My question is, that that document asking your colleague whether you had netting discussions, related to FLIP; is that correct? And the answer is yes, is it not?

Mr. EISCHEID. Yes, this related to FLIP, correct.

Senator LEVIN. Mr. Manth—well, let me ask Mr. Wiesner. I have a little time left. You are the partner in charge of the Washington National Tax Office during the BLIPS review. Exhibit 65[1] is a May 7, 1999 e-mail from Mr. DeLap. He forwards an e-mail from Mark Watson, who reports that based on new information he had just learned at a meeting with Presidio on BLIPS that he is no longer comfortable with the BLIPS product because there is only a remote possibility of making a profit, and the bank controls the loan proceeds, so it is doubtful it is not even a real loan. He also reports that another technical reviewer at WNT is concerned about who is the borrower, and Mr. DeLap recommends not moving forward until these issues are resolved.

Then, Mr. Wiesner, on May 7 and May 10 you meet with Mr. Rosenthal and Mr. Watson to discuss their concerns. You announce

[1] See Exhibit No. 65 which appears in the Appendix on page 623.

that the decision was made to move forward. You overruled your technical people on this, did you not?

Mr. WIESNER. Senator, what was reflected here was on—when we started our discussions of whether or not we could arrive at a more likely than not opinion in January. After 2 months of deliberation, I had believed, because I thought I had received everyone's sign-off, that we had arrived at a more likely than not conclusion. Mr. DeLap then began his review of the transaction, and there were some follow up e-mails and memorandums such as this memorandum on Friday, May 14.

To the extent that there were issues raised that were new issues raised concerning the transaction, yes, we took those very seriously.

Senator LEVIN. One of the issues is whether or not the representations which are material to your firm's tax opinion are credible; is that correct?

Mr. WIESNER. Yes, sir, that is correct.

Senator LEVIN. Whether those representations are credible. If you take a look at Exhibit 7,[2] you wrote this memo on February 7.

"Last, an issue that I am somewhat reluctant to raise, but I believe is very important going forward concerns the representations that we are relying on in order to render our tax opinion on BLIPS I. In each of the 66 or more deals that were done last year, our clients represented that they 'independently' reviewed the economics and had a reasonable opportunity to earn a pre-tax profit. Also, they had no 'agreement' to complete the transaction in any predetermined manner, i.e., close out the deal on 12/31 and trigger the embedded tax loss."

Now your writing. "As I understand the facts, all 66 closed out by year-end and triggered the tax loss. Thus, while I continue to believe that we can issue the tax opinions on BLIPS I, the issue going forward is can we continue to rely on the representations in any subsequent deals if we go down that road?"

Now, when you were confronted with that evidence—66 out of 66, that is not a coincidence—what did you do? Did you evaluate whether KPMG should rely on the client's representations for these BLIPS deals?

Mr. WIESNER. Senator, in the memorandum we are referring to, the e-mail which was February 24, the first paragraph of the e-mail was my conclusion that we still could issue a more likely than not tax opinion. We had considered——

Senator LEVIN. Is this for the ones that existed, or for a new one?

Mr. WIESNER. This was for the 66 transactions that we were talking about for 1999.

Senator LEVIN. Let us separate those out for the moment. You said later on in that memo, going forward, the issue is whether we can continue to rely on the representations made.

Mr. WIESNER. Yes, I did, Senator, because after I made my conclusion based on an evaluation of the law, and that is that the fact that the 66 people got in and got out, that does not, per se, result in the transactions of each individual not meeting the economic

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[2] See Exhibit No. 7 which appears in the Appendix on page 415.

substance doctrine. But then, looking forward and worrying as a professional about the sort of—the types of representations we are looking for here and the reasonableness of the representations, I had a concern from a business point of view of whether we could continue to rely on the representations.

Senator LEVIN. But you did continue, did you not?

Mr. WIESNER. I am not sure on that, Senator, but if in fact we did, a determination was—my——

Senator LEVIN. You are not sure whether you continued to sell BLIPS deals?

Mr. WIESNER. Senator, this memorandum really was my last involvement in the BLIPS transaction.

Senator LEVIN. Well, let me tell you, you did continue to sell BLIPS deals. Now, does that trouble you?

Mr. WIESNER. Well, Senator, I would have to look and examine the issue as we did for the 1999 deals and determine, again, whether there was a reasonable basis for each of the individuals to make their representation. And that was an issue for 1999 as well as going forward that I and Washington National Tax wasn't in a position to make.

What I did to follow up was talk to Mr. Eischeid and to make sure that Mr. Eischeid and the people in the field who were dealing with the clients would explore the issues.

Senator LEVIN. I don't see how in heaven's name as a tax professional you raise an issue, 66 out of 66 representations turn out not to be accurate. And you raise first the question as to whether you ought to issue the opinions that you subsequently issued. But then you say going forward. Going forward. Now you raise an issue. What about future deals? Should we continue to sell this? Should we continue to rely on these representations that are unanimously disproved by the facts?

These are not credible representations. You put them in your client's mouth. You folks write the representations. There is no prospect of a profit on the investment. Sixty-six times out of 66 that turns out to be the case. You raise the question, and then you continue to go forward as a firm anyway. You continue to sell this tax deal.

Mr. EISCHEID. Senator, I am certain that I don't agree with your characterization. We don't believe that the representations that our clients made to us were false and that it is——

Senator LEVIN. It turned out not to be true 66 out of 66 times. Would you agree with that?

Mr. EISCHEID. No, Senator, I would not. I think the representation that we're speaking to is that the client at the time that they entered into the transaction believed that they had a reasonable opportunity to make a profit from their investment transaction. I think that's the representation and——

Senator LEVIN. Mr. Wiesner, you said, "My recommendation is that we deliver the tax opinions in BLIPS I and close the book on BLIPS and spend our best efforts on alternative transactions." The firm did not do that. They did not follow your advice. Should they have?

Mr. WIESNER. Senator, my responsibility was, again, as a technical reviewer of the transaction and coming to my conclusion with respect to the transaction and what we should do. I made the recommendation from my own personal view and in my own judgment, and—but I was not the person who would ultimately make the decision.

Senator LEVIN. Does it trouble you the firm went forward and continued to sell BLIPS? You were troubled when you wrote the memo. Are you troubled now when I tell you the firm went ahead and sold BLIPS, more BLIPS? Does that bother you?

Does anything bother you? Now I am asking you a direct question. You made a recommendation, Mr. Wiesner. You are a professional. You recommended to your firm that they stop selling BLIPS. They didn't. My question: Does that bother you?

Mr. WIESNER. Senator, I was—again, in the context of the situation, I was making my own personal recommendation in terms of what I thought was a course of action. This is an area of very complex, difficult interpretation of the law, application of the facts to the law, and I made my best determination and made my recommendation.

Mr. EISCHEID. And, Senator, I might point out——

Senator LEVIN. Could you answer my question?

Mr. EISCHEID. I am sorry.

Senator LEVIN. Are you going to answer my question? I know it was a personal recommendation of yours. That is my question. Are you personally bothered by the fact that your recommendation was not followed?

Mr. WIESNER. Would I have preferred that my recommendation were followed?

Senator LEVIN. Yes.

Mr. WIESNER. Yes.

Senator LEVIN. Thank you, Mr. Chairman.

Senator COLEMAN. Thank you. We will excuse the panel and now call our next panel.

Senator LEVIN. Mr. Chairman, I do have questions for the record for the witnesses that I did not get to, and I am wondering if the record can be kept open for those witnesses.

Senator COLEMAN. Without objection.

Senator LEVIN. Thank you.

Senator COLEMAN. I would now like to welcome our third panel to today's hearing: Richard Berry, Jr., Senior Partner with Pricewaterhouse Coopers, New York City; Mark Weinberger, Vice Chair of Tax Services for Ernst & Young, Washington, DC; and, finally, Richard H. Smith, Jr., Vice Chair of Tax Services for KPMG LLP, New York City.

Again, I want to thank you for your attendance at today's hearing, and I look forward to hearing your testimony.

Before we begin, pursuant to Rule VI, all witnesses who testify before the Subcommittee are required to be sworn. At this time I would ask you to please stand and raise your right hand. Do you swear that the testimony you are about to give before this Subcommittee is the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. BERRY. I do.

Mr. WEINBERGER. I do.

Mr. SMITH. I do.

Senator COLEMAN. As I have indicated to witnesses before in the other panels, I would like you to confine your testimony to 5 minutes in a statement but that your entire written testimony will be entered into the record.

We will start with Mr. Berry, who will go first, followed by Mr. Weinberger and finish up with Mr. Smith. And after we have heard all the testimony, we will turn to questions.

Mr. Berry, you may proceed.

TESTIMONY OF RICHARD J. BERRY, JR.,[1] SENIOR TAX PARTNER, PRICEWATERHOUSE COOPERS LLP, NEW YORK, NEW YORK

Mr. BERRY. Thank you. Good afternoon, Chairman Coleman and Senator Levin. I am Rick Berry, and I serve as the national leader of Pricewaterhouse Coopers tax practice. I am pleased to be here today to discuss the important topic of abusive tax shelters.

Let me say right at the outset that we share the Subcommittee's concerns about the impact that abusive shelters have on our tax system. I welcome the opportunity to discuss our own experience with the Subcommittee. I know you have had a long day so far, so I will briefly summarize my written testimony.

From 1997 to 1999, we had a small group of less than 10 people who worked on three tax shelters known as FLIP, CDS, and BOSS. The BOSS transaction triggered widespread public attention and controversy in the fall of 1999. As a result, we decided that we had made a regrettable mistake being in this business. Our reputation was hurt, our clients and people were embarrassed, and it was incompatible with our core business.

We got out of this business immediately. We established an independent and centralized quality control group. We strengthened our procedures to ensure that we would never again engage in this type of activity. We decided the appropriate course of action was to shut down the BOSS transactions and refund all the fees we had received.

Not one of the BOSS transactions was ever completed. We also never, I repeat, never did any of the so-called Son of BOSS transactions. We stopped doing FLIP and CDS as well. We have now been out of this business for almost 4 years.

Not long after this, the IRS contacted our firm to review our compliance with the registration and list maintenance requirements of the tax law. The next step to putting this behind us was to work with the IRS to resolve any issues relating to our registration and list maintenance obligations. We fully cooperated with the Service. We reached a closing agreement in June 2002 and made a settlement payment. We agreed to provide the IRS with over 130 tax planning strategies for their review. They are in the final stages of this review, and no issues have been raised.

The IRS also reviewed our quality control procedures and told us they were comprehensive, thorough, and effective. We continue to cooperate with the Service and fully abide by the terms of our agreement.

[1] The prepared statement of Mr. Berry appears in the Appendix on page 303.

Our experience almost 4 years ago served as a wake-up call to our tax practice. Our partners were adamant that we get out of this business immediately. We took the unusual step of shutting down the largest transaction and returning all of our fees. We settled with the IRS. We implemented comprehensive quality control procedures to ensure that the firm would never again be involved with potentially abusive tax products. We take responsibility for our actions, and we have learned from our mistakes. As a result, our tax practice is once again dedicated to the core values on which our firm was founded.

Thank you for the opportunity to testify before you today. I look forward to your questions.

Senator COLEMAN. Thank you, Mr. Berry. Mr. Weinberger.

TESTIMONY OF MARK A. WEINBERGER,[1] VICE CHAIR, TAX SERVICES, ERNST & YOUNG LLP, WASHINGTON, DC

Mr. WEINBERGER. Good afternoon, Chairman Coleman and Senator Levin. My name is Mark Weinberger, and I am representing Ernst & Young. I appreciate the opportunity to participate in addressing the important matters being considered by your Subcommittee.

The subject of tax shelters is complex, and the complexity begins with the definition of tax shelters. When I discuss tax shelters, I am referring to products that have been widely marketed that are intended to generate tax benefits substantially in excess of any anticipated economic and business benefits, generally to shelter income from other sources. Beginning in the mid-1990's, these products were marketed with increasing frequency by investment banks, law firms, financial service firms, accounting firms, and other professional service firms, including ours.

The stock market boom and the proliferation of the stock awards in the 1990's created an unprecedented number of individual taxpayers with large gains and significant potential tax liabilities. Initially, in an effort to be responsive to client needs, we and other firms looked for legitimate tax planning to try and meet their needs. Perhaps reflecting the tenor of the times, these efforts rapidly evolved into competitive and widespread marketing of those ideas.

Selling and marketing are essential parts of any business, but we should not allow any part of our tax practice to be dominated by a sales mentality. Our past involvement in the type of activities that are the focus of this Subcommittee's attention is not reflective of our—and we believe your—expectations of our role as professionals. Ernst & Young has more than 23,000 employees in the United States. That number includes more than 6,000 professionals in the tax practice who provide a wide range of tax services to more than 22,000 tax clients. The revenues derived from the work under scrutiny by this Subcommittee never accounted for more than one-half of 1 percent of our firm's revenues. Our core tax practice was and is assisting our clients in their efforts to comply with the tax laws and reduce their tax liability in a manner that is appropriate

[1] The prepared statement of Mr. Weinberger appears in the Appendix on page 309.

and consistent with the tax law. We are committed to doing business in ways that embody the highest professional standards.

To make sure that we stay true to who we are as a firm, since I have assumed responsibilities, we have implemented a host of policy, procedural, and organizational reforms designed to create the highest quality professional environment. In addition, we have entered into a settlement agreement with the IRS regarding tax shelter registration and list maintenance requirements. And we have disbanded the group that had been involved in developing and marketing of tax products of the type at issue. This has nothing to do with the merits of the transactions; it has to do with who we want to be as a firm.

We have made a number of organizational changes that are relevant in the context of this hearing. Ernst & Young has established a new full-time position called Americas Director for Tax Quality, who is a senior serving client representative who now has full-time responsibility just to look over all of our quality initiatives; established a Tax Technical Review Committee 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 from our general counsel's office and our quality department, 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 on any matter about which they may have concerns.

In addition to our most recent initiatives, we continue to adhere to our policies under which we do not recommend transactions that have been listed by the IRS as potentially abusive or substantially similar; and, furthermore, we do not enter into confidentiality agreements with our clients for tax services.

Finally, as part of our efforts to move forward, earlier this year Ernst & Young executed a closing agreement with the Internal Revenue Service resolving all issues regarding tax shelter rules and regulations. A key aspect of that agreement is our commitment to implement a quality and integrity program to promote the highest standards of practice and ongoing compliance with laws and regulations.

The agreement includes a significant investment by our firm in education, data collection, national review, and annual audits of our practices across the country. This will ensure consistent quality for our firm and our clients.

In closing, we believe these initiatives, individually and collectively, will foster the highest standards of professionalism within Ernst & Young. We believe these policies are the right course for our firm and our clients.

That said, in the years ahead, there surely will be disagreements between the IRS and taxpayers. Our tax laws are enormously complex, and there is more than ample room for disagreement on any number of issues. Where the Service and the taxpayers disagree, those differences should reflect well-reasoned and good-faith interpretations of the rules as applied to a particular taxpayer's facts and circumstances.

Let me assure you that we know who we are and who we want to be. We have taken, and are taking, numerous steps to ensure that quality and professionalism are the touchstones for everything we do.

Thank you again for the opportunity to discuss our positive changes with you, Mr. Chairman and Senator Levin, and I will answer the Subcommittee's questions at the appropriate time.

Senator COLEMAN. Thank you, Mr. Weinberger. Mr. Smith.

TESTIMONY OF RICHARD H. SMITH, JR., VICE CHAIR, TAX SERVICES, KPMG LLP, NEW YORK, NEW YORK

Mr. SMITH. Thank you, Mr. Chairman.

Mr. Chairman, Senator Levin, my name is Richard Smith. I am the Vice Chair of Tax Services for KPMG. While today's hearing is focused on certain tax strategies KPMG presented to clients in the past, I would like to describe how KPMG's policies and practices have changed since then.

The business and regulatory environment are markedly different today than at the time KPMG and its competitors presented such strategies, and KPMG has moved forward as well. KPMG has no higher priority than restoring public trust in the accounting profession. It is no longer enough to say that a strategy complies with the law or meets technical standards. Today, the standard by which we judge our conduct is whether any action could in any way risk the reputations of KPMG or our clients. If it could, we will not do it. Our reputation, our integrity, and our credibility are simply too important to put at risk.

Some of the more significant changes and new procedures in place at KPMG include:

One, we have substantially changed KPMG's tax services and offerings. Today, KPMG offers our clients tax services that are tailored to address their distinct business objectives and tax planning needs. We no longer offer or implement aggressive look-alike tax strategies. In particular, we no longer offer or implement FLIP, OPIS, BLIPS, or SC2, or any similar transactions. Additionally, KPMG does not and will not accept any new engagements for advice and opinions on tax shelters that have been listed and deemed abusive by the Internal Revenue Service.

Two, over the past 3 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.

First, we have created the new position of Partner in Charge of Tax Risk and Regulatory Affairs. This partner analyzes each tax strategy proposed by the firm to determine if it could in any way put KPMG or our clients at risk.

Second, the partner in charge of our Washington National Tax Practice must sign off on the technical merits of all significant tax strategies.

Finally, the Department of Professional Practice-Tax reviews all tax strategies to ensure that they are in compliance with the firm's policies and procedures. Each of these partners has veto power over any tax strategy proposed and operate independently from our operations and business development functions. If any tax strategy puts KPMG or our clients at risk, is not technically correct and defensible, or is inconsistent with our policies or procedures, it will not be approved.

Three, we have also revised our procedures with respect to list maintenance and registration obligations under the Internal Revenue Code. In early 2000, KPMG established a practice, procedure, and administration group in Washington National Tax as the contact point for analysis of disclosure, list maintenance, and registration issues. KPMG's procedures and training programs have been updated continuously since that time, tracking developments in the law and fine-tuning our compliance processes.

Four, practices and positions focused on look-alike strategies are no longer part of this firm. In 2002, two practices in particular, Stratecon and Innovative Solutions, were eliminated. Many of the partners who were part of these practices are no longer with the firm. We have abolished positions such as national deployment champions and area deployment champions, which were charged with marketing these strategies to our clients. We also eliminated the Tax Innovation Center, which was responsible for supporting the marketing of look-alike tax strategies.

Five, our tax training program now focuses on technical developments rather than marketing strategies. We have discontinued weekly tax partner calls, training programs, and other activities that primarily focus on marketing. Tax partners calls and training now concentrate on changes in the law and technical tax developments.

Six, in 2002, KPMG implemented a firm-wide compliance and ethics hotline. This hotline is designed to encourage anyone within KPMG to report their concerns about any potentially unethical, improper, or illegal conduct within the firm, and is in addition to long-standing channels for employee communication.

Seven, we have put in place more stringent rules about offering tax services to executives at our SEC audit clients. Under the Sarbanes-Oxley Act, the audit committees of our SEC audit clients must preapprove all services provided by KPMG, including tax services. We have applied this disclosure and approval discipline to tax advice offered to executives of SEC audit clients.

Eight, we are constantly looking at additional steps we can take to improve and enforce compliance with these policies and practices.

Senator COLEMAN. If you would just summarize?

Mr. SMITH. I will just sum up and move forward. Thank you, Senator.

Senator COLEMAN. Thank you.

Mr. SMITH. We encourage anyone at KPMG to bring to our attention immediately any actions that are inconsistent with these guiding principles and procedures and to suggest additional policies or procedures that would help ensure that we are providing the highest quality tax services and advice to our clients.

KPMG looks forward to being part of the solution and wants to work with Congress as well as the IRS and other policymakers as you consider sound and responsible approaches to better define what tax strategies are allowable under the law and to further strengthen the enforcement of the tax code.

Thank you, and I look forward to your questions.

Senator COLEMAN. Thank you, Mr. Smith.

First, let me say that I applaud the efforts that you have taken and the commitment that you have made to apply the highest standards, the sensitivity that we are hearing today regarding the impact this has on the reputation of firms and the industry. So I want to put on the record my appreciation for that.

At the same time, obviously, as we look back, the past is not a pretty past, and part of the concern, as we sit here, our job is to figure out where we go from here. Was the past just simply a product of the booming 1990's and being awash in cash? And the sense I get, gentlemen, is that—and, by the way, not just PWC and Ernst & Young and KPMG. We could have had the table lined up with everybody in the business, it seems, looking for ways to figure out how to wash out profit and to limit liability. I mean, that is the reality.

So the question is: How do we make sure it does not happen again? How do we make sure that these statements today that you make saying, hey, we have changed our process, we have cleaned up our act, will be the reality should this economic engine start booming again? And that is a concern.

I do not think we need to have an IRS agent sitting there next to you as you make your policy decisions. But as we look at the past, clearly, there is a very sorrowful record, I think.

Mr. Berry, I would take it that you would agree that these FLIP, BOSS, CDS things, as you look back, lacked economic substance.

Mr. BERRY. Mr. Chairman, with respect to the BOSS transaction, which we did not do, that in my judgment is an abusive shelter, or would have been.

With respect to FLIP and CDS, if not abusive, they come very close to that line. They do not meet our quality standards. We regret that we ever got involved in those transactions, and we would not do them today.

Senator COLEMAN. Would you have an opinion on BLIPS?

Mr. BERRY. I am not familiar with those transactions. We never did them.

Senator COLEMAN. We talked about registering a little bit, and perhaps, Mr. Weinberger, on that issue. My concern is the lack of registration service as the way to keep things under the radar. Would you agree with that?

Mr. WEINBERGER. Senator, I agree that transparency and the ability for the IRS to be able to identify transactions quickly and respond is absolutely a cornerstone to being able to deal with this process going forward. And that involves registration on the part of promoters. It involves disclosure by taxpayers. And it involves the list maintenance rules that the IRS also passed.

Senator COLEMAN. How do we ensure that there is transparency on a regular basis? Is it going to require more legislation?

Mr. WEINBERGER. Well, Senator, since the original transactions that were discussed today and others that are out there have occurred, there have been significant regulatory changes, and there are legislative changes before the Senate Finance Committee. The environment has changed in many ways, not the least of which is the disclosure rules are now more aligned with the registration and list maintenance rules, which creates a web so that not only will individuals have to disclose transactions, but the promoters are supposed to register them and maintain lists as a mechanism to be able to give the IRS the information to be able to actually know when those transactions occur and to respond appropriately.

Senator COLEMAN. Mr. Smith, does KPMG have internal controls regarding to ensure that IRS registration requirements are met?

Mr. SMITH. Yes. Certainly over the years, we have improved our policies and procedures to reflect not only the changes that have taken place in the law and regulations, as Mr. Weinberger described, the changes in the disclosure rules as well as the listing requirements. But we have put in policies and procedures that go beyond those particular rules that I think are helpful in addressing the concerns that you are talking about today.

For example, for us we think transparency is so important that we are going to err on the side of registration beyond what might be required in the law and regulations.

Senator COLEMAN. One of the areas of questioning that was generated by my distinguished Ranking Member, Senator Levin, had to do with the fee structure. To me, why not base fees on profits that would be generated by a transaction, if you really believe that, versus fees that are being generated due to the amount of loss you are going to take? I mean, it is clear that that was the standard. Is that something that needs to be dealt with legislatively?

Mr. SMITH. I think that there are a number of different ways that fees could be structured, and I think there have been some significant changes that have occurred over the past couple of years.

Mr. DeLap talked about the changes with regard to contingent fees. We think that those were good changes and certainly have focused on how do we bring transparency to our fees as well as bring transparency for the government into the transactions in which we are involved.

Senator COLEMAN. And, again, to note from an industry-wide perspective, I take it, Mr. Weinberger, that Ernst & Young also used a fee system based on taxes avoided under the shelters in the past. Is that correct?

Mr. WEINBERGER. Senator, we had fixed fees that were based on investments which were attributable to the losses.

Senator COLEMAN. Has that process been changed today?

Mr. WEINBERGER. Yes, the AICPA and the SEC have rules on contingent fees, and obviously we need as an industry to comply with all of those. The vast majority of work that our firm does is hourly based. There are certain circumstances where they are specifically allowed to have value-billing based on the complexities of different transactions or the investment involved.

Senator COLEMAN. And my last question, because I am trying to figure out where we go from here, and I could spend a lot of time getting very angry, as my colleague, I think justifiably, from Michigan has been as he has looked at the amounts of tax avoidance as a result of these schemes and the impact that it has.

Gentlemen, I would like you all to respond. Talk to me about the lessons you have learned what the industry as a whole should take from what we have discussed today, and where does the tax adviser industry go from here? Where do we go from a legislative perspective as well as from an internal perspective? And I take it your statements of the controls you set in place perhaps have answered that, but I would like your sense. Is there more legislation that we are going to have to enact in order to keep the reins on this thing and ensure that people meet the highest quality ethical standards? Mr. Berry.

Mr. BERRY. Yes, my firm is very supportive of additional legislation, particularly in the areas of increased disclosure, both on the part of the taxpayer and the tax preparer, and definitely increased penalties.

Senator COLEMAN. Mr. Weinberger.

Mr. WEINBERGER. Senator, I think that legislation will never solely prevent individuals, if they do not step up to the plate and do the right thing. So I think it takes our part as a professional service firm. I think it does take the IRS following up on the transactions they identify. I think the transparency and disclosure rules are crucial. We have an incredibly complex tax code. I am not Pollyanna-ish enough to think that we are going to simplify it, but that would certainly be a huge benefit to dealing with those who want to aggressively use the tax code in ways that take advantage of the complexity. And like Mr. Berry, I do think the cost/benefit analysis of looking at whether or not when you give advice you are following the rules, it should be further analyzed, absolutely.

Senator COLEMAN. Mr. Smith.

Mr. SMITH. Yes, I think all of the component pieces of the system are important to improving compliance with the tax code. The IRS, clients, tax advisers, Congress—I think all of those are important in terms of the policies that they set.

At the end of the day, it is how a professional feels about themselves and how they feel that they should conduct themselves, and that is part of setting the tone at the top within each of those organizations and institutions. And it is about executing on setting the highest professional standards and making sure that we live up to those.

So I think the internal controls and changes that have been made by certainly the three firms before you right now, as well as the changes with regard to listing and disclosure that apply to the firms and apply to the taxpayers, are important developments in the entire system.

We certainly support anything that relates to further transparency and enforcement of that transparency.

Senator COLEMAN. Thank you, Mr. Smith. Senator Levin.

Senator LEVIN. Thank you, Mr. Chairman.

I am glad one of you mentioned the need to increase penalties. The current penalty for promoting an abusive tax shelter is $1,000. Now, there is no way that that is anything other than a parking ticket. And when professionals promote abusive tax shelters, it seems to me that the penalty has got to be similar to what the penalty is paid by the taxpayer that they are advising and putting documents into the hands of. And so one of the provisions of the bill which we will be introducing will be increased penalties, but they are going to be significant because the current penalties of $1,000, I think a maximum of $10,000 for a similar violation, is a joke. And it is a pitiful joke.

Mr. Smith, your prepared statement says on page 4 at the top that in 2002, KPMG eliminated two tax groups that "were responsible for developing tax strategies specifically designed to be presented to multiple clients, Stratecon and Innovative Solutions." And when did that happen in 2002?

Mr. SMITH. That happened as I came on as the Vice Chair of Tax, Senator, which would have been in April.

Senator LEVIN. Of last year?

Mr. SMITH. Yes.

Senator LEVIN. Well, when you look at Exhibit 89,[1] if you would take a look at your exhibits, this is the organizational chart for KPMG for 2003 that your firm supplied to the Subcommittee in February of this year in response to the subpoena.

Now, we asked for organizational charts for each of several years so we could understand the way your firm is organized. The 2003 chart still lists Stratecon. How do you explain that?

Mr. SMITH. This organizational chart is inaccurate.

Senator LEVIN. Your own organizational chart is inaccurate?

Mr. SMITH. This particular version——

Senator LEVIN. Your own organizational chart is inaccurate? Is that what your testimony is?

Mr. SMITH. This version that you have is not accurate in terms of——

Senator LEVIN. This is your document, KPMG 000001. I mean, this is what you supplied to us. This is the first document you supplied to us in response to a subpoena. Are you testifying that the document you supplied us showing your organizational makeup for 2003 was inaccurate?

Mr. SMITH. I think it reflects a change in one box in this particular organizational chart which has me as the Vice Chair of Tax. There are numerous—as I just perused over this particular organizational chart before me, there are numerous errors in terms of the organization.

Senator LEVIN. All right. I just want to make it clear. This is the chart that your firm supplied to us. Is that correct?

Mr. SMITH. I suspect it is, Senator.

Senator LEVIN. Can you get us an accurate chart?

Mr. SMITH. Yes.

Senator LEVIN. Because I think the Subcommittee has a right to expect when we subpoena documents that you will give us accurate documents. Is that a fair expectation, would you say?

Mr. SMITH. I would have expected that you would have received something other than a draft organizational chart.

Senator LEVIN. Was this a draft that you submitted to us?

Mr. SMITH. Let me restate that, sir. This document that you have does not reflect our organization.

Senator LEVIN. OK. Now, it also refers to a PFP, Personal Financial Planning, as I understand it.

Mr. SMITH. Yes.

Senator LEVIN. Innovative Strategies, do you see that?

[1] See Exhibit No. 89 which appears in the Appendix on page 680.

Mr. SMITH. I don't see——

Senator LEVIN. Do you see where it says PFP Inno Strat, J. Eischeid? Do you see that, the third column?

Mr. SMITH. I'm sorry. I don't.

Senator LEVIN. Excuse me, J. Eischeid.

Mr. SMITH. Oh, I do see it, yes.

Senator LEVIN. OK. It doesn't refer to Innovative Solutions, which your statement refers to.

Mr. SMITH. Innovative Strategies or Innovative Solutions——

Senator LEVIN. They are the same?

Mr. SMITH [continuing]. Was a practice that we no longer had after I became Vice Chairman, notwithstanding what is reflected on this organizational chart.

Senator LEVIN. We can't find Innovative Solutions, which your testimony referred to, in any of your charts. It is always Innovative Strategies.

Mr. SMITH. Well, the two practices, Senator, that I focused on when I became Vice Chair in terms of making some changes to our focus and to our business were Stratecon and Innovative Strategies or Innovative Solutions.

Senator LEVIN. To either name, is when you——

Mr. SMITH. Either name from my perspective.

Senator LEVIN. I have got you.

Mr. SMITH. It is the practice that was represented by this prior organizational chart.

Senator LEVIN. OK. I want to ask about another document. This is a proprietary document which we are going to put in front of you. We did not put it in our documents because it is proprietary. It is a long one.

Mr. SMITH. Thank you.

Senator LEVIN. It is dated November 26. Do you see that?

Mr. SMITH. Yes, Senator, I do.

Senator LEVIN. OK. Now, if you take a look at about the eighth line on the left, it still shows Stratecon there. You said that you eliminated it in April 2002.

Mr. SMITH. Yes.

Senator LEVIN. We have a date, November 26, 2002, which still shows Stratecon, and it still shows Solutions in Development. How do you explain that?

Mr. SMITH. Yes. As I came in to serve as the Vice Chair of Tax, I made very clear that we were going to make changes to our structure in terms of the organization and focused on these two in particular, and others.

This document reflects the fact that the systems that we had had not yet been changed at the particular point in time when this document was produced.

Senator LEVIN. I thought you said you terminated—it is just very unclear to me. I thought you said you terminated Stratecon when you came in in April 2002. And my question is: Why does Stratecon still show as having Solutions in Development on November 26, 2002? It is a straightforward question.

Mr. SMITH. Yes, and——

Senator LEVIN. I don't understand your answer.

Mr. SMITH. Let me try to elaborate on it, Senator, and that is, we have a number of systems, accounting systems throughout our business, and stand-alone databases in various parts of our business, and I believe that this particular document reflects a database that was not updated based on the changes that we made in our practice.

Senator LEVIN. So this document is wrong, too. It wasn't updated as of November 26? It was incorrect?

Mr. SMITH. Systems changes in terms of databases do take some time to implement, so it is reflective that we had had a Stratecon practice and that certain things had been worked on, yes.

Senator LEVIN. There is an e-mail from Mark Watson, Exhibit 34,[1] Mr. Smith, on July 22, 1999.

Mr. SMITH. That was Exhibit 34, Senator?

Senator LEVIN. Yes, Exhibit 34, to you and Mr. Wiesner. This is about the BLIPS economic substance issue. It raises questions. It says, "It seems very unlikely that the rate of return on the investments purchased with the loan proceeds will equal or exceed the interest charged on the loan and the fees incurred by the borrower to secure the loan. . . . Before any fees are considered, the client would have to generate a 240-percent annual rate of return on the $2.5 million foreign currencies investment in order to break even. If fees are considered, the necessary rate of return to break even would be even greater."

Mr. Watson also noted that the BLIPS client "has a tremendous economic incentive to get out of the loan as soon as possible due to the large negative spread."

And then he asked you, "Before I submit our non-economic substance comments on the loan documents to Presidio, I want to confirm that you are still comfortable with the economic substance of this transaction." He had told our staff that he never heard from you following that memo. Is that correct?

Mr. SMITH. Well, my recollection doesn't serve me back to 1999, Senator, but let me provide you some insights that might be helpful.

Senator LEVIN. I just want to know, because in terms of time we are running out. Do you remember responding to this memo?

Mr. SMITH. I have no particular recollection of responding to this memo, but I know what I would do having read this memo right now, and that would have been—he talks about a commitment that he has, I think for the following day, and so I either would have called him or I would have known that that deadline was not something that we needed to meet, and I would have gotten back to him either in a general meeting about this matter or specifically.

Senator LEVIN. All right. Now, turn to Exhibit 13,[2] if you would. This is an August 1999 Mark Watson memo. It says before BLIPS "engagement letters are signed and revenue is collected, I feel it is important to again note that I and several other WNT partners remain skeptical that the tax results purportedly generated by a BLIPS transaction would actually be sustained by a court if chal-

[1] See Exhibit No. 34 which appears in the Appendix on page 521.
[2] See Exhibit No. 13 which appears in the Appendix on page 450.

lenged by the IRS. We are particularly concerned about the economic substance of the BLIPS transaction."

And then if you look at the top of the page, you will see that Steven Rosenthal responded to Mark Watson that very day as follows: "I share your concerns." And then a few lines later, "I continue to be seriously troubled by these issues, but I defer to Phil Wiesner and Richard Smith to assess them."

So now your two professionals seriously question the economic substance of BLIPS, and they appear to be identifying you as well as Mr. Wiesner as individuals who ignored their concern and pushed through the approval of BLIPS. You have heard Mr. Watson's testimony. How did BLIPS get approved when there are such serious questions about its economic substance?

Mr. SMITH. Well, I certainly don't agree with the characterization that we ignored their concerns. If we go back and look at the entire time line here, you go back to January or February 1999, and there was in-depth consideration of all of the issues that were implicated within BLIPS. These are a couple among those which where the debate continued. Certainly it was encouraged that everybody have the opportunity to raise concerns that they had throughout the process at any point in the process so that those could be concerned—be considered, excuse me.

Senator LEVIN. If the professionals in their positions today had the same problems with the tax product, would you proceed with it?

Mr. SMITH. I would say that if people have technical concerns with regard to any matters that we have, that we would consider them seriously in our discussion. The difference——

Senator LEVIN. I am sure that is what your position is, that you would seriously consider them. But given what you know now—and I think then from these memos—of their concerns, lack of economic substance, no real loan. Over and over again they were told. This came to you anyway. Would you override their concerns today?

Mr. SMITH. I think our process has evolved in terms of how we might address this today. One of the things that we have learned in terms of how to deal with these types of issues is that we put out as our standard that we got to "more likely than not." And we believe that we reached that standard.

The issue with that standard is that it is close to the edge of the cliff. You are up to and—you are not to cross that edge. But certainly once you go up there, it is often the cautious and the right thing to do to back away and not approach these types of issues in the same manner.

So the change in the way that we would go about this would be to consider that and assure ourselves that we are not conducting ourselves in a way that would have this same level of risk associated with it.

Senator LEVIN. Over the last 5 years, Mr. Smith, did KPMG encourage the sale of its tax products to potential clients?

Mr. SMITH. We are in a business, Senator, and we do talk to our clients about tax advice, and we encourage and talk to our professionals about making sure that they represent our clients and that they think about their industry and the issues that face them and work to represent them fully.

Senator LEVIN. Well, it is not a response to the question, and I want to ask it—I am going to try it again.

Mr. SMITH. Sure.

Senator LEVIN. It is a very significant question. It goes to the heart of all of the promoting that you did. You have given us a list of all the tax products which you developed, which were offered for sale. We have seen the marketing plans, the telemarketing, the profiles of likely clients for your tax products, the internal databases that were used to develop potential client lists for some of your tax products; again, your telemarketing center in Fort Wayne, Indiana; the unsolicited contacts with clients to tell them of KPMG tax products and services; the revenue goals that you set for your tax groups; your sales opportunity center that was intended to help its personnel sell your tax products.

I just want to talk now about tax products, and my question to you, again, is: Have you over the last 5 years encouraged the sale or acceptance of tax products to potential clients?

Mr. SMITH. Certainly our encouragement of our professionals to serve their clients has extended over the past 5 years as well as before that.

Senator LEVIN. I have just got to keep asking it. It is my last question. I may have to ask it two or three more times. Have you encouraged the sale or acceptance of your tax products to potential clients?

Mr. SMITH. We have encouraged our tax professionals to advise our clients, and we do that, have contact with——

Senator LEVIN. Did that include—look, I have got to just keep asking this. Did that include encouraging the sale or acceptance of your tax products by those clients?

Mr. SMITH. Well, Senator, I think that——

Senator LEVIN. It is a straightforward question.

Mr. SMITH. In a number of different components of our business, we talk to our clients in many different ways, over the telephone and in writing, in meetings face-to-face, and we do encourage our tax professionals to meet with our clients and talk to them about the complexities of the tax code and to talk about their business and the things that they ought to be thinking about from a tax perspective, yes. [Laughter.]

Senator LEVIN. Is "yes" the answer to my question?

Mr. SMITH. I believe that my entire response was the answer to your question.

Senator LEVIN. But is the "yes" at the end of it intended to respond to my question? Did KPMG——

Mr. SMITH. I'm trying to——

Senator LEVIN. No, I am sorry. See, you come here and you are asking us to believe that you have basically changed your ways, things are done differently there now for various reasons. And, frankly, I am skeptical. And one of the reasons which makes me skeptical is I cannot get a straight answer out of you to a very direct question, whether or not KPMG encouraged the sale or acceptance of its tax products to potential clients. There is a mass of evidence that you did, but I cannot get you to say, "Yes, one of the things we did was encourage the sale or acceptance of our tax products to potential clients." I cannot get you to say that.

Mr. SMITH. Well——

Senator LEVIN. Even though it is obviously true. It is as clear as the nose on your face that it is true.

Mr. SMITH. I think we are in agreement, Senator, because what you just said was one of the things that we do is to encourage our professionals, yes, to——

Senator LEVIN. No. You just say encourage professionals. Look, Mr. Smith, I don't want to play a game with you. I want to try to get a direct answer, and I will try one more time. But you understand the reluctance to give a direct answer to me raises questions about what you are saying that you are trying to change your ways or you have changed your ways or you are going to through a lot of procedures.

Now, unless I can get a straight answer to a question that has overwhelming evidence in support of a yes answer, I cannot—I am skeptical about what you are telling us otherwise. So let me ask it one last time.

Over the last 5 years, is one of the things that KPMG did was encourage the sale or acceptance of its tax products to potential clients? Can you give me a yes or no answer to that?

Mr. SMITH. I can, Senator.

Senator LEVIN. And what is it?

Mr. SMITH. Yes.

Senator LEVIN. Thank you. Thank you, Mr. Chairman.

Senator COLEMAN. Thank you, Senator Levin.

With that, the hearing record will be kept open for 3 weeks. The witnesses are reminded that when answering supplemental written questions from the Subcommittee, they will still be under oath.

I want to thank the witnesses for appearing before us today. This hearing is adjourned.

[Whereupon, at 1:10 p.m., the Subcommittee was adjourned.]

U.S. TAX SHELTER INDUSTRY: THE ROLE OF ACCOUNTANTS, LAWYERS, AND FINANCIAL PROFESSIONALS

THURSDAY, NOVEMBER 20, 2003

U.S. SENATE,
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS,
OF THE COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee met, pursuant to notice, at 9:05 a.m., in room 216, Hart Senate Office Building, Hon. Norm Coleman, Chairman of the Subcommittee, presiding.

Present: Senators Coleman and Levin.

Staff Present: Raymond V. Shepherd, III, Staff Director and Chief Counsel; Joseph V. Kennedy, General Counsel; Mary D. Robertson, Chief Clerk; Leland Erickson, Counsel; Mark Greenblatt, Counsel; Steven Groves, Counsel; Frank J. Minore, Detailee, General Accounting Office; Kristin Meyer, Staff Assistant; Steve D'Ettorre, Staff Assistant; Kevin Carpenter (Senator Specter); Elise J. Bean, Staff Director/Chief Counsel to the Minority; Bob Roach, Counsel and Chief Investigator to the Minority; Julie Davis, Professional Staff Member to the Minority; Laura Stuber, Counsel to the Minority; Brian Plesser, Counsel to the Minority; Christopher Kramer, Professional Staff Member to the Minority; Beth Merillat-Bianchi, Detailee, Internal Revenue Service; Jim Pittrizzi, Detailee, General Accounting Office; Ken Seifert, Intern; Jessilyn Cameron, Brookings Fellow; David Berrick (Senator Lieberman); and Rudy Broiche (Senator Lautenberg).

OPENING STATEMENT OF SENATOR COLEMAN

Chairman COLEMAN. This hearing of the Permanent Subcommittee on Investigations is called to order.

I want to begin by thanking my distinguished Ranking Member, Senator Levin, again for his work in this area and his deep concern for taxpayers, his concern for just kind of a fundamental sense of right and wrong in business practices. I think when we address those concerns, when we clear up things that are very problematic, such as we examined last Tuesday and which we will address today, I think we all benefit.

Senator LEVIN. Thank you, Senator Coleman.

Chairman COLEMAN. On Tuesday, this Subcommittee heard testimony under oath concerning the role of major accounting firms in the development, marketing, and implementation of generic tax products with no substantial economic purpose other than to reduce tax burdens, the result being to rob the U.S. Treasury of billions of dollars annually.

Let me begin by saying I am troubled by what I heard on Tuesday and troubled by what I did not hear. We had accounting firm after accounting firm come forward and tell us, "Mr. Chairman, what we did was wrong." Yet, I remain troubled that it wasn't some revelation that came to them after the fact that what they did was wrong. Common sense would dictate that they knew what they were doing was wrong when they were doing it.

Although the various firms gave tortured explanations of multiple levels of review and hours of deliberation they engaged in before reaching their decisions of more probable than not legality, I think the answer is much simpler. It was the 1990's. The surge in the market made many awash in cash. There were millions of dollars to be made and everybody else was doing it. But the bottom line itsthat it was wrong, it was unethical, and in some cases was illegal.

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 Brink's truck through any purported loophole.

Last Tuesday shined a light on a dark and shameful period for the accounting industry. That was the past and it must remain the past. The future is much brighter. I was bolstered by the fact that all the firms said these abusive tax shelters are a thing of the past. Some admitted their mistakes. All said they would sin no more.

We heard that many of the people involved in these abusive tax shelters are no longer working for these companies, that they have put in place policies and procedures that will deter such practices in the future, and that they have recommitted themselves to the highest ethical and business standards.

It was obvious last Tuesday and it will be demonstrated today that accounting firms did not act alone. Others, including otherwise reputable investment advisors, banks, and law firms were part and parcel of these fraudulent schemes. Moreover, they also provided the added benefit of making detection by the IRS difficult. These entities provided a veneer of legitimacy for abusive tax shelters that were, in fact, illusory or sham transactions with little or no economic substance driven primarily for favorable tax consequence.

Based on PSI's investigation, investment advisors were essential for developing and implementing the financial transactions for these shelters. In fact, investment advisors have been deemed to be promoters of tax shelters bought by the IRS for certain sheltered transactions, triggering registration obligations.

However, the Permanent Subcommittee has determined that Presidio, an investment firm that clearly promoted at least two abusive tax shelters, BLIPS and OPIS, did not register these shelters with the IRS. By refusing to register these abusive tax shelters, it is obvious that KPMG and Presidio attempted to conceal their existence from the IRS. There are others who are also complicit—lawyers and bankers who made money, lots of money, and had to know what they were doing was wrong.

This Subcommittee was not playing Monday morning quarterback when it focused on these transactions. The players in these abusive tax shelters had to know there was no economic substance to these transactions and that their efforts to avoid IRS detection by failing to register them was part of a deliberate cover-up. It seems clear to this Senator that ethical concerns were gagged and blindfolded by the lure of big dollars.

Major law firms are essential to the tax shelter business. They were routinely utilized by the accounting firms to provide tax opinions in order to protect taxpayers from penalties if challenged by the IRS. Some firms provided hundreds of cookie cutter opinions of various tax schemes. The other firms took on the additional role of soliciting, developing, and marketing tax schemes. In fact, the IRS has targeted at least two prominent law firms as promoters of tax shelters.

As someone who practiced law for 17 years in the Minnesota Attorney General's Office, former Solicitor General of the State of Minnesota, I am well aware of the ethical standard that requires attorneys to avoid even the appearance of impropriety. Based on our investigation, it is difficult for me to understand how that standard was not violated in these cases.

In addition, the existence of a closed business relationship with KPMG also raises concerns about whether any independent analysis and advice was provided. I look forward to hearing the testimony of the attorneys involved in these transactions.

And the bankers, I know, take great pride in what they do and the code of conduct they insist upon for their employees and themselves. Most Americans may not think of bankers as their friend next door, but for generations, Americans have come to expect that banks are a bastion of fiscal responsibility in possession of their money, their savings, their hopes, and their dreams. In this case, it appears that bankers helped facilitate these transactions for the price of admission into a tax shelter business that allowed everyone involved to profit.

Prominent banks provided the necessary loans for tax shelters. While the banks have traditionally concerned themselves primarily with credit risks, these loans were critical for generating the artificial paper losses in the tax shelter industry. For the banks involved, these schemes were merely a vehicle to generate substantial profits.

Given the evidence that PSI has uncovered in the sworn testimony the Subcommittee has heard, it is imperative to ensure that the proper regulatory and oversight framework exists to address the myriad of participants involved in the tax shelter industry.

On the last panel, we will hear from the agencies charged with enforcing the laws. The Internal Revenue Service is primarily responsible for interpreting and enforcing the tax laws. High rates automatically create a large incentive to find loopholes or tax strategies. The complexity of the tax code also reduces the transparency of returns, making it very difficult for the regulators to follow what is going on in the private sector.

On Tuesday, the Subcommittee heard testimony that accounting and investment firms structured deals to intentionally conceal their efforts from the IRS. It is imperative that Congress not allow the

IRS to become the toothless paper tiger that is ignored by those involved in the tax shelter industry. We must give them the tools, the resources, and the direction necessary for the proper enforcement of our Nation's tax laws. Congress must not allow the IRS to be an irrelevancy.

After today's hearing, I intend to discuss with Senator Levin what follow-up action we need to take in order to address the problems exposed by this investigation. A number of potential reforms were discussed at Tuesday's hearings. These include more expansive and explicit reporting requirements, tougher penalties for noncompliance, and more effective internal review procedures within the professional firms involved in these transactions. The scope of my response will depend very much on the behavior of the professional firms and the willingness and ability of the regulators to address these issues.

If Congress needs to act in order to provide more resources or to simplify tax laws and close loopholes that are being upheld by the courts, then we will do so. Let me be very clear, however. I am against additional regulation just for the sake of more regulation. The preferable way is professionals who self-impose a high ethical standard and to consistently act in accordance with those standards without requiring Congressional review to highlight transgressions.

But sometimes, regulations such as the Sarbanes-Oxley Act are the only way to restore the public trust without which our tax and financial systems cannot work. I do intend to see public trust in the application of tax laws restored. Congress will take the necessary steps to prevent a recurrence or the proliferation of abusive tax shelters.

With that, the distinguished Ranking Member, Senator Levin.

OPENING STATEMENT OF SENATOR LEVIN

Senator LEVIN. Thank you very much, Mr. Chairman. First, let me thank you for these hearings, thank you and your staff for all the support that you have given to this investigation. It has been critical and the country is very much in your debt for doing this.

Today, as you point out, is the second of 2 days of hearings on our year-long investigation into the role of professional firms, such as accounting firms, banks, investment advisors, and law firms, in the development, marketing, and implementation of abusive tax shelters.

The purpose of the transactions that we have been looking at and the transactions creating those shelters wasn't to make a profit, but it was to produce a tax loss to offset or to shelter income. These transactions were a sham, a deception, an abuse of honest taxpayers.

The first day of hearings focused on KPMG, a leading accounting firm that for the past 5 years has been heavily involved in the development and marketing of generic tax products to multiple clients, including some potentially abusive or illegal tax shelters. It took some time at the last hearing before KPMG would admit that it has been promoting tax products, but in the end, they finally did.

Today's hearing will examine some of the professional firms that have joined forces and worked hand-in-glove with KPMG in the tax shelter business—banks, investment advisors, and lawyers, without which those abusive tax shelters would never have polluted so many tax returns and robbed Uncle Sam and average taxpayers of billions of dollars of revenues.

The Subcommittee's investigation is focused on four KPMG tax shelters known by their acronyms, BLIPS, FLIP, OPIS, and SC2. The first three have already been identified by the Internal Revenue Service as potentially abusive or illegal tax shelters. The fourth, SC2, is under IRS review. BLIPS, FLIP, and OPIS required the participation of a bank, investment advisory firm, and law firm to work. Each of the professional firms here today had a role in one or more of these tax products and helped provide the legal or financial facade of economic substance for transactions whose only real purpose was to reduce or eliminate the buyer's taxes.

KPMG sold BLIPS, FLIP, and OPIS to about 300 people. It is no accident that the same banks, investment advisors, and law firms appear over and over again in connection with the transactions needed to implement these tax shelters. In fact, KPMG courted and built up relations with each of these professional firms because it couldn't implement its tax products without them. KPMG also wanted to form business alliances with other respected professionals to increase its stature in client contacts.

An internal KPMG memorandum that we just received this week, which is Exhibit 137,[1] lays it all out. In 1997, a month before he left the firm to form his own investment advisory firm called Presidio, a senior KPMG partner, Robert Pfaff, sent a memo to the two top officials in the KPMG tax services practice with a number of suggestions for, "KPMG's Tax Advantaged Transaction Practice." Among other suggestions, the memo argues for the development of "turnkey" tax products, tax shelters that KPMG clients could use without any changes to reduce their taxes.

The memo also stated that, in most cases, it will be "difficult or impossible for KPMG to be the sole provider of a tax advantaged product," in other words, a tax shelter, "due to restrictions placed on the firm's scope of activities by authorities."

The memo described KPMG's "dilemma" in its words, as follows: "To avoid IRS scrutiny, KPMG had to market its tax products as investment strategies, but if it characterized its services as providing investment advice to clients, it could attract SEC scrutiny and have to comply with Federal securities regulations."

And this memo, again, which we just received this week, explains it as follows: "It is clear we cannot openly market tax results of an investment. Rather, our clients should be made aware of investment opportunities that are imbued with both commercial reality and favorable tax results. Conversely, we cannot offer investments without running afoul of a myriad of firm and securities rules. Ultimately, it was this dilemma that led me to the conclusion that KPMG needs to align with the likes of a Presidio."

In other words, KPMG recognized that to make its tax products work, KPMG itself could not provide "investment advice." It also knew it could not issue loans or provide financing. It had no authority to practice law. It needed assistance from other profes-

[1] See Exhibit No. 137 which appears in the Appendix on page 2735.

sionals with those capabilities to carry out its tax schemes and it found them.

Law firms like Brown and Wood, which later became Sidley Austin Brown and Wood, issued favorable, boilerplate legal opinion letters for BLIPS, FLIP, and OPIS, issuing more than 250 opinion letters in all.

Investment advisory firms like Quellos doing business as Quadra, and Presidio helped set up hundreds of BLIPS, FLIP, and OPIS transactions.

Banks like Deutsche Bank, HVB Bank, and others financed hundreds of BLIPS, FLIP, and OPIS transactions. Deutsche Bank and HVB together provided more than $5 billion in financing for these transactions.

Everyone, of course, got paid lots of fees. For example, in BLIPS, clients paid a set fee at 7 percent of the planned tax loss. Now think about that. If anything demonstrates that the goal of these schemes was to produce paper tax losses, it is that the fee was based on the size of the planned tax loss. The higher the planned tax loss, the higher the fee.

In the case of the BLIPS fee, after certain expenses were subtracted, the remaining money was divvied up among the firms that carried out the client's BLIPS transaction. KPMG and the banks each got 1.25 percent, what they called 125 basis points. The investment advisor got 2.75 percent, or 275 basis points. The law firm generally got $50,000 for each opinion, possibly more in cases where the expected tax loss was large.

Looking at just the four tax products examined by this Subcommittee, KPMG brought in fees totalling at least $124 million. Sidley Austin Brown and Wood, with more than 250 opinion letters, raked in at least $50,000 per boilerplate letter and made more than $12 million. Deutsche Bank hauled in about $33 million from its OPIS transactions and expected to make the same again from BLIPS. HVB made over $5 million in less than 3 months doing BLIPS deals in 1999 and decided on doing more in the year 2000, due in part, in its own words, to "excellent profitability."

Now, what exactly were these fees for? The law firm Sidley Austin Brown and Wood provided a so-called independent legal opinion letter finding that the tax products complied with the law. In fact, the law firm collaborated heavily with KPMG to develop the products and write the opinion letters. The banks provided financing and nominal currency transactions that acted as an investment fig leaf to disguise transactions that were really tax driven. The investment advisors provided the design and the rhetoric to recast the tax dodges as investment strategies.

The facts echo what this Subcommittee uncovered during its Enron investigation: Respected professional organizations offering their services and making a lot of money by assisting other parties to complete highly structured and deceptive transactions. In this case, the transactions were intended to help KPMG's clients reduce or eliminate paying their fair share of taxes owed to Uncle Sam. By facilitating these tax schemes, these organizations also opened themselves up to possible violations of the laws against the promoting of abusive tax shelters and against aiding or abetting tax evasion.

Now, relative specifically to the SC2 tax product, we had planned to have at today's hearing one of the pension funds that KPMG approached and convinced to participate in SC2 transactions. None of the SC2 tax products could have been sold absent a charity willing to accept S Corporation stock donations under unusual circumstances. To save time, we asked the pension fund to submit a written statement instead of appearing here today.

That statement sets forth these key facts. KPMG initiated the contact with the charity. The charity did not know its 28 benefactors beforehand, and the charity was asked and expected to hold the stock it was given "for several years" and would then "be able to sell the stock back to the owner and receive cash." In short, it is clear that SC2 was intended to provide only temporary stock donations.

Also relative to SC2, we did not have time at the last hearing to address a number of very troubling statements made by the former KPMG tax partner Lawrence Manth, who headed up the SC2's sales effort and who claimed that KPMG was selling SC2 to benefit police and firefighters. The documents are overwhelming in demonstrating the opposite. KPMG was not acting altruistically in selling SC2, but again, it was helping its clients reduce or eliminate their taxes. If the sole objective was to make a charitable donation, SC2 donors could have simply donated cash instead of going through the exercise of first donating stock, then buying it back for cash, and we plan to follow up on those statements with Mr. Manth and others.

The industry which promotes abusive tax shelters should have no place in the business plans of respected legal and financial professionals. It is time to put an end to banks, investment advisors, and law firms using their talent to promote, aid, or abet dubious and abusive tax shelter schemes.

Finally, we will hear today from three key regulators: The IRS, the Federal Reserve, and the newly formed Public Company Accounting Oversight Board. Each has a role to play in convincing, or if necessary forcing, accounting firms, banks, investment advisors, and law firms to get out of the abusive tax shelter promotion business. To help those efforts, Congress needs to enact stronger penalties for promoting, aiding, or abetting abusive tax shelters. The current fines of $1,000 for individuals and $10,000 for corporations are useless as deterrents.

We also need more enforcement dollars for the IRS to go after tax shelter promoters. We also need to put an end to auditor conflicts of interest that arise when accounting firms sell tax shelter services to their audit clients and then turn around and audit their own handiwork. We need to clarify and strengthen the economic substance doctrine.

We need a coordinated regulators' review to identify abusive tax shelter products some accounting firms, banks, investment advisors, and law firms are selling, and to stop them from assisting the purveyors of abusive tax shelters.

And, as our Chairman, I think very eloquently pointed out, we need the professions themselves to adhere to higher standards of conduct.

Again, my thanks to you, Mr. Chairman, and to your staff for all the help you have given me.

Chairman COLEMAN. Thank you, Senator Levin.

I would now like to welcome our first panel to today's important hearing: Raymond J. Ruble, a former partner for the law firm of Sidley Austin Brown and Wood; Thomas R. Smith, a current partner with Sidley Austin Brown and Wood; and finally N. Jerold Cohen, a partner with the law firm of Sutherland Asbill and Brennan. I thank each of you for your attendance at today's hearing and look forward to hearing your testimony.

Before we begin, pursuant to Rule 6, all witnesses who testify before this Subcommittee are required to be sworn. I would ask you to each rise and raise your right hand.

Do you swear that the testimony you are about to give will be the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. RUBLE. I do.

Mr. SMITH. I do.

Mr. COHEN. I do.

Chairman COLEMAN. Thank you, gentlemen.

Gentlemen, we do have a timing system. I would ask that you keep your statements to 5 minutes. Your fully prepared statements will be entered into the official record.

Mr. Ruble, we will have you go first this morning, followed by Mr. Smith and finish up with Mr. Cohen. After we have heard all of your testimony, we will turn to questions. Mr. Ruble, I understand that you are accompanied by counsel. Counsel, please identify yourself for the record.

Mr. HOFFINGER. Jack Hoffinger.

Chairman COLEMAN. Thank you. Mr. Ruble, you may begin.

TESTIMONY OF RAYMOND J. RUBLE, FORMER PARTNER, SIDLEY AUSTIN BROWN AND WOOD, LLP, NEW YORK, NEW YORK, REPRESENTED BY JACK HOFFINGER

Mr. RUBLE. Thank you, sir. Senator Coleman and Senator Levin, my name is R.J. Ruble. I would very much like to respond to your questions on the matters that are being discussed today and I appreciate your endeavors in this regard. However, I have been instructed by my counsel not to testify based on my Fifth Amendment constitutional rights.

Chairman COLEMAN. Mr. Ruble, I would like to see if I could just explore two matters with you. One, if you could just turn to Exhibit 116[1] in the exhibit book, it appears to be an e-mail from R.J. Ruble that reads as follows: "This morning, my managing partner, Tom Smith, approved Brown and Wood, LLP, working with the newly conformed tax products group at KPMG on a joint basis in which we would jointly develop tax products and jointly share in the fees, as you and I have discussed." Is this, in fact, an e-mail that you prepared?

Mr. RUBLE. I must respectfully decline to answer on the grounds asserted.

[1] See Exhibit No. 116 which appears in the Appendix on page 2691.

Chairman COLEMAN. I would just ask one other question, again, for my foundational purposes. You have in the exhibit book Exhibits 90a. and 90b.[1] Exhibit 90a. purports to be an opinion by KPMG regarding some of the tax shelters that we talked about. Exhibit 90b. purports to be a Brown and Wood legal opinion. I would note that both opinions appear to have substantially the same language, in fact, almost the exact language. I would ask you again if that is a correct assertion.

Mr. RUBLE. I have been instructed to decline to answer on the grounds asserted.

Chairman COLEMAN. Given the fact that you are asserting your Fifth Amendment right against self-incrimination to all questions asked of you by the Subcommittee, you are excused, Mr. Ruble.

Mr. RUBLE. Thank you very much, sir.

Chairman COLEMAN. Mr. Smith.

TESTIMONY OF THOMAS R. SMITH, JR.,[2] PARTNER, SIDLEY AUSTIN BROWN AND WOOD, NEW YORK, NEW YORK, LLP

Mr. SMITH. Thank you, Mr. Chairman and Senator Levin. My name is Tom Smith. I am a partner in the law firm of Sidley Austin Brown and Wood and I am pleased to answer your questions to the extent that I can.

I joined Brown and Wood in 1963 and have spent my career there as a securities lawyer. I am not a tax lawyer. But from 1996 to May 1, 2001, at the time of our merger with Sidley and Austin, I was the managing partner of Brown and Wood.

Mr. Chairman, our firm wants to cooperate with the Subcommittee to the maximum extent it can. The area of tax work that brings us here today is an area that our firm no longer participates in. Unfortunately, my personal files on these matters were lost in the destruction of our office in the World Trade Center on September 11, and Mr. Ruble, the person in our firm most knowledgeable about these matters, is not available to you or to us. Thus, we are limited in the information we can provide.

Mr. Ruble is no longer a partner of the firm. He was expelled from the partnership on October 24, 2003, for activities in violation of the partnership agreement, that is, accepting undisclosed compensation and for refusing to explain his conduct to the firm.

As a result, we are not confident that the information Mr. Ruble has given us in the past and upon which we have relied is accurate, and we have so advised the Subcommittee staff, the Internal Revenue Service, and other interested parties.

That said, let me tell you a bit about the tax practice at Brown and Wood. Of the approximately ten tax partners at Brown and Wood before the merger, Mr. Ruble was virtually the only one who engaged in this practice, although he consulted with others on discrete issues. At the time Mr. Ruble began providing concurring opinions to individual taxpayers, Brown and Wood had an opinion committee and expected partners to seek the advice of that committee or of the other colleagues at the firm of novel and unsettled legal issues. In addition, Brown and Wood required approval of tax

[1] See Exhibit No. 90a. and 90b. which appear in the Appendix on pages 684 and 781.
[2] The prepared statement of Mr. Smith appears in the Appendix on page 312.

opinions by a second tax partner, and as a matter of fact, during the period in 1999, we expanded that second opinion requirement to all lawyers.

After the merger, the firm maintained and expanded the size of the opinion committee and further enhanced its policies in this area. The purpose of this policy was to help ensure the quality and consistency of tax advice provided by the firm and to provide an electronically maintained library of tax opinions that all tax lawyers could access.

No set of procedures will stop an individual from acting improperly if he or she is unwilling to abide by the rules of our profession and to engage in blatant acts of deceit and concealment. Nevertheless, we have hired a tax attorney whose principal responsibility is to monitor our internal procedures and our compliance with the evolving requirements of the Internal Revenue Service.

Prior to the merger of Brown and Wood and Sidley and Austin and as part of our transition planning, it was decided that the combined firm would stop providing individual tax opinions that this Subcommittee is considering and we would reorient the tax practice to the corporate transactional work that is central to both firms' practices. This action reflected the decision of Brown and Wood and the combined firm to redirect the efforts of the firm to our core tax work and did not and does not reflect on the quality of the work performed earlier. I understand that no court has decided that Mr. Ruble's tax opinions are wrong, much less rendered in bad faith.

Although Mr. Ruble had confirmed that he had stopped issuing opinions of this type, the firm discovered that additional opinions had been issued after the merger. When confronted with this, Mr. Ruble said that the opinions were the last in the typewriter and were being rendered because he had pre-merger commitments to provide them to clients. He was told to stop issuing such opinions. He assured the firm that he had stopped, but in fact, he lied to us. He evaded our controls we had in place and he breached the trust we reposed in him.

We had and have procedures in place designed to ensure that all of our lawyers, partners, associates, and others act in compliance with applicable laws and the highest ethical standards. In a law partnership, the effectiveness of procedures of this sort is highly dependent upon the trustworthiness of our partners.

Both Sidley Austin Brown and Wood and I personally want to thank you for the open, cooperative, and professional treatment we have received from both the Majority and Minority staff.

Chairman COLEMAN. Thank you, Mr. Smith.

Mr. Cohen, before we proceed, I note that you have a gentleman with you. For the record, would you please identify him.

Mr. COHEN. A partner, J.D. Fleming, who has come with me.

TESTIMONY OF N. JEROLD COHEN,[1] PARTNER, SUTHERLAND ASBILL AND BRENNAN, LLP, ATLANTA, GEORGIA, ACCOMPANIED BY J.D. FLEMING

Mr. COHEN. Mr. Chairman, Senator Levin, thank you very much for inviting me to these hearings. I commend you on the hearings. I think they are very important. I think if they lead to the passage of some of the provisions that were passed in the Senate CARE Act or to some of the provisions that are now in the JOBS Act, I think that will be very good.

I am especially pleased to hear both Senators acknowledging that the Service needs more resources. Over the last 7 years, its workload has gone up over 11 percent and its workforce down by over 11 percent. You just can't keep that up and it is showing, and it is showing in some of these things.

First of all, let me say that my firm, Sutherland Asbill and Brennan, has not been involved in the development, marketing, or implementation, or the promotion, aid, or abetment of the tax shelters that you have asked us about. In fact, the fourth of the shelters, SC2, I know nothing at all about.

We have been engaged by clients who were under audit by the Internal Revenue Service long after they participated in these transactions to represent them, and we have been representing them in that regard.

Every time we discuss with a client potential representation, we inform them that we cannot—cannot—participate in any suit against any promoter, whether it is the promoter or a firm that has been involved with the transaction, that we represent, and we have a litigation group that represents all of the major accounting firms, five back then, four now, in totally unrelated litigation. We tell them because of that, we cannot represent them in any action against anyone connected with this, these transactions, and we suggest to them that they obtain other counsel to represent them in that regard. We tell them that several times and we tell them to engage other counsel sooner rather than later because there is a statute of limitations problem in any actions that they might want to consider.

Now, having said that, let me also commend the staff for the Minority Report. I haven't read the whole thing, it is awfully long, but I thought it was very good. I know they worked long and hard at that. In fact, I called some of the staffers a couple of times and found them working late at night on that.

But after my letter responding to your questions and reading the Minority Report, I found that I could make further responses to some of your questions. I respect the pressure the staff was under and I know that our firm is only discussed in three pages of the large report. But I wish they had had time, and I know they didn't, to consult with me because there are a lot of misstatements in those three pages about my firm's activities.

First of all, it states that KPMG referred over two dozen clients to us. That is not true. I am not saying that I would not have liked to have had more clients, because we shared the costs of our rep-

[1] Letter to Senators Coleman and Levin, dated November 18, 2003, with responses to questions appears in the Appendix on page 315.

resentation among all the clients, and I am sure all of the clients would have liked to have had more, but we never had two dozen clients referred to us by KPMG to my knowledge. I have no idea what KPMG told you. We had clients coming in from other clients, from financial advisors, and from law firms. In fact, the first clients we had with regard to the three transactions, the three products, if you will, that I knew about came from law firms.

Let me also say that I can tell you now that we have in the three transactions that we have worked on approximately 40 such clients. That is, reading the numbers you have in your report, it is not an inconsiderable number to me, but it is a small part of the landscape.

Now, the report suggests that our only disclosure to the client was in the engagement letter, which is quite clear. Your report does cite the engagement letter stating to the clients that we cannot represent them before the accounting firms. It suggests that that is all we did, and there is an opinion that came out that cannot be correct—because it did not represent the facts.

The facts are that is not all we did. Before undertaking any engagement, we spoke to the client or to their financial advisor or whoever their advisor was. Some of these clients are so wealthy that you don't speak to the clients. They always contact the lawyers either through their own in-house lawyer or through their financial advisors, and all were advised, clients, financial advisors, in-house people, that they needed to get another lawyer to—if they contemplated any action against anyone in connection with the products. They were told to do that right away because there was a statute of limitations problem.

Now, the report also suggests that representing clients when another group in my firm represents KPMG is a conflict of interest. I will have to tell you, that goes way beyond any ethical responsibility I have been aware of in my 42 years of practice, way beyond that. And even though there is not a conflict there, we, as I said, took care to tell—KPMG knew we could not defend them against any of these clients and the clients knew we also could not represent them. If there is a conflict, I would suggest that there may be a conflict in both representing the clients before the IRS and against KPMG. It gives you a pretty tight rope to walk in making your arguments.

Finally, I would like to mention the fact that the report suggests that we entered into agreements hiring KPMG. We entered into one such so-called Covell agreement. It was entered into because the client was already being advised by KPMG. We thought we might need to have some advice from KPMG. We did not want to waive the client's attorney-client privilege, the privilege with respect to our advice, and so we entered into the one Covell letter. We never entered into another one with connection with these transactions because we never used that one, so it was never, ever used.

Chairman COLEMAN. I would ask you to summarize the rest of your testimony, Mr. Cohen.

Mr. COHEN. Well, the summary is—I think that I will go back to the start. I wish the staff had talked to me a little—had time to talk to me. I know I am not a big piece of this action, and I think I could have corrected these things. Having read the rest of the report, I am sure they would have corrected the record on that score.

And once again, I would say the one thing you didn't mention, you or Senator Levin, you mentioned that you want more disclosure. I think that is badly needed. You mentioned that you want more resources for the IRS. I think that is badly needed. The one thing you haven't mentioned is the one that I think is the most important, and that is an extension of the statute of limitations where there is no disclosure. I think that will go a lot further. In my experience, penalties have not done the job. Back when I was Chief Counsel of the Internal Revenue Service, we fought tax shelters on a much broader scale, much lower dollars, and the penalties didn't seem to stem that tide. Thank you.

Chairman COLEMAN. Thank you, Mr. Cohen, and I do want to thank you for your testimony. It has been very clarifying. I will tell you up front that on first blush, our concerns had to do with potential conflicts of interest with KPMG and you have gone a long way to explaining that and helping us understand it better, so I do thank you for that.

Let me just make sure that I do understand. First, did KPMG refer tax audit cases to you?

Mr. COHEN. I think they did, but not in the——

Chairman COLEMAN. You said you never had two dozen. Do you know what the number was?

Mr. COHEN. No, I do not at this time. I can try to find that out and submit that number to your staff. But I would say I have no idea whether KPMG thought that they referred more clients to us than they actually referred, but the references—frequently, clients come in from a number of sources. Most of our references came from law firms, from financial advisors, from the clients themselves who had talked to other clients.

Chairman COLEMAN. And I take it KPMG has an ongoing relationship with Sutherland Asbill and Brennan?

Mr. COHEN. The firm continues to defend in malpractice cases, other than cases involving tax shelters, KPMG and the other three of the remaining large accounting firms.

Chairman COLEMAN. Could you tell us the approximate amount of attorney fees that KPMG generated?

Mr. COHEN. I haven't the slightest idea.

Chairman COLEMAN. Could you provide that to us after——

Mr. COHEN. If under our professional responsibility we are allowed to and we can go to KPMG and get that authorization, that waiver, we would be more than happy to do so.

Chairman COLEMAN. I would appreciate that.

Did KPMG ever tell you they would knowingly refer clients to your firm when the subject matter was a tax scheme/shelter that they were deeply involved in?

Mr. COHEN. Never.

Chairman COLEMAN. In referring the cases that they did refer to you, my question has to do with whether you then turned around and retained KPMG to serve as consultants in the case? You indicated in your testimony that happened one time.

Mr. COHEN. One Covell letter, that's right.

Chairman COLEMAN. And then you——

Mr. COHEN. That's it.

Chairman COLEMAN [continuing]. Indicated that not again?

Mr. COHEN. Not again, and let me mention this. I never—I don't recall a client that came in just—KPMG said, go to me. My understanding was that they gave the clients a choice of firms.

Chairman COLEMAN. Thank you, Mr. Cohen.

Mr. Smith, according to IRS pleadings filed against Brown and Wood, Brown and Wood issued approximately 600 opinion letters regarding these 13 different tax avoidance products during Mr. Ruble's tenure. Can you give me a sense of kind of the knowledge, how it worked in Brown and Wood, whether folks would know about what Mr. Ruble was doing, whether they would know kind of the volume of what he was doing, the type of things that he was doing? How did that work? How did that supervision oversight work?

Mr. SMITH. Senator Coleman, I will, but let me just caution, I am sure you can tell, and I am very outraged, I can tell you what we were told and what our understanding was and I can go through that with you.

Mr. Ruble's practice in this area, I think, to the best of my understanding, really started in 1997. You referred to an e-mail in which there was a discussion—it said that there was a discussion with me. The first I knew about that e-mail was when I read it in the *Wall Street Journal* several weeks ago. I knew nothing about that. We had never been told that there was any sort of an alliance or proposed alliance with KPMG or anyone else. Had he had that conversation with me, I would have immediately talked to our executive committee about it, that I was basically the chairman of that, and this has never happened and we never approved any sort of an alliance with KPMG. That would have required a lot of analysis on our part and it just never happened.

Chairman COLEMAN. That e-mail is Exhibit 116,[1] I think, in the books in front of you, if you turn to Tab 116, the large black book right there.

Mr. SMITH. Yes.

Chairman COLEMAN. And as I indicated before, the bottom of that e-mail, "Subject, Joint Projects; Author, R.J. Ruble; Date, 12/15/97, 11:08 a.m. This morning, my managing partner Tom Smith—"

Mr. SMITH. Yes.

Chairman COLEMAN. "—approved Brown and Wood, LLP, working with the newly conformed tax products group at KPMG on a joint basis in which we would jointly develop and market tax products and jointly share in the fees as you and I have discussed." You indicate that that e-mail is not true, not accurate?

Mr. SMITH. We never—I never saw this and it is totally untrue.

Chairman COLEMAN. Are you aware of any agreement or effort to market tax products with KPMG?

Mr. SMITH. No.

Chairman COLEMAN. Can you help me understand? Is that something that would be unusual for a law firm to do?

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[1] See Exhibit No. 116 which appears in the Appendix on page 2691.

Mr. SMITH. It would be unusual for Sidley Austin Brown and Wood to do, and at that time Brown and Wood. I would be happy to tell you what our understanding was that we were doing. When you asked——

Chairman COLEMAN. Please. I would appreciate that.

Mr. SMITH. Yes. You asked how we handled this at the firm. In 1998, the revenues increased materially in this area and as the chairman, as the managing partner, I undertook and the executive committee undertook to see if we could get a better handle on what these opinions were, was this a business we should be in, what sort of exposure to risks that we had because of these opinions, and exactly what our role was in supplying these opinions. And I called the practice group head, Tom Humphries, and asked him, who was aware of what was happening here but really had not been involved with these opinions. Some of the partners had been involved with certain discrete issues, but not with the total product. That was a total opinion.

I looked at those opinions and read them. They were more likely than not based on factual representation opinions. Quite frankly, sir, I was really not in a position to pass on the validity of those opinions. I think we had four or five of our tax partners read those opinions and advise us, and the advice we got was that they were valid opinions under the then law.

We discussed with Mr. Ruble and with our tax partners exactly what our role was in this and we were told that our role was to provide concurring opinions to taxpayers, and a lot of times to their financial advisors, and Mr. Cohen testified that you do this, and that KPMG wanted an outside law firm to do this, that KPMG would designate to help the financial advisors understood this.

We understood his role to be not involved in the design of these products, but that KPMG would come to him with the product and ask him if he could render the concurring opinion. Now, to do that, Mr. Ruble had to do a thorough analysis of what was in there. It was my understanding we inquired about this, that he would perhaps make suggestions so that he could render his opinion and perhaps he might—I guess if he saw something there to improve the product, he might have passed that on. That is just an assumption on my part. We thought he was being given the product and just saying if—rendering his opinion on them, more likely than not based on the factual assumptions.

Chairman COLEMAN. My concern is, first, he issued approximately 600 opinions, so I take it he is generating a substantial amount of fees which I would then suspect is not under the radar screen of Brown and Wood?

Mr. SMITH. Absolutely not.

Chairman COLEMAN. He is generating volume here?

Mr. SMITH. Absolutely not.

Chairman COLEMAN. If he is generating that volume, I am just again trying to understand the internal mechanism. He was generating a lot of money in a tax area?

Mr. SMITH. Right.

Chairman COLEMAN. I take it he is not operating solely by himself?

Mr. SMITH. Well, that is a good question. We have all of this under review. I think in large measure, what we most fear in a law firm, he was a lone wolf, and this is——

Senator LEVIN. What?

Mr. SMITH. A lone wolf, Senator Levin, not to mention a rogue partner, which is your greatest fear.

Chairman COLEMAN. And you understand, though, again, having been in the profession for a number of decades and understanding there are lone wolves but understanding the structure of law firms, you have a guy generating a lot of fees——

Mr. SMITH. Correct.

Chairman COLEMAN [continuing]. And complex issues that when looked at are pretty clear. You look at these issues and you have on the BLIPS cases, I believe there were 66 investors. These are supposed to be 7-year investment schemes. Every one of them gets out after 60 days. You look at this thing and you can see it is being created for generating tax loss. That is what it is about. I am still troubled by the sense that it is just Mr. Ruble.

Mr. SMITH. Well, it was Mr. Ruble who was rendering the opinions and dealing with the clients. I know of no instance in my understanding where any other tax lawyer at Brown and Wood were involved in the dealings with the clients.

We had the other tax partners in the group, in a highly esteemed group, I think we had four or five of them review these opinions and advise us as to whether or not they were appropriate. And as I say, I am a securities lawyer and I have to rely on their advice in this regard.

Chairman COLEMAN. Senator Levin.

Senator LEVIN. The IRS has alleged in court that Sidley Austin Brown and Wood issued about 600 opinion letters on 13 potentially abusive or illegal tax shelters, and it is our understanding that about half of those letters, perhaps 250 to 300, were issued in connection with BLIPS, FLIP, and OPIS. Would that be about right?

Mr. SMITH. Yes, we did render approximately 600, and I think it was 13 different transactions. I just don't know the answer as to how many applied to which.

Senator LEVIN. You don't have any idea about how many were issued in conjunction with BLIPS, FLIP, and OPIS?

Mr. SMITH. No, sir. I can get you that——

Senator LEVIN. Well, we will tell you. Let us assume that our information is correct, and if you would——

Mr. SMITH. I would assume, yes.

Senator LEVIN [continuing]. For the purpose of discussion say about 300. Now, we understand that your firm charged substantially the same fee, $50,000, for each letter provided to BLIPS, FLIP, and OPIS clients.

Mr. SMITH. It was a fixed fee. I think it started at $50,000. There may have been different amounts in different instances.

Senator LEVIN. Possibly a little more——

Mr. SMITH. Yes.

Senator LEVIN [continuing]. If the tax loss was more?

Mr. SMITH. No, I don't think it was—it was my understanding it was never based on the size of the transaction.

Senator LEVIN. Well, we will get to that later in terms of the fees.

Mr. SMITH. Yes.

Senator LEVIN. So you got $50,000 for each letter, approximately?

Mr. SMITH. Approximately, that is my understanding in this.

Senator LEVIN. Now, these letters were drafted after the initial prototype, is that correct? In other words, there was an initial letter on each of these and then the following letters, follow-up letters, were virtually identical to the prototype letter, is that not correct?

Mr. SMITH. Could you help me with what you mean by prototype?

Senator LEVIN. The first letter that you wrote approving BLIPS, for instance, was followed by dozens and dozens of other letters——

Mr. SMITH. That is correct.

Senator LEVIN [continuing]. And so the first letter was the prototype.

Mr. SMITH. OK. I understand.

Senator LEVIN. And then all the successive letters, 50 or 100 on each, BLIPS, FLIP, and OPIS, were then basically cookie cutter opinions following that prototype opinion, is that correct?

Mr. SMITH. Yes. To my understanding, yes. I could not tell you to what extent they varied based on the facts. It could have been.

Senator LEVIN. All right. It could have been——

Mr. SMITH. But that was my basic understanding of it.

Senator LEVIN. All right.

Mr. SMITH. Pretty similar, basically similar, Senator, to——

Senator LEVIN. Virtually identical? Basically the same, but use your words. Now, the clients' names were changed. In how many cases were there client consultations?

Mr. SMITH. I couldn't answer that question, Senator.

Senator LEVIN. Is it possible that in most cases, there were no client consultations, you simply submitted the letter?

Mr. SMITH. I couldn't answer that question.

Senator LEVIN. All right.

Mr. SMITH. That is a question we would be interested in. We would be interested in the answer to that question.

Senator LEVIN. I would hope so.

Mr. SMITH. Yes.

Senator LEVIN. Who was your client?

Mr. SMITH. Well, we were rendering these opinions to the taxpayer. I don't think we—and that was—hopefully, we had engagement letters with respect to this which explain this and explain our role. But these opinions were being rendered—I don't think we rendered more than one opinion to any taxpayer, and that was the sole piece of legal work we did for those taxpayers, these concurring opinions.

Senator LEVIN. Right.

Mr. SMITH. KPMG as a national tax group were also rendering an opinion, to my understanding.

Senator LEVIN. The taxpayer was supposed to be your client. You don't know whether there was any personal contact with those taxpayers in most cases or not, do you, for instance, in the BLIPS transactions? Do you have any idea?

Mr. SMITH. It was my understanding that Mr. Ruble was available to consult, primarily with the financial advisors of these taxpayers. I have no idea.

Senator LEVIN. You have no idea. Did you ever ask Mr. Ruble, in all your conversations with Mr. Ruble, about this matter, as to whether he ever met with your clients?

Mr. SMITH. The tax partners would have.

Senator LEVIN. Did you ask your tax partners whether there was ever any connection?

Mr. SMITH. I did not, sir.

Senator LEVIN. Is that not an important question for a law firm, as to whether you have any contact with your client or not?

Mr. SMITH. I think it is an important question.

Senator LEVIN. But you didn't ask that of these tax partners of yours?

Mr. SMITH. I don't recall asking that, yes.

Senator LEVIN. On the question of fees, according to the American Bar Association Model Rule 1.5, a lawyer "shall not make an agreement for, charge, or collect an unreasonable fee," and then cites the factors to be considered in setting a fee amount as the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly.

It used to be that legal opinions were written for one client on a particular set of facts, but mass marketed tax products are accompanied by mass production of legal opinion letters with boilerplate language, and this is what happened here, according to your own testimony, and as a matter of fact, that is what happened with these tax shelters, BLIPS, FLIP, and OPIS. Virtually all the costs associated with the letters are attached, therefore, to drafting the first prototype opinion, which would be labor intensive. But after that, with the cookie cutter follow-ups by the hundreds, the firm has very limited costs since it used that boilerplate language to produce the later letters and rarely even consulted with the client, or you don't even know whether the clients were consulted.

Now, my question has to do with the fees that were charged on these letters. Did your firm estimate in advance about how many opinion letters would be issued for a shelter?

Mr. SMITH. It is my understanding that we had no idea how many taxpayers would be investing in these structured products.

Senator LEVIN. And would be referred to your firm?

Mr. SMITH. That would be referred to our firm.

Senator LEVIN. So now how would you decide on the fee? How can you charge $50,000 for a cookie cutter opinion letter when you don't know if you are going to issue 1, 5, 50, 100, or 200 of those letters, same fee, $50,000? How do you decide on that fee? What is it based on?

Mr. SMITH. We would have to ask Mr. Ruble how he——

Senator LEVIN. Well, you asked Mr. Ruble. I am sure you had these conversations. You ended up firing him. What did he say when you asked him, how do you base a fee?

Mr. SMITH. I never asked him how he would base the fee or——

Senator LEVIN. But you knew you were getting $50,000 for each piece of paper that your firm was issuing?

Mr. SMITH. That would be part of his——

Senator LEVIN. And you have an ethical obligation to charge your clients, who you probably never even saw, a reasonable fee. How do you base a $50,000 fee?

Mr. SMITH. That would be part of the arrangement that he would have made in the first instance, what the fees would cost, and we had no idea whether or not we were going to make money on this or not. If we were going to get $50,000 a transaction and we only had two or three, we are clearly going to lose a lot of money.

Senator LEVIN. So you did figure out that if there were only two or three of these, you would lose money.

Mr. SMITH. Well, obviously we would. The time would be greater than that.

Senator LEVIN. So what was your break-even point?

Mr. SMITH. I have no idea, Senator.

Senator LEVIN. Does your firm have any idea?

Mr. SMITH. I can sort of do an analysis of that. I doubt if we had much of an idea as to what the break-even point would be, because going into this, you wouldn't know how much research was going to be involved. You wouldn't know—I assume that there was—Mr. Ruble was conferring with his clients or the advisors of his clients to a certain extent. I can't tell you to what extent.

Senator LEVIN. Do you know how many hours? Was there a billing kept for this kind of——

Mr. SMITH. Yes.

Senator LEVIN. About how many——

Mr. SMITH. I do not have that with me. I would be happy to provide you with that.

Senator LEVIN. So you did keep track of about how many hours went into the preparation of that opinion?

Mr. SMITH. Yes.

Senator LEVIN. All right. You will submit that to the Subcommittee?

Mr. SMITH. Yes.

Senator LEVIN. But you decided—were you involved in this decision that no matter how many opinions were issued, they were all going to be about $50,000 a crack?

Mr. SMITH. I was not involved in that decision.

Senator LEVIN. Who was, besides Mr. Ruble?

Mr. SMITH. Well, at this point, I am just perplexed as to answer any of these questions. I will see what I can find out on that.

Senator LEVIN. Let me turn now to Exhibit 117.[1] This is a KPMG employee stating that, "Our deal with Brown and Wood is that if their name is used in selling the strategy, they will get a fee. We have decided as a firm that B&W opinions," that is your law firm, "should be given in all deals." They are deciding that your opinion is going to be given to presumably your client. Isn't that astounding, that some outside company is going to decide that your opinion is going to be given to folks who are supposed to receive independent advice and be your clients?

[1] See Exhibit No. 117 which appears in the Appendix on page 2692.

Mr. SMITH. Senator Levin, this was not our understanding. It was our understanding on these transactions that the taxpayer was going to be given a choice of two or three firms.

Senator LEVIN. So this comes as a surprise to you?

Mr. SMITH. Oh, absolutely.

Senator LEVIN. There was no deal with Brown and Wood, right?

Mr. SMITH. Well, certainly not to my knowledge, or the knowledge of the executive committee.

Senator LEVIN. And did you ask Mr. Ruble whether he had made a deal on your behalf with KPMG?

Mr. SMITH. Well, I don't know that we asked him if he had made a deal, having had—but we inquired heavily throughout this as to exactly what his role was.

Senator LEVIN. Did you ask him whether he had made a deal with KPMG?

Mr. SMITH. I didn't.

Senator LEVIN. Did anybody ask, as far as you know, on behalf of your firm? Did we have some kind of an arrangement with KPMG? Did anybody ask him that question?

Mr. SMITH. Well, the arrangement——

Senator LEVIN. Since you got hundreds of referrals at $50,000 a crack, did anybody ask Ruble in your presence or otherwise whether there was an arrangement with KPMG and your firm?

Mr. SMITH. Well, as——

Senator LEVIN. As far as you know, did anybody——

Mr. SMITH. There is an arrangement implicit in what I described.

Senator LEVIN. Did anyone ask Mr. Ruble explicitly whether or not there was a deal between your firm and KPMG that the users of these tax shelters would be given your letter?

Mr. SMITH. I have no knowledge of anyone asking him if there was a deal.

Senator LEVIN. Or an agreement?

Mr. SMITH. Agreement.

Senator LEVIN. My time is up, thank you.

Chairman COLEMAN. Thank you, Mr. Levin.

Let me continue and make sure I understand. The client is the taxpayer, is that correct?

Mr. SMITH. That is correct, Senator Coleman.

Chairman COLEMAN. Not KPMG. So how did the client come to your attention or to Mr. Ruble's attention?

Mr. SMITH. They would—it was our understanding, in connection with KPMG marketing these investment products that they would give the taxpayer the choice of two or three firms and that is how we would be approached thereafter.

Chairman COLEMAN. So KPMG is supposed to give the taxpayer a number of firms and it is your testimony you are not aware of any arrangement, marketing arrangements or the other type of interconnecting relationships that the Ruble e-mails reflect?

Mr. SMITH. It was our understanding that there was absolutely no efforts on our part to market or promote these products.

Chairman COLEMAN. In Exhibits 90a. and 90b.[1]—I think really have the first pages, but there are many page——

[1] See Exhibits No. 90a. and 90b. which appear in the Appendix on pages 684 and 781.

Mr. SMITH. This would be in the other book?

Chairman COLEMAN [continuing]. Opinions. Yes. If you look at Exhibit 90a., it would be just the first page, 90a. is on the stationery of KPMG. I believe Exhibit 90b. would be—you have just the first page of the opinion from Brown and Wood. So KPMG, as I would understand it, is providing an opinion to the taxpayer, right, and then Brown and Wood is supposed to provide an independent analysis, is that correct?

Mr. SMITH. That is correct.

Chairman COLEMAN. And if one looks at these opinions, the language is in substantial portion exactly the same. Do you work with the tax firms in developing your opinions?

Mr. SMITH. It was our understanding that he—his role was to review the product and determine whether he could give a concurring opinion, and really the only input that he would have would be whether or not there needed to be modifications so that he could opine.

Chairman COLEMAN. Again, these opinions are being reviewed by others in the firm?

Mr. SMITH. There was a second signer requirement throughout this provision.

Chairman COLEMAN. And so if the others in the firm are seeing kind of the exact duplications of opinions and opinion after opinion after opinion, would that shine a light or would that raise a concern to anybody?

Mr. SMITH. That, with respect to a product, the opinions are going to be basically the same. I don't know that that would shine a light. I must add that in terms of this second opinion requirement, among the many things that we are looking at is to what extent that was observed.

Chairman COLEMAN. I am concerned about the relationship with KPMG, whether——

Mr. SMITH. Right.

Chairman COLEMAN. Where is the independence in this? I can tell you from where we are sitting, Mr. Smith, there doesn't seem to be a heck of a lot of independence. From where we are sitting, as a matter of fact, there isn't. Let us lay that out. Now, the question is, is it Mr. Ruble or did it go beyond Mr. Ruble and that is what we are trying to understand.

Mr. SMITH. That what went beyond? I am sorry, Senator.

Chairman COLEMAN. The intertwining of relationships between a law firm and an accounting firm, the marketing of tax products between a law firm and an accounting firm. That is what we are trying to understand, and we are looking at stuff that says that it has been approved, it has been discussed. We are looking at substantial legal opinions that are almost exact between the accounting firm and the law firm.

Mr. SMITH. With respect to these products, they would be almost exact. I can't really tell you to what extent there might be differences, but here again, it is something I can find out for you.

Chairman COLEMAN. How do you avoid this in the future? What is Sidley Austin Brown and Wood doing today to make sure that rogue partners don't have the capacity to get involved in sham relationships with accounting firms or tax products like this?

Mr. SMITH. Well, I testified that we have strengthened our opinion policy. We have been coming up with more of a structured opinion policy. Throughout the time that we were rendering these opinions, one specific thing that we have done is put in—is have a tax attorney whose job is to monitor opinions being given in the department. We have an electronic library of these opinions, who the second opinion writer is, and this is to avoid any tax opinions being rendered that hasn't been reviewed.

But I must caution that law firms operate on a degree of trust. As you know, 25 years ago, when I first joined Brown and Wood, it was just pretty much a general partnership. We trusted each other. Unfortunately, this has been very much eroded in this instance.

We have this situation with Mr. Ruble under review, and as part of that review, we are going to consider what additional controls we have to have. I am just absolutely apoplectic that this happened and embarrassed that this happened.

Chairman COLEMAN. Senator Levin.

Senator LEVIN. I want you to look again, Mr. Smith, at Exhibit 116.[1] This is a Ruble e-mail. It is dated December 15, 1997. "This morning, my managing partner, Tom Smith, approved Brown and Wood, LLP, working with the newly conformed tax products group at KPMG on a joint basis in which we would jointly develop and market tax products and jointly share in the fees as you and I have discussed. To the extent it is possible, it would be very beneficial from our perspective to involve our San Francisco office and I have given Paul Pringle and Eric Haueter of that office your name and telephone number. Please call me when you have a chance." Mr. Smith, did you, in fact, approve Brown and Wood working with the newly conformed tax products group at KPMG as that e-mail stated?

Mr. SMITH. Absolutely not.

Senator LEVIN. Now, there were two other persons from the law firm's San Francisco office, Mr. Pringle and Mr. Haueter—it is a little hard to read, but any rate, Eric Haueter. So KPMG writes—Mr. Bickham at KPMG writes Mr. Ritchie at KPMG that the B&W initiative is moving ahead, as you can see from the attached. Now, if you will look at Exhibit 120.[2]—got it?

Mr. SMITH. Yes.

Senator LEVIN. All right. A meeting actually took place between KPMG and your two tax professionals.

Mr. SMITH. They were not tax lawyers. Paul Pringle and Eric Haueter are securities lawyers, corporate securities.

Senator LEVIN. All right.

Mr. SMITH. Corporate securities.

Senator LEVIN. Your two lawyers.

Mr. SMITH. Yes.

Senator LEVIN. Two lawyers for the B&W law firm. What took place at that meeting?

Mr. SMITH. I have no knowledge of that, Senator.

Senator LEVIN. Are they still with your firm?

[1] See Exhibit No. 116 which appears in the Appendix on page 2691.
[2] See Exhibit No. 120 which appears in the Appendix on page 2699.

Mr. SMITH. Absolutely.

Senator LEVIN. Have you asked them?

Mr. SMITH. No, I haven't, sir.

Senator LEVIN. You might do that.

Mr. SMITH. I will.

Senator LEVIN. Now, if you will take a look at Exhibit 112,[1] it is a memo dated 3 months later. By the way, before I go to that exhibit, you say you have not talked to those two lawyers——

Mr. SMITH. About that matter.

Senator LEVIN. About that matter. Is this the first time you learned that those two lawyers were named as having been at that meeting with KPMG?

Mr. SMITH. The first time I have learned of that, yes.

Senator LEVIN. Right now?

Mr. SMITH. Right now.

Senator LEVIN. All right. So now look at Exhibit 112, and this is March 13, 1998, and this is from—it is a KPMG memo saying that a working group has been formed to work on OPIS, and this working group includes R.J. Ruble of Brown and Wood. Is that unusual?

Mr. SMITH. Well, I had——

Senator LEVIN. That he is part of a working group at KPMG?

Mr. SMITH. I had heard that term working group, and it was my understanding that—working group can mean any number of things. It was my understanding that his role, as I have testified, was to provide these concurring opinions, and to the extent that he felt that a modification would be required for him to do that, perhaps that was it. When I read working group, I just had assumed that it would be something like a mailing list or something like that. I have scratched my head as to what working group means, but my understanding, I have said over and over again what his role was.

Senator LEVIN. Now Mr. Cohen——

Mr. COHEN. Yes, sir?

Senator LEVIN. Is it not true that the PSI staff invited you to come here to Washington to talk with them, you indicated you preferred not to travel here, and that you instead would want to talk to the staff by telephone?

Mr. COHEN. I spoke with the staff about not attending this because I had some client conflicts.

Senator LEVIN. Right, that you wanted to talk to them by phone?

Mr. COHEN. Yes.

Senator LEVIN. OK.

Mr. COHEN. With respect to this hearing, Senator Levin.

Senator LEVIN. And you spoke with our staff by phone on several occasions, is that true?

Mr. COHEN. I did.

Senator LEVIN. And is it true that you told the staff that your firm was then representing 24 KPMG clients?

Mr. COHEN. I don't believe—that we were representing 24? Not to my recollection, but I will try to get that number for you when I return and give that to Ms. Bean.

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[1] See Exhibit No. 112 which appears in the Appendix on page 2678.

Senator LEVIN. Is it possible you told our staff, as their notes indicate, that you were representing 24 KPMG clients?

Mr. COHEN. Well, of course, anything is possible. To my recollection, I did not.

Senator LEVIN. Did you say that you were sure that KPMG was giving your firm's name to KPMG clients that you got?

Mr. COHEN. I don't recollect that, but let me say that having read the staff's review where Mr. Jones, who heads up their controversy practice, was giving out the list of a coalition which, by the way, had about 50 lawyers in it, and we certainly would have been in that group.

Senator LEVIN. But in terms of your stating to our staff that you were sure that KPMG was giving your firm's name to KPMG clients that you got, you don't remember that?

Mr. COHEN. I don't recall stating that, but I will tell you that I suspect that is true.

Senator LEVIN. All right. Now, we interviewed a KPMG client that was referred to your firm and he told the Subcommittee that he was not repeatedly counseled that your firm represented KPMG and that he only understood that for the first time when he asked your firm for advice on whether he should sue KPMG.

Mr. COHEN. Well, he did not ask the firm. He always spoke through his financial advisor, Mr. Thornette. Mr. Thornette was, in fact, told before the engagement that we represented—that our litigation team represented KPMG and that his client, Mr. Schwartz, should obtain other counsel if he intended to pursue any cause with respect to the transaction he went into and that he should do that sooner rather than later. And that was repeated when Mr. Thornette called us later to say that he had now decided to pursue that course.

Senator LEVIN. Now, I want you to think about this scenario with me.

Mr. COHEN. Certainly.

Senator LEVIN. A client is sold a tax shelter by KPMG that turns out to be illegal, or allegedly illegal, and he wants to sue KPMG because the IRS is after him. Now, how do you undertake that representation to begin with?

Mr. COHEN. How do we undertake that?

Senator LEVIN. Yes. In other words, you had a long relationship, did you not, with KPMG? You had defended KPMG against malpractice claims. In addition to the malpractice claims, you had also represented KPMG against claims that they had given bad accounting advice, is that correct?

Mr. COHEN. In business transactions, yes, that is correct.

Senator LEVIN. So now you have a question of whether or not a client of yours with whom you had a longstanding relationship had sold an illegal tax shelter. When that comes to your attention, isn't that something where you would immediately say, I can't get involved in that matter because——

Mr. COHEN. No, that I cannot defend the taxpayer——

Senator LEVIN. Yes.

Mr. COHEN. What comes to my mind—no, I don't see a conflict there.

Senator LEVIN. In representing a taxpayer?

Mr. COHEN. No, in a tax proceeding. I could not represent that taxpayer in a proceeding against KPMG and I so informed the taxpayer and I advised the taxpayer, going beyond my ethical responsibilities, to obtain other counsel and to do that sooner rather than later.

Senator LEVIN. OK. Now take a look at Exhibit 45.[1]

Mr. COHEN. I don't have a copy of the exhibits. Are these the exhibits?

Chairman COLEMAN. The white volume has Exhibit 45.

Senator LEVIN. This is a letter sent in September 2002 by KPMG to your firm agreeing to assist the law firm in its representation of a KPMG client who had bought BLIPS.

Mr. COHEN. All right.

Senator LEVIN. So you hired KPMG as an expert in this case that was brought against him, is that correct?

Mr. COHEN. We hired—this is a typical Covell letter that is used by attorneys to protect their clients' confidential communications with them from disclosure and thereby waiver of the attorney-client privilege. At the time, as I said, this is the only one of these we entered into at the time we thought that we would be conferring with the KPMG. They had been previously the client's accounting firm. They were providing the documents in response to some things called Information Document Requests, or IDRs, furnished by the IRS, and we thought we might need their advice. We never used their advice in this connection and we therefore—we just never entered into another Covell arrangement, in connection with these transactions. But this is quite common in connection with securities, antitrust, business litigation, etc.

Senator LEVIN. This was in a firm, however, is that not correct, where a client of KPMG was also a client of yours?

Mr. COHEN. That is correct.

Senator LEVIN. And you used KPMG as the expert in the case which was brought against your client?

Mr. COHEN. That is not correct. As I said——

Senator LEVIN. That is not correct? This was not a case that was brought against your client, the taxpayer?

Mr. COHEN. We did not use KPMG as an expert. That is the part that is not correct.

Senator LEVIN. That is the part that——

Mr. COHEN. That is correct. There is no——

Senator LEVIN. You used their services in a case.

Mr. COHEN. Well, that is actually——

Senator LEVIN. Is that accurate?

Mr. COHEN. Actually, the services that they provided were primarily in response to the Information Document Requests of the IRS, which they had already started providing to their client. It turned out that there was no exchange of information that needed protection via the Covell letter. Is that—have I explained that enough?

Senator LEVIN. Was that the limit of any advice that you got, of any assistance that you got from KPMG in that case?

Mr. COHEN. The limit was——

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[1] See Exhibit No. 45 which appears in the Appendix on page 557.

Senator LEVIN. Do you see the problem here? Do you see what——

Mr. COHEN. The limit was the furnishing of documents that had to be turned over to the IRS, yes.

Senator LEVIN. And you could not get those documents except to hire them in that case and to pay them a fee? You could not get the documents otherwise, is that what you are telling me?

Mr. COHEN. Well, we could not get the documents unless KPMG was willing—except through one of two sources, the client or the client's financial advisor—I guess three sources, or through KPMG.

Senator LEVIN. Did you have to pay KPMG to get those documents?

Mr. COHEN. No. All——

Senator LEVIN. You could have gotten them without hiring them to provide services in that case.

Mr. COHEN. The fees that KPMG received with respect to its services to the client were billed to the client.

Senator LEVIN. Well, they were also, were they not, going to bill you?

Mr. COHEN. No.

Senator LEVIN. Well, what is this engagement letter which says our fees for this engagement will be based on the complexity of the issues? This is Exhibit 45.

Mr. COHEN. Our fees in this engagement will be based on the complexity——

Senator LEVIN. It says here, we are pleased to engage KPMG to assist Sutherland—that we are pleased you have engaged KPMG.

Mr. COHEN. Well, since the client was being billed for this, this was run by the client's advisor as to whether this was the arrangement the client had with KPMG for fees.

Senator LEVIN. And so the fees on page 2 that they are talking about are fees that they were charging to your joint client, is that correct?

Mr. COHEN. These are fees that they were charging the client for their services in responding to Information Document Requests and the next paragraph makes it clear that our firm, since we are not being—we are not remitting anything to KPMG, we will only remit something to KPMG after the client sends a check to us.

Senator LEVIN. And so the only funds that went to KPMG were from your joint client? Is that correct?

Mr. COHEN. The only funds that went to KPMG were from KPMG's client.

Senator LEVIN. Who was also your client?

Mr. COHEN. My client, I was representing this client in connection with the audit and the potential settlement of his tax matter.

Senator LEVIN. So joint client?

Mr. COHEN. Well, I don't——

Senator LEVIN. It was a client of both of yours?

Mr. COHEN. Yes.

Senator LEVIN. OK.

Mr. COHEN. But that is—in my—normally, Senator, I would think of a joint client as someone you are jointly representing before the IRS. That is not the case.

Senator LEVIN. I understand.

Mr. COHEN. That is not the case.

Senator LEVIN. It was a client of both of yours——

Mr. COHEN. Well——

Senator LEVIN. In different matters?

Mr. COHEN. That is true, Senator, and I will tell you that I have a lot of——

Senator LEVIN. I am just asking you if that is accurate.

Mr. COHEN. That is absolutely accurate. I have a lot of clients that are joint clients in that sense.

Senator LEVIN. I understand.

Mr. COHEN. In fact a number of major corporations in the country are clients of mine for tax matters and are joint clients in that they are clients of KPMG.

Senator LEVIN. Thank you.

Mr. COHEN. Certainly.

Chairman COLEMAN. Gentlemen, thank you for your testimony. Mr. Smith, I know that you were reading a statement that has not been submitted to the Subcommittee. Would you make that available to the Subcommittee?

Mr. SMITH. Yes.[1]

Chairman COLEMAN. Thank you. Your testimony has been very helpful. Thank you very much.

I would now like to welcome our second panel to today's important hearing: William Boyle, former Vice President of the Structured Finance Group of Deutsche Bank; and Domenick DeGiorgio, former Vice President of Structured Finance at HVB America. I thank each of you for your attendance at today's hearing and look forward to hearing your testimony.

Before we begin, pursuant to Rule 6, all witnesses who testify before the Subcommittee are required to be sworn. I would ask at this time that you please stand and raise your right hand.

Do you swear that the testimony you are about to give before the Subcommittee will be the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. BOYLE. I do.

Mr. DEGIORGIO. I do.

Chairman COLEMAN. As I indicated, gentlemen, before the previous panel, we use a timing system here. Statements should be five minutes. If you have a more complete statement, your entire statement will be entered into the record.

Mr. Boyle, we will have you go first, followed by Mr. DeGiorgio. After we have heard all the testimony, we will turn to questions. Mr. Boyle, you may proceed.

TESTIMONY OF WILLIAM BOYLE,[2] FORMER VICE PRESIDENT, STRUCTURED FINANCE GROUP, DEUTSCHE BANK AG, NEW YORK, NEW YORK

Mr. BOYLE. Chairman Coleman, Ranking Member Senator Levin, and members of the Subcommittee, thank you for inviting me today. My name is William Boyle. I am a former employee of Bankers Trust. I joined Deutsche Bank when it acquired Bankers Trust.

[1] The prepared statement of Mr. Smith appears in the Appendix on page 312.

[2] The prepared statement of Mr. Boyle with an attachment appears in the Appendix on page 317.

I left Deutsche Bank 2 years ago and am now an independent consultant.

I welcome the opportunity to speak today about a transaction called BLIPS. The Subcommittee requested that I appear for an interview, which I was pleased to do so last week. The Subcommittee also requested that I appear today to testify, and I am pleased to do so voluntarily.

Mr. Chairman, I was not involved in BLIPS at its inception. The BLIPS transaction was first proposed to Deutsche Bank in early 1999. Deutsche Bank played a banking role in the BLIPS transactions. My personal involvement in BLIPS began around June 1999, when I became a Vice President in the Structured Transactions Group of Deutsche Bank.

BLIPS was developed for clients of KPMG. I understand it was designed for KPMG—I am sorry. I understand it was designed by KPMG or Presidio Advisors or both. BLIPS involved interest rate swaps and investments in foreign currency option contracts and foreign and domestic fixed-income securities.

As part of BLIPS, Deutsche Bank issued to investors approximately 56 loans from September 1999 through October 1999. The stated principal amount plus premium of these loans was approximately $7.8 billion. The average size of the loan issued to the BLIPS investor by the bank was approximately $139 million.

The bank lent money to investors and it executed transactions as directed by investors' investment advisors. As a major global bank, Deutsche Bank was able to provide financial services for such transactions. These services included providing large loans, custody services, foreign exchange option trading, and interest rate derivatives.

The transactions were not designed by Deutsche Bank. The bank did not present BLIPS to investors or in any other way market, sell, or promote it. Deutsche Bank did not provide any tax advice to any of the investors, nor did the bank discuss with any investor any potential tax benefits of the investment.

Deutsche Bank took several risk management steps to assure that its actions in the BLIPS transactions were limited to its role as the executor of the financial transactions. Let me summarize those actions.

First, before making the loans, Deutsche Bank conducted an internal review process. The internal groups that reviewed the bank's provision of services were Deutsche Bank Private Banking, Global Markets, Tax, Legal, Credit Risk Management, Treasury, and Compliance.

Second, each of the BLIPS investors agreed in writing that Deutsche Bank had not provided them with any tax, legal, investment, or other advice, and that they had, in fact, received such advice from expert professionals. One paragraph of that agreement read, "You have been independently advised by your legal counsel and will comply with all Internal Revenue laws of the United States."

Third, the bank received written representation letters from KPMG, Presidio, and each investor that described the limited scope of Deutsche Bank's involvement in the BLIPS transactions. This was done so that there would be no misunderstanding.

Fourth, Deutsche Bank consulted with a prominent outside independent law firm for its counsel. The law firm drafted and reviewed the transactional documents pertaining to the bank. It also provided Deutsche Bank with a legal opinion, which has been provided to the committee. This opinion concluded, among other things, that Deutsche Bank is not a promoter or organizer of the BLIPS transactions and that Deutsche Bank had no responsibility to register the transaction as tax shelters.

Regarding the tax treatment, Deutsche Bank understood that the BLIPS transactions involved potentially favorable income tax benefits that could be claimed by investors. In discussing the tax issues, it is important to describe the role of the bank. Deutsche Bank provides banking services for a transaction. As such, it is not customary or appropriate to provide legal or tax advice to its clients, nor is it customary or appropriate to determine in advance whether a client's tax position will later be sustained. Historically, that is not a role that banks are authorized to play.

Deutsche Bank's role as the executor of financial transactions meant that the determination of whether the investor's tax position would be sustained was outside of its banking role. Such a determination was the appropriate responsibility of the investor's lawyers and accountants. However, Deutsche Bank carefully considered its involvement in BLIPS and sought independent legal advice that it was complying with its responsibilities.

Mr. Chairman, that concludes my oral statement and I would be pleased to answer questions.

Chairman COLEMAN. Thank you very much, Mr. Boyle.

Mr. DeGiorgio, I notice you have a gentleman with you. Would he please identify himself for the record?

Mr. SKARLATOS. Yes, sir. My name is Brian Skarlatos.

Chairman COLEMAN. You may proceed, Mr. DeGiorgio.

TESTIMONY OF DOMENICK DeGIORGIO,[1] FORMER VICE PRESIDENT, STRUCTURED FINANCE, HVB AMERICA, INC., NEW YORK, NEW YORK, ACCOMPANIED BY BRIAN SKARLATOS

Mr. DEGIORGIO. Thank you, Mr. Chairman. Chairman Coleman, Ranking Member Senator Levin, and members of the Subcommittee, my name is Domenick DeGiorgio and I am a Managing Director in the New York City office of Bayerische Hypo-und Vereinsbank, otherwise known as HVB. I appreciate the Subcommittee's invitation to come before you to discuss HVB's limited involvement with tax-oriented transactions in the late 1990's.

We agree with the Subcommittee that there are important public policy issues raised by the tax shelter phenomenon and we support the Subcommittee's investigation into it. We look forward to discussing with you in the future the issues it raises.

My written testimony addresses the specific questions asked by the staff about HVB's role in any tax-oriented transactions. As I point out in that submission, we were only involved in one particular series of transactions that the Subcommittee is investigating, the so-called BLIPS transactions, and our role there was

[1] The prepared statement of Mr. DeGiorgio appears in the Appendix on page 326.

limited to providing traditional banking services, such as lending, foreign currency trading, and some interest rate derivative trading.

We did not organize, promote, or market any tax shelter transactions and we certainly did not offer tax advice or tax opinions or any other kind of financial or investment advice to any of the customers. We did not refer any customers to KPMG or Presidio and we did not accept, or, for that matter, were offered any referral fees. To reiterate, our role was strictly as bankers in these transactions.

The Subcommittee staff has assured us that they agree HVB's activities in connection with the BLIPS transactions were legal and appropriate. We complied with applicable statutory and regulatory obligations. We followed our own cautious and conservative internal lending policies and the "know your customer" requirements.

However, we recognize that the mass marketing of abusive tax shelters is a serious problem and we agree that financial institutions should not facilitate these types of products. Indeed, we discontinued our participation in the BLIPS transactions as soon as the IRS announced its position that they were improper. Since then, we have addressed our concerns about tax structured transactions by exiting the business entirely. We have concluded that tax structured transactions require extensive outside expert advice and go beyond our expertise as banking professionals.

The staff has also told us that they appreciate HVB's candor and openness in providing information during the Subcommittee's investigation. Senator Levin's Minority Report released Tuesday makes a note of that fact.

We have fully cooperated with your inquiries. We have produced thousands of pages of documents and have given several hours of interviews with the staff, even before my appearance here today. We even requested a friendly subpoena before my appearance here today so that I would be able under the financial privacy laws to discuss any questions or respond to any questions you may have.

As I said, my written testimony addresses the specific issues you have asked me to discuss and I will be happy to discuss them now.

Chairman COLEMAN. Thank you, Mr. DeGiorgio. I apologize. Having lived in Brooklyn, New York, and my neighbors were Keratanuito, Kalavido, and Camparelli, I should have been able to handle DeGiorgio, so—— [Laughter.]

Mr. DEGIORGIO. Mr. Chairman, it happens all the time.

Chairman COLEMAN. I apologize for that, and thank you for your cooperation.

Did KPMG, in your discussions with KPMG—first of all, how many of these BLIPS transactions was HVB involved in?

Mr. DEGIORGIO. Over the 2-year period, approximately 30 transactions.

Chairman COLEMAN. Did KPMG ever indicate to you this was a tax mitigation strategy versus an investment strategy?

Mr. DEGIORGIO. We certainly were aware, as opposed to being ignorant, regarding the inherent tax benefits associated with the investment strategy.

Chairman COLEMAN. Did it ever become clear to you that this was not going to be a 7-year collateral premium loan as originally laid out, that this was going to be a 60-day deal?

Mr. DEGIORGIO. We certainly recognized soon after the funding date that the likelihood of going beyond a 60-day period was less probable than the probability of this transaction remaining through maturity.

Chairman COLEMAN. If I can direct your attention to Exhibit 111.[1] This, I believe, is a Presidio credit request, and if you look at the second page, I think it is, under background, counterparty purpose of transaction, it reads as follows. "HVB will earn a very"—again, let me just back up. If you go to page 1, under comments, it says, "We are seeking an approval to fund four 7-year collateralized premium loans." That is in the box labeled comment. That is on the No. 1 relationship.

If you then go to box three, it notes that "HVB will earn a very attractive return if the deals run to term. If, however, the advances are prepaid within 60 days, and there is a reasonable prospect they will be, HVB will earn a return of two-point"—I can't read that—a certain percent "on the average balance of the funds advanced, and given the fact that our collateral will most likely be cash deposits, at least for the early stage of the transaction, we enjoy the possibility of earning an infinite ROE," presumably return on investment, "on these loans."

So at what point did somebody tell you these things are going to be 60-day deals and not 7-year premium high-risk loans?

Mr. DEGIORGIO. The communication regarding the likelihood of these transactions or the investors terminating their positions prior to the 7-year maturity rate came to the bank through the Presidio investment firm. I don't recall the exact verbiage used, but it went along the lines of it is likely that if the investors do not earn a substantial return on their investment during phase one of the investment strategy, they are likely to terminate their positions before the end of the year.

Chairman COLEMAN. I have trouble with—well, let me back it up. Out of the 30 BLIPS transactions, how many got out after 60 days?

Mr. DEGIORGIO. Eleven were funded in 1999 and all 11 terminated their positions in 1999.

Chairman COLEMAN. In 60 days?

Mr. DEGIORGIO. Yes.

Chairman COLEMAN. Did that raise any question in your mind about whether these were 7-year premium deals or 60-day deals?

Mr. DEGIORGIO. Well, it certainly turned out to be 60-day transactions, but I still believe that there was some rational explanation and basis for entering into a 7-year facility.

Chairman COLEMAN. How did you come to the interest rates on these? Do you recall what the interest rate was for these loans?

Mr. DEGIORGIO. I thought I would have that information on the front page of this exhibit, but I don't seem to see it there.

Chairman COLEMAN. Well, how do you arrive at something generating a premium? What is the basis for that?

Mr. DEGIORGIO. I am sorry, generating a premium?

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[1] See Exhibit No. 111 which appears in the Appendix on page 2660.

Chairman COLEMAN. Yes. In these loans, you have a base loan, right, then you have a premium, how does that happen? What kind of conditions do you need for that to happen?

Mr. DEGIORGIO. The rate on the premium, is that what you are asking me?

Chairman COLEMAN. Yes.

Mr. DEGIORGIO. That is——

Chairman COLEMAN. I was told, I believe, by staff that it was right around 17 percent.

Mr. DEGIORGIO. Correct.

Chairman COLEMAN. Is that a high rate?

Mr. DEGIORGIO. I think it was closer to 18 percent, and that is strictly a function of the net present value derived between the difference of the loans or the funds advanced and—over a 7-year term—and the stated or face amount of the loan.

Chairman COLEMAN. But again, based on a 7-year term?

Mr. DEGIORGIO. Correct.

Chairman COLEMAN. But early on, you are noting that the reasonable prospects that this is going to be 60 days.

Mr. DEGIORGIO. Well, we certainly had some questions as to whether or not the investors could make a substantial return on their investment.

Chairman COLEMAN. What kind of credit risk was there with these loans?

Mr. DEGIORGIO. The credit risk was nominal.

Chairman COLEMAN. And that is——

Mr. DEGIORGIO. As I am sure you see, most of the transactions were over-collateralized.

Chairman COLEMAN. Is that unusual?

Mr. DEGIORGIO. Not necessarily. In many situations where trading activities or underlying investments are the motives or basis for taking down a loan, the collateral coverage is rather high.

Chairman COLEMAN. Did you have any knowledge whatsoever that by getting out after 60 days, with the premiums that these generated, that you were generating a tax loss for an investor?

Mr. DEGIORGIO. Again, we certainly were not ignorant of the resultant tax benefits. It is part of our due diligence.

Chairman COLEMAN. And you realize our concern that these resulting tax benefits couldn't have come about unless you participate in this.

Mr. DEGIORGIO. Well, we certainly also recognized that a loan needed to be funded and you needed banks to fund those loans. But I think with permission, I would like to just elaborate on that for a moment and make it clear to the Subcommittee that for the tax advice and the tax analysis and the tax aspects of this transaction, our due diligence included understanding what support or level of support firms such as KPMG could and was willing to provide to its client base. And having received a copy of the draft of the opinion that was authored by KPMG, we certainly felt comfortable that based on the letter of the law and the analysis, that the opinion was well reasoned and it was supported by case study and we had no expertise or ability to challenge the conclusions reached in that opinion.

Chairman COLEMAN. Mr. Boyle, let me get back to this issue about getting out in 60 days. Did Deutsche Bank expect that the taxpayers would likely terminate the BLIPS after only 60 days, even though the stated term of the loan was 7 years?

Mr. BOYLE. I think that Deutsche Bank understood there was a strong likelihood of that happening, and, in fact, it did happen.

Chairman COLEMAN. I think strong likelihood may be an understatement. Will you turn to Exhibit 69,[1] please. By the way, how many BLIPS transactions did Deutsche Bank process?

Mr. BOYLE. I believe approximately 56.

Chairman COLEMAN. How many is that?

Mr. BOYLE. I believe 56.

Chairman COLEMAN. Fifty-six. Exhibit 69 is from Presidio Advisors.

Mr. BOYLE. OK.

Chairman COLEMAN. And it is to John Rolfes at Deutsche Bank. Can you identify who John Rolfes is?

Mr. BOYLE. John Rolfes, I believe, is a Managing Director in the Private Bank.

Chairman COLEMAN. And this says, "John, further to our Friday phone conversation, I would like to describe the necessary financing steps the BLIPS program will require," and it lays it out. Day one, investor borrows a certain amount for 7 years, 16 percent annual rate. On day two, and I'm going to go now to the fourth paragraph, excuse me, day 7. On day 60, investor exits partnership and unwinds all trades in partnership. So Deutsche Bank up front knew that even though you were issuing what was a 7-year loan with an interest rate predicated on that, in fact, this was a 60-day deal.

Mr. BOYLE. Well, clearly, the credit agreement was 7 years, but you can see everyone got out of the loans we were involved in in a 60-day period, yes.

Chairman COLEMAN. And again with Deutsche Bank, as with HVB, collateral here was more than the amount of the loan and the premium combined, is that correct?

Mr. BOYLE. Yes.

Chairman COLEMAN. Deutsche Bank didn't have much risk in this.

Mr. BOYLE. Deutsche Bank had risk depending upon what the underlying assets were. I believe in the first stage, as you had seen, they elected to invest them in kind of short-term money market fund-type investments, so those were fairly very low risk, yes.

Chairman COLEMAN. And didn't Deutsche Bank insist that if collateral ever dipped below the 100 percent—101 percent figure, Deutsche Bank would be entitled to get its money back immediately?

Mr. BOYLE. Yes. Well, I think that is a normal provision. I don't think that provision itself is unusual because your recourse is to the assets that are there, so you want to ensure that you can dispose of the assets and repay the loan, yes.

Chairman COLEMAN. So tell me again the reason for the 16 percent interest. How do you arrive at that figure?

[1] See Exhibit No. 69 which appears in the Appendix on page 644.

Mr. BOYLE. My understanding is the client requested a premium loan, and once again, you determine the 16 percent rate would—you would basically discount that back and ensure that you received all the payments——

Chairman COLEMAN. So the client requests a premium loan and it is a premium loan that feeds into the tax consequences, the opportunity to get a tax loss, is that correct?

Mr. BOYLE. That is my understanding, yes.

Chairman COLEMAN. And that is what happened in all of these situations?

Mr. BOYLE. Yes.

Chairman COLEMAN. Senator Levin.

Senator LEVIN. Mr. DeGiorgio, looking at this straight, would you not agree that this was basically intended to be a tax deal for the taxpayer? Just to cut through all this stuff before—I am going to go through all of it with you anyway——

Mr. DEGIORGIO. OK.

Senator LEVIN [continuing]. To prove it, but—— [Laughter.]

In your heart of hearts, is this not clearly intended to be a tax deal?

Mr. DEGIORGIO. I think to dispute the notion that there were inherent and significant tax benefits is ridiculous. However, the investment strategy was described to us as a significant motive for these investors to enter into this transaction.

Senator LEVIN. Could there be any profit in this transaction? I mean, is there any way? Just take a look at it. The only thing which was at risk was 7 percent of the premium, correct?

Mr. DEGIORGIO. During phase one, which is the first 60-day period?

Senator LEVIN. Right.

Mr. DEGIORGIO. Correct.

Senator LEVIN. The only thing that was at risk, and they all bailed out after 60 days——

Mr. DEGIORGIO. Right.

Senator LEVIN [continuing]. And we will go through that just to show that is what the intention was. That is what the plan was, to finish at 60 days and then collect your tax loss. So assuming that is what happened, the only possible money that had any risk attached to it was that 7 percent that the taxpayer put up to pay all the fees, is that correct?

Mr. DEGIORGIO. Again, at least initially during phase one——

Senator LEVIN. During the 60 days.

Mr. DEGIORGIO. Yes.

Senator LEVIN. OK. Is that correct?

Mr. DEGIORGIO. Yes.

Senator LEVIN. All right. Now, within 1 week after this loan was taken out by the taxpayer, the loan was assigned to an investment fund, right?

Mr. DEGIORGIO. Correct.

Senator LEVIN. And you were aware of that fact?

Mr. DEGIORGIO. Yes.

Senator LEVIN. Why wasn't the loan just made to the investment fund?

Mr. DEGIORGIO. That, I don't know. I am not sure why there was a two-tiered fund.

Senator LEVIN. Why there was an assignment?

Mr. DEGIORGIO. Correct.

Senator LEVIN. You don't know why these loans were just not made to the investment fund? Would there have been a tax advantage if it had been made to the investment fund?

Mr. DEGIORGIO. There probably was, if I recall some of the aspects of the KPMG opinion, it did refer to a shifting of liability from one entity to another.

Senator LEVIN. Assignment of——

Mr. DEGIORGIO. Being correlated with the tax benefit.

Senator LEVIN. Of course. From what you now know, would you agree the only way that the tax benefit, the tax loss, would be created is if the loan originally went to the taxpayer and then was almost immediately assigned to that so-called investment fund? Is that what you now are aware of?

Mr. DEGIORGIO. I am—the only way is a strong statement and I probably couldn't make that. But I can certainly ascertain that it is one way of creating a tax loss.

Senator LEVIN. All right. If you could think of the other reason for doing that, let the Subcommittee know, will you, for the record?

Mr. DEGIORGIO. Sure.

Senator LEVIN. We haven't been able to find one yet, but if you can find one, let us know.

Now, did you eventually come to understand, at least, that BLIPS was primarily a tax avoidance scheme?

Mr. DEGIORGIO. No, I did not.

Senator LEVIN. Let us go to Exhibit 107.[1] Is it Alex Nouvakhov—am I pronouncing his name correctly?

Mr. DEGIORGIO. Very close.

Senator LEVIN. All right. He is with your bank?

Mr. DEGIORGIO. Yes, he is.

Senator LEVIN. Now, he acknowledged to us that he knew that BLIPS was a tax shelter and here is what his notes read, if you could take a look at his notes. They are a little bit hard to read, but you will see on the right-hand side, right in the middle where there is a 7 percent and then there is an arrow up. Do you see that?

Mr. DEGIORGIO. I am with you.

Senator LEVIN. OK. It says, "Seven percent fee equity paid by the investor for tax sheltering." Do you see that?

Mr. DEGIORGIO. Yes, I do.

Senator LEVIN. Well, he was aware of it, then, right?

Mr. DEGIORGIO. Well, certainly—I certainly was present at the meeting where this presentation was made.

Senator LEVIN. Is that an accurate note?

Mr. DEGIORGIO. The note reflects the cost and how Presidio had intended on charging its investors for participating in the investment structure.

Senator LEVIN. He didn't say investment structure. He says tax sheltering. Was that an accurate note or wasn't it?

[1] See Exhibit No. 107 which appears in the Appendix on page 2646.

Mr. DEGIORGIO. Actually, what Alex Nouvakhov thought at the point in time, I don't recall Presidio mentioning or referring to this as a tax shelter, but they certainly described to us how the calculation of the cost to the investor was being made.

Senator LEVIN. Did you understand it basically to be a tax sheltering effort?

Mr. DEGIORGIO. I am sorry, can you repeat that, Senator?

Senator LEVIN. Did you understand this at that point, then, to be basically a tax sheltering effort?

Mr. DEGIORGIO. No. I still referred to this——

Senator LEVIN. I know you referred to it. I am talking about what you understand as a knowledgeable business person. Mr. Nouvakhov referred to it as a tax shelter and that the 7 percent fee was for that purpose. Now I am asking you, under oath, did you understand this to be and believe it to be basically a tax sheltering effort?

Mr. DEGIORGIO. No, I did not. I still viewed it as an investment strategy with inherent tax benefits.

Senator LEVIN. Now take a look at Exhibit 124.[1] This is an HVB document. This begins on day 48. And then if you look at the second line on page one, it says, "Day 48, ten business days prior to the withdrawal date." That is your document, right?

Mr. DEGIORGIO. Yes, it is.

Senator LEVIN. So it was obvious to you when you prepared this document that the withdrawal was going to occur on day 60, was it not?

Mr. DEGIORGIO. Not exactly.

Senator LEVIN. What does it mean, ten business days prior to withdrawal date? It doesn't say possible withdrawal date. It says withdrawal date, right? Are you familiar with this document?

Mr. DEGIORGIO. Absolutely.

Senator LEVIN. Does it say prior to withdrawal date? Am I reading it right, or is this something subject to interpretation like Mr. Nouvakhov's notes?

Mr. DEGIORGIO. No, not at all. I can explain it fully.

Senator LEVIN. All right.

Mr. DEGIORGIO. Given the time of year, obviously it was fourth quarter 1999 going into a Y2K event, we as an institution—since we had reasonable expectations that the transactions would terminate within a 60-day period—prepared our back office and operations teams for the reasonable expectation of an unwind.

Senator LEVIN. Within 60 days?

Mr. DEGIORGIO. Within 60 days. But I have to say, Senator, if this were a different time of the year, in other words, if these transactions were funded in January and the 60-day period occurred within the first quarter of that year, this process would never have been put in place. It was simply a function of year-end constraints in addition to the Y2K events.

Senator LEVIN. To summarize your testimony, you had the reasonable expectation that the withdrawal would occur by day 60 and then that happened in every case?

Mr. DEGIORGIO. Correct.

[1] See Exhibit No. 124 which appears in the Appendix on page 2705.

Senator LEVIN. There was a theoretical possibility that it wouldn't occur within 60 days, is that correct?

Mr. DEGIORGIO. Theoretical possibility.

Senator LEVIN. And your bank could force it to end at 60 days, couldn't it?

Mr. DEGIORGIO. No.

Senator LEVIN. You didn't have the power to end it at 60 days?

Mr. DEGIORGIO. No, unless there were violations in the collateral ratio.

Senator LEVIN. And the collateral ratio was 100 percent-plus, right?

Mr. DEGIORGIO. Hundred-and-one-point-two-five.

Senator LEVIN. Pretty solid collateral there?

Mr. DEGIORGIO. Absolutely.

Senator LEVIN. No risk for the bank?

Mr. DEGIORGIO. No credit risk. Plenty of execution and operational and administrative risks.

Senator LEVIN. There were operational risks. Didn't you control the fund? Wasn't it in your custody?

Mr. DEGIORGIO. The funds were not necessarily at risk because you are absolutely correct. The funds remained in an account under the customer's name at the bank.

Senator LEVIN. At your bank?

Mr. DEGIORGIO. Correct. The risks I am referring to, again, are operational regarding the trading activities——

Senator LEVIN. Which was limited to the 7 percent that the customer put up, right?

Mr. DEGIORGIO. During the first 60 days, correct.

Senator LEVIN. And you had the reasonable expectation when it would end, right?

Mr. DEGIORGIO. Yes. I said that.

Senator LEVIN. I now want you to say it, though, in connection with this point, which is that since there was an expectation that it would end within 60 days and there was no risk to the bank of its funds at all within that 60 days, because you were more than fully collateralized, that therefore the reasonable expectation was there would never be a risk to the bank.

Mr. DEGIORGIO. Certainly the likelihood of there being credit risk to the bank was low, as we have ensured to protect ourselves with the over-collateralization measures.

Senator LEVIN. And if you look at Exhibit 125,[1] you have a chart showing that all the loan proceeds—not the equity, not that 7 percent, the taxpayer's equity—is converted into Euros and will be converted back 30 days later. So this is a Euro account. This is not the loan, the premium loan or the basic loan. This is just the 7 percent, is that correct, or is this the whole loan?

Mr. DEGIORGIO. This is the whole loan proceeds.

Senator LEVIN. This is the loan proceeds?

Mr. DEGIORGIO. Right.

Senator LEVIN. So the so-called loan, and there is a great question as to whether there was a loan here at all since, for all the reasons that have been given the other day, but basically it was in

[1] See Exhibit No. 125 which appears in the Appendix on page 2711.

your control, fully collateralized, and expected to be terminated at 60 days during which there was no risk, but in any event, during that period, there was a deposit into a Euro account, is that basically correct?

Mr. DEGIORGIO. That is correct.

Senator LEVIN. Were any of the loan proceeds during that period put at risk during the investment scheme, as part of the investment scheme?

Mr. DEGIORGIO. Not during the first 60-day period.

Senator LEVIN. That is the period we are talking about, right?

Mr. DEGIORGIO. Yes.

Senator LEVIN. My time is up. Thank you.

Chairman COLEMAN. We will come back to a second round, Senator Levin.

Senator LEVIN. Thank you.

Chairman COLEMAN. Mr. Boyle, on the issue about whether the loan was at risk in terms of the Deutsche Bank transactions, did Deutsche Bank lay out some requirement that the loan had to be invested in certain types of securities?

Mr. BOYLE. There was a list of permitted investments, yes.

Chairman COLEMAN. And these, it is my understanding, they generate a lower rate of return than the interest that the Deutsche Bank was charging?

Mr. BOYLE. I believe that the investment that they chose for the first days was an investment that——

Chairman COLEMAN. So Deutsche Bank knew up front there was going to be no profit generated within this 60-day period.

Mr. BOYLE. To the—you mean with—after——

Chairman COLEMAN. Investor.

Mr. BOYLE. After he made the investment, yes.

Chairman COLEMAN. And again, at least the Deutsche Bank clearly got from Presidio a memo saying this is a 60-day deal.

Mr. BOYLE. Like I said before, there was an expectation that it may very well wind up at 60 days, and in fact, did unwind.

Chairman COLEMAN. I mean, again, expectation. On day 60, investor exits partnership and unwinds all trades in partnership. That is Exhibit 69. That is not an equivocal expectation, is it?

Mr. BOYLE. That language is clearly not, no, sir.

Chairman COLEMAN. Exhibit 113.[1] This is a memo, Deutsche Bank Private Bank management committee meeting talking about the BLIPS product, is that correct?

Mr. BOYLE. Yes.

Chairman COLEMAN. And on page two, it indicates that KGT suggests that 25 customers be selected from different geographic areas. PKS will ensure that written agreements be prepared. Can you help me understand why you would want to select 25 customers from different geographic areas?

Mr. BOYLE. I don't know precisely. That was a Private Bank recommendation, I guess, to John Rolfes. I don't believe that applied to us per se in the Structured Transactions Group.

Chairman COLEMAN. Is that unusual, to put those kinds of geographic limitations on this?

[1] See Exhibit No. 113 which appears in the Appendix on page 2679.

Mr. BOYLE. I don't know, to be honest with you, sir. No.

Chairman COLEMAN. Our concern here, is this an effort to keep this under the radar screen?

Mr. BOYLE. I don't know.

Chairman COLEMAN. Have you heard of any other similar restrictions being placed in any other Deutsche Bank transactions?

Mr. BOYLE. Not that I am aware of, no.

Chairman COLEMAN. And Deutsche Bank ultimately engaged in 56 of these deals. Senior management said 25. What is the reason for the difference?

Mr. BOYLE. The reason for the difference. A different—originally, we were focusing on the amount that we may potentially loan and we wanted to do things in different stages to make sure we were comfortable executing the transactions, and I believe the initial stage, we were approached with the idea of doing up to 25 investors.

Chairman COLEMAN. Again, I go back to this question that Senator Levin asked of Mr. DeGiorgio. Looking at this, is there any question in your mind that these were tax shelters that were going to be used to provide opportunities for taxpayers to generate loss and write it off?

Mr. BOYLE. Well, it is very clear from the opinions and everything that there were significant tax benefits that the investor may report on its return, yes.

Chairman COLEMAN. Were you concerned? Is Deutsche Bank concerned at all about the reputational risk for being involved in this stuff?

Mr. BOYLE. You know, like all investments, we are very concerned in terms of reviewing, going through a very thorough internal review.

Chairman COLEMAN. Have you changed your practices today?

Mr. BOYLE. I am no longer an employee, so—I am certain they adjusted everything accordingly, but I am not there anymore.

Chairman COLEMAN. And Mr. DeGiorgio, you have indicated that HVB has, in fact, changed its practices?

Mr. DEGIORGIO. That is correct, and it is DeGiorgio. [Laughter.]

Chairman COLEMAN. And it changed its practices because these are abusive tax shelters?

Mr. DEGIORGIO. Well, when it became abundantly clear to the bank that the IRS had issues with the strategy, as was reflected, I believe, in a notice in August 2000, we immediately discontinued our participation in the transaction.

Chairman COLEMAN. And again, it is your testimony here today that in spite of the fact that you had—how many BLIPS accounts did you have?

Mr. DEGIORGIO. Approximately 30.

Chairman COLEMAN. Thirty, that you had 30 BLIPS accounts, that all of these were purported to be 7-year loans at 16 percent interest rate, even though it was clear they were going to be exiting in 60 days and they were all exited on 60 days, and at the time, you weren't aware that these were abusive tax shelters?

Mr. DEGIORGIO. That is correct.

Chairman COLEMAN. Senator Levin.

Senator LEVIN. Mr. Boyle, take a look at Exhibit 70,[1] if you would. This is a bank document relative to BLIPS. It is called a new product committee overview memo. Take a look at page three, if you would, and it is point 12. "It is imperative that the transaction be wound up after 45 to 60 days and the loan repaid due to the fact that the HNW individual will not receive his or her capital loss or tax benefit until the transaction is wound up and the loan repaid." Is that correct?

Mr. BOYLE. Excuse me?

Senator LEVIN. Is that—did I read that correctly?

Mr. BOYLE. Well, you read it correctly, yes.

Senator LEVIN. So it was imperative that this be wound up in 45 to 60 days in order that the person get their tax benefit? Am I reading it right?

Mr. BOYLE. Well, like I said before, the loan itself was a 7-year loan that people had the option of repaying at any time within that particular 7 years. And based upon the tax opinion, if they wanted to potentially take that tax benefit in the current year——

Senator LEVIN. Not potentially. Forget the potentially.

Mr. BOYLE. OK.

Senator LEVIN. If they wanted to get the tax benefit.

Mr. BOYLE. If they wanted to get the tax benefit, they would have had to unwind it in the current year, yes.

Senator LEVIN. And that was 60 days?

Mr. BOYLE. Yes, sir.

Senator LEVIN. OK. Now, in Exhibit 106,[2] this is your PowerPoint presentation about this transaction. This is your Structured Transaction Group. That is the group that implemented BLIPS. You were part of that group, were you not?

Mr. BOYLE. Yes, sir.

Senator LEVIN. Page 7 of the exhibit describes the client environment for the group. It says that your group was doing "tax driven deals."

Mr. BOYLE. Those are the words, yes.

Senator LEVIN. Is that a lie? Is your own PowerPoint presentation a lie?

Mr. BOYLE. No. I mean, the group was involved in complex financial transactions in which there were significant tax benefits, yes.

Senator LEVIN. No. Not significant tax benefits. Let us put that aside. We have heard that rhetoric two or three times. We are talking about your own PowerPoint that says these were "tax driven deals." Were those words a lie?

Mr. BOYLE. I did not prepare the document.

Senator LEVIN. Were they accurate?

Mr. BOYLE. That there were significant tax benefits?

Senator LEVIN. No, that they were tax driven.

Mr. BOYLE. I don't know the precise context that they are using tax driven, but clearly, if you believe that——

Senator LEVIN. Give me a context for that. These are three words, tax driven deals.

Mr. BOYLE. Yes. If you——

[1] See Exhibit No. 70 which appears in the Appendix on page 646.
[2] See Exhibit No. 106 which appears in the Appendix on page 2622.

Senator LEVIN. That doesn't mean some tax benefits. That means these were tax driven deals. That is your document. That is your bank's document.

Mr. BOYLE. Yes.

Senator LEVIN. Was that accurate or not, that these were tax driven deals?

Mr. BOYLE. If they are referring to the fact that there were significant tax benefits, yes.

Senator LEVIN. Otherwise, if they were driven by those benefits—driven?

Mr. BOYLE. Well, you have to look at——

Senator LEVIN. Driven means that is the principal point. That is the driver. You know what the word means.

Mr. BOYLE. Yes, sir.

Senator LEVIN. Let us not fiddle around with words. Were these tax driven deals?

Mr. BOYLE. I don't know which ones—I don't know which deals they were referring to in that——

Senator LEVIN. BLIPS.

Mr. BOYLE. BLIPS?

Senator LEVIN. Was BLIPS a tax driven deal?

Mr. BOYLE. I am not sure they are referring to BLIPS in that transaction.

Senator LEVIN. Well, was BLIPS a tax driven deal?

Mr. BOYLE. BLIPS had a very significant tax benefit, yes, sir.

Senator LEVIN. Yes. And so you are denying it was a tax driven deal?

Mr. BOYLE. No, I am saying if tax driven means significant tax benefits, yes.

Senator LEVIN. And if it means that the principal purpose of it was tax benefits, it was not?

Mr. BOYLE. That is something we weren't involved in deciding or reviewing.

Senator LEVIN. You weren't involved in reviewing? I am asking you, you are saying that there were tax benefits. You knew that much.

Mr. BOYLE. Yes. We understood that——

Senator LEVIN. But you can't say that it was driven by tax benefits, is that correct?

Mr. BOYLE. Yes.

Senator LEVIN. You are not saying that?

Mr. BOYLE. No. I mean, you are asking me what the investors' intentions were. We did not talk to the investors, no, sir.

Senator LEVIN. I am talking about your chart at your bank, your PowerPoint presentation.

Mr. BOYLE. Right.

Senator LEVIN. You were part of the committee that prepared it. I am asking you, are those words accurate, that you were looking at tax driven deals. You are not going to—you are going to basically tell me today that if it means something that it doesn't mean, then yes. Now I am asking you, if it means what it says, is the answer yes or no? Was your bank engaged in tax driven deals?

Mr. BOYLE. Like I said before, if it means transactions that may have significant tax benefits, yes. And I did not prepare this——

Senator LEVIN. If it means that the principal purpose was tax benefits, then yes or no?

Mr. BOYLE. I don't—I am not aware of that.

Senator LEVIN. The other word is "gain mitigation strategies," by the way. Take a look now at page 17 of that same exhibit. You will see that BLIPS is listed as one of the deals implemented by the group.

Mr. BOYLE. Yes.

Senator LEVIN. Were you aware of the fact, Mr. Boyle, that the premium part of the so-called loan when it was repaid would generate a tax loss for the taxpayer?

Mr. BOYLE. I was aware that may be the position they took, yes, I was.

Senator LEVIN. Thank you. Now, it was designed as a 7-year investment program, but I think you indicated that the reasonable likelihood was that the taxpayer would get out after 60 days. Is it not true that it was anticipated that taxpayers would get out at 60 days?

Mr. BOYLE. We understood that they made that choice, yes.

Senator LEVIN. Was it anticipated the taxpayers would get out, not possibly get out, but was it anticipated that they would get out at 60 days?

Mr. BOYLE. I would say it was anticipated that they would get out, yes.

Senator LEVIN. Thank you. You said anticipated they get out, yes, you meant, I assume, that they would get out in 60 days?

Mr. BOYLE. In 60 days, yes, sir.

Senator LEVIN. Thank you. Now, was the amount of funds that were at risk limited to the funds contributed by the taxpayer, that 7 percent?

Mr. BOYLE. No. They had a series of permitted investments that they could choose from. In the first stage, my understanding is they all invested in what you would refer to as low-risk investments.

Senator LEVIN. So that if the 60-day period was the limit of the loan, then the risk in the foreign currency transactions would be limited to the funds contributed by the taxpayer, that 7 percent?

Mr. BOYLE. I believe so, yes.

Senator LEVIN. Was the 7 percent approximately that was contributed by the taxpayer in Presidio that was held in your bank until the investment fund was closed, is that also true?

Mr. BOYLE. I am sorry?

Senator LEVIN. Your bank held the funds?

Mr. BOYLE. I believe so, yes. Well, yes. It went into a custody account in the Private Bank.

Senator LEVIN. So the funds were held in your custody?

Mr. BOYLE. For the benefit of the client, yes.

Senator LEVIN. Yes. And the 7.7 percent was intended to cover market risks, transaction costs, and Deutsche Bank fees, is that correct?

Mr. BOYLE. Yes.

Senator LEVIN. Now, there was an Exhibit 103,[1] if you take a look at that. It is from Mick Wood. He worked at the bank?

[1] See Exhibit No. 103 which appears in the Appendix on page 2615.

Mr. BOYLE. Yes.

Senator LEVIN. In response to a memo that you wrote to him about BLIPS, this is, I think, similar to the question that our Chairman raised, and if I am duplicating it exactly, then forgive me. I may have missed your exhibit reference here, Mr. Chairman. But Exhibit 103 is a reply to a memo that you wrote about BLIPS, and he said, "I would have thought you could still ensure that the issues are highlighted by ensuring that the papers are prepared and all discussion held in a way which makes them legally privileged." It sounds like he is suggesting that Deutsche Bank should hide the program behind the claim of privilege, is that correct?

Mr. BOYLE. You may possibly interpret it that way. My understanding—I don't know—I don't recall much of what was hidden. I think the only things I recall was trying to limit the tax discussion with our attorneys to the appropriate professionals in the bank to review that. I think everything else is fairly well laid out, including any potential tax benefits that the investor may receive from the transaction.

Senator LEVIN. You are saying that the purpose for the privilege was not to hide this program behind such a claim?

Mr. BOYLE. I think the purpose—I don't remember precisely, but I think generally my recollection is that the reference to privilege was more to—as you recall, we were advised—not advised, but we were counseled by an outside law firm and they were preparing a tax opinion with respect to our role in the transaction and it was, I believe, to limit the access people had internally to that document to the appropriate professionals that should be reviewing it.

Senator LEVIN. And the purpose of limiting access to the document?

Mr. BOYLE. To the tax opinion, yes.

Senator LEVIN. The tax opinion?

Mr. BOYLE. Yes.

Senator LEVIN. Take a look at Exhibit 104.[1] This is an e-mail from Ivor Dunbar——

Mr. BOYLE. Yes.

Senator LEVIN. Co-head of your Structured Transaction Group who implemented BLIPS, and that again was your group, I gather, and here is what he says under point two, privilege.

Mr. BOYLE. Yes.

Senator LEVIN. "This is not easy to achieve, and therefore a more detailed description of the tax issues is not advisable." Don't describe the tax issues.

Mr. BOYLE. Yes.

Senator LEVIN. Keep those out of any paper trail.

Mr. BOYLE. Right.

Senator LEVIN. Is that right?

Mr. BOYLE. That is clearly what he said there, yes.

Senator LEVIN. Yes. Now look at point three in that same e-mail, reputation risk. "In this transaction, reputation risk is tax related and we have been asked by the tax department not to create an audit trail." The tax department, don't create an audit trail in respect to the bank's tax affairs. "The tax department assumes pri-

[1] See Exhibit No. 104 which appears in the Appendix on page 2618.

mary responsibility for controlling tax related risks, including reputation risk, and will brief senior management accordingly. We are therefore not asking risk and resources committee to approve the reputation risk.” Boy, isn’t that unusual?

Mr. BOYLE. I don’t——

Senator LEVIN. Not to approve a reputation risk because we want to do this orally?

Mr. BOYLE. I don’t believe that is what he was getting at. I think what they were doing is in terms of reviewing the tax—the transaction, they were restricting that to the tax professionals, the attorneys, and senior management. I don’t believe that—when you go through the internal documents in terms of the approvals and that, I mean, it was always clear that there were tax benefits that may arise to the investor in the transaction. I don’t believe that was hidden or kept low profile at any point in time.

Senator LEVIN. No, but it was hidden. Not the tax benefits. What was hidden is what you are so unwilling to say but which is so obviously true, which is that was the principal purpose of the transaction. That is what the effort was. Obviously, there are tax impacts of every transaction. But this, the fact that this was intended to be a tax shelter, and that was its principal purpose, which is obvious from everything, is what they didn’t want to say there, because there would be a reputational risk at that point.

And let me go on to that reputational risk. By the way, would there not be a reputational risk if, in fact, your papers—every time your papers say that the principal purpose of this was a tax deal, does that not create a reputational risk?

Mr. BOYLE. If that is, in fact, true. I don’t recall anything——

Senator LEVIN. Yes, it would create a reputational risk every time you would say, this is a tax deal primarily, right? You would agree that creates a reputational risk?

Mr. BOYLE. Yes, I would—yes, but I don’t recall those words out there anywhere in terms of——

Senator LEVIN. Well, we have gone through a lot of documents which quite clearly talk about this being a tax deal.

Mr. BOYLE. Yes, sir.

Senator LEVIN. Having to be wound up in a certain number of days and so forth. So what we see here is the tax department at Deutsche Bank saying that the reputational risk here was so great that it pulled the review of the BLIPS program out of your risk and resources committee because there would have been a paper trail, as you just indicated, and it instead personally briefed Mr. John Ross, who is the CEO of Deutsche Bank Americas.

Now, how many times do you think that that would have happened, where there were these kind of tax deals that were pulled away from that committee and orally discussed with the CEO instead because of a statement that there is a reputational risk in having this reviewed by your committee? Do you think that happened frequently or would this be unusual?

Mr. BOYLE. No. My understanding is that it was not pulled away from that committee because of BLIPS. I think that was a general policy that the bank was going through, that the tax aspects would be reviewed by the tax professionals and senior management.

Senator LEVIN. But it says here, though, in Exhibit 104 again that we are, therefore, not asking risk and resources committee to approve reputational risk on BLIPS. This will be dealt with directly by the tax department and John Ross. I am asking you, was that common?

Mr. BOYLE. With respect to any tax related transaction, yes.

Senator LEVIN. It was?

Mr. BOYLE. I believe so.

Senator LEVIN. OK. I believe that the chairman is covered in Exhibit 113,[1] where that same type of issue was raised—where it says, John Ross approved the product, however, insisted that any customer found to be in litigation be excluded from the product, the product be limited to 25 customers, and that a low profile be kept on these transactions. Again, try me on this one. Why a low profile? Why limit it to 25?

Mr. BOYLE. My recollection of the conversations, we were sitting down and taking Mr. Ross through the transaction, particularly our role in the transaction, and because it involved a more likely than not opinion for the potential tax benefit to the investor, we wanted to make very clear what our role was just in terms of banking, that we are not out there marketing or providing tax advice and that type of thing. So I am—my guess is he was referring to that conversation.

Senator LEVIN. My final line of questions, if I ask the indulgence of the Chair, who has been very generous in many ways. Exhibit 105,[2] if you take a look at that, is an e-mail from you, Mr. Boyle, to John Wadsworth, and this is going to take a couple of minutes to work through this.

Mr. BOYLE. Actually, I don't have Exhibit 105. Oh, here it is.

Senator LEVIN. You have it? OK. Here is what you wrote. "During 1999, we executed $2.8 billion of loan premium deals as part of BLIPS approval process. At that time, NetWest and HVB Bank had executed approximately a half-billion dollars of loan premium deals. I understand that we based our limitations on concerns regarding reputational risk which were heightened in part on the proportion of deals we have executed relative to the other banks." You had done a lot of this, compared to the other banks, and here is what you proposed.

"In addition to the execution of the underlying FX transactions, we would like to lend an amount of money to HVB Bank equal to the amount of money HVB Bank lends to the client. We could potentially make a market interest rate loan secured by HVB high coupon loan to the client which would be secured by the underlying FX transactions. The loan we fund HVB Bank with could be differentiated from the underlying loan to the client because of the market coupon versus high coupon, the date the loans are made, and the fact that we do not face the client as HVB Bank does."

So in other words, Mr. Boyle, the reputational risk to Deutsche Bank for doing additional BLIPS deals was so great that the bank is not permitting any additional transactions, and in response to that situation, your solution is not to halt BLIPS transactions.

[1] See Exhibit No. 113 which appears in the Appendix on page 2679.
[2] See Exhibit No. 105 which appears in the Appendix on page 2619.

Rather, you propose to fund and execute additional BLIPS transactions through the front of another bank, HVB.

Now, if the reputational risk is that great, shouldn't Deutsche Bank stop its participation rather than try to hide its involvement in more of these transactions?

Mr. BOYLE. I think we have to put this note in context from what I remember. The bank itself had reached the conclusion back in November or October 1999 they didn't want to participate anymore with these particular transactions. My understanding is that there may have been other opportunities to do some more. We approached Mr. Wadsworth with respect to revisiting this, and he clearly was not interested in doing any more of these deals, and it stopped at that point.

Senator LEVIN. Mr. DeGiorgio, did Deutsche Bank approach HVB about this idea?

Mr. DEGIORGIO. Yes, it did.

Senator LEVIN. And did you or HVB accept the idea?

Mr. DEGIORGIO. No, we did not.

Senator LEVIN. You rejected it?

Mr. DEGIORGIO. Yes, we did.

Senator LEVIN. And why?

Mr. DEGIORGIO. Because we were concerned with the operational and execution risks associated with the transaction that would not have been alleviated in the structure that had been proposed, as you see in this e-mail.

Senator LEVIN. Thank you. Thank you, Mr. Chairman.

Chairman COLEMAN. Thank you. Mr. DeGiorgio and Mr. Boyle, you are excused.

I would now like to welcome our third panel to today's hearing: John Larson, Managing Director of Presidio Advisory Services; and Jeffrey Greenstein, Chief Executive Officer of Quellos Group, formerly known as Quadra Advisors. I thank each of you for your attendance at today's hearing and look forward to your testimony.

Before we begin, pursuant to Rule 6, all witnesses who testify before the Subcommittee are required to be sworn. At this time, I would ask you to please stand and raise your right hand.

Do you swear that the testimony you are about to give before this Subcommittee is the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. LARSON. I do.

Mr. GREENSTEIN. I do.

Chairman COLEMAN. Again, as you have seen with the earlier panels, I would like testimony to be 5 minutes. Your written testimony will be entered into the record in its entirety.

Mr. Larson, we will have you go first this morning, followed by Mr. Greenstein. After we have heard all the testimony, we will then turn to questions. Mr. Larson.

TESTIMONY OF JOHN LARSON, MANAGING DIRECTOR, PRESIDIO ADVISORY SERVICES, SAN FRANCISCO, CALIFORNIA

Mr. LARSON. I have no advance statement.

Chairman COLEMAN. Mr. Greenstein.

TESTIMONY OF JEFFREY GREENSTEIN,[1] CHIEF EXECUTIVE OFFICER, QUELLOS GROUP, LLC, FORMERLY KNOWN AS QUADRA ADVISORS, LLC, SEATTLE, WASHINGTON

Mr. GREENSTEIN. Mr. Chairman, Senator Levin, my name is Jeff Greenstein and I appreciate the opportunity to be here today. I am the Chief Executive Officer of Quellos Group, based in Seattle, and since our founding in 1994, we have focused on providing both asset management services to institutional and private clients worldwide.

We understand and very much respect the Subcommittee's responsibility in this area and its interest in ascertaining whether there is a need to change public policy.

You have asked me to address tax advantaged investments or strategies with names like BLIPS, SC2, FLIP, and OPIS. With respect to BLIPS and SC2, we have no experience in these areas whatsoever and, therefore, I cannot comment. With respect to the latter two strategies, I am able to discuss the investment and structural aspects with the Subcommittee today, although let me emphasize that I do not have any tax expertise and thus am not able to provide meaningful input on the tax aspects of either strategy.

As you have heard, prior to our involvement, the international accounting firm of KPMG developed FLIP in the mid-1990's to provide its clients with a tax savings investment strategy. In the course of many conversations and meetings, KPMG advised us that its senior tax experts, many of whom had direct Treasury or IRS experience, had carefully researched the existing statutes and regulations and that KPMG's national tax office had concluded that these transactions would likely yield favorable tax treatment for its investors under the Internal Revenue Code.

By way of history, our introduction to KPMG occurred in 1995 in a matter completely unrelated to what we are here today to discuss. We were working with one of our clients to restructure a portion of their portfolio to meet their investment objectives. Given the importance of analyzing any investment portfolio on an after-tax basis, our client asked to review our portfolio recommendations with its tax advisor, KPMG, and therefore, at the client's request, we did.

As a result of this prior interaction, KPMG later contacted us to see if we would apply our investment expertise to help with the security transactions related to one of its strategies. This strategy later became known as FLIP. KPMG presented us with a set of predefined criteria that it had designed for FLIP and told us that transactions meeting these criteria would likely result in favorable tax consequences. Our role as investment advisor was to identify, analyze, implement, and manage the specific stock and option transactions that were required to execute FLIP.

These transactions gave investors a reasonable prospect of earning an economic profit which, in fact, was very real as a number of FLIP and OPIS investors did indeed realize an overall profit. The profit potential was directly linked to the gradual appreciation in the public shares of one of the world's major financial institu-

[1] The prepared statement of Mr. Greenstein appears in the Appendix on page 334.

tions. KPMG specifically approved all of the stock and option transactions after it had determined that the transactions met the criteria for obtaining favorable tax consequences.

Our role as investment advisor was formalized in 1997 with an agreement between KPMG and Quadra that defined our different roles. In the agreement, KPMG confirmed its responsibility for the tax aspects of the strategy while agreeing that Quadra had responsibility for only providing investment advice. KPMG was and remains an international accounting firm with an excellent reputation and deep resources and we relied on its tax analysis, conclusions and advice. Additionally, a prominent national law firm concurred with their opinion.

KPMG began introducing FLIP to potential investors during 1996, and subsequently, Pricewaterhouse Coopers, PWC, developed a similar strategy with similar tax attributes. They sought and received our assistance in providing investment-related advice and execution services. PWC also provided a detailed opinion of this strategy which was consistent with KPMG's earlier conclusion that the Internal Revenue Code likely afforded favorable tax treatment.

In 1998, we were approached again by KPMG with respect to a variation of the FLIP transaction known as OPIS. It was our understanding that KPMG had been offering this strategy to its clients through another investment advisor, the Presidio Group, but that the Presidio Group had exhausted its capacity. At that time, KPMG requested our assistance with executing OPIS. For OPIS, all of the investment and structural aspects of the strategy were fully developed, the nature of the financial instruments and security transaction had been fully specified, and our role was simply to implement the trades and execute the documents required as prescribed by KPMG.

Chairman COLEMAN. I would ask you to summarize the rest of your testimony, Mr. Greenstein.

Mr. GREENSTEIN. Thank you. I want to reiterate that our focus has been on meeting the financial and investment objectives of our clients through thoughtful, sophisticated, disciplined, and well-researched portfolio management. This presented us with the opportunity to work with some of the most respected groups in the industry, and I think it is important to note that we have not been working with the accounting firms in strategies along these lines for years.

And with that, that is an abridged version of my prepared remarks and I would be happy to address any questions you might have.

Chairman COLEMAN. Thank you, Mr. Greenstein. Your complete remarks will be entered into the record, without objection.

Mr. Larson, you were originally—at one point, you were Senior Manager at KPMG, is that correct?

Mr. LARSON. That is correct, yes.

Chairman COLEMAN. And when did you move over to Presidio?

Mr. LARSON. In the summer of 1997.

Chairman COLEMAN. And, in fact, were you involved in forming Presidio Advisory Services?

Mr. LARSON. I was.

Chairman COLEMAN. And was that with another member of KPMG?

Mr. LARSON. Yes, Robert Pfaff.

Chairman COLEMAN. So would it be fair to say that you knew the ins and outs of these kinds of transactions, you had experience and history?

Mr. LARSON. Yes, that would be fair.

Chairman COLEMAN. And, in fact, I believe you were involved in developing FLIP's transactions?

Mr. LARSON. I was one of the team of developers, yes.

Chairman COLEMAN. Now, it is fair to state, Mr. Larson, that Presidio knew the BLIPS transaction was specifically designed so that investors would exit on day 60 of the transaction, regardless of the fact that BLIPS was a financing structure as a 7-year loan, is that correct?

Mr. LARSON. I would—I do not agree with that.

Chairman COLEMAN. Would you turn to Exhibit 69,[1] please.

Mr. LARSON. The black one or the white one?

Chairman COLEMAN. Sixty-nine is in the white one. It is a memo, Presidio Advisors Group. It is from Amir Makov. Do you know who that is?

Mr. LARSON. Yes. He is my other business partner.

Chairman COLEMAN. He is a partner? He has certain authority and can speak for Presidio with authority?

Mr. LARSON. Yes, correct.

Chairman COLEMAN. And this is a memo to John Rolfes, CEO at Deutsche Bank?

Mr. LARSON. John was the Managing Director.

Chairman COLEMAN. Managing Director, I am sorry. And in the memo, it lays out, "John, further to our Friday conversation, I would like to describe the necessary financing steps the BLIPS program will require," and it lays out—it starts with the day one, investor LLC borrows $100,000, and then principal amount for 7 years at 16 percent annual. So 7 years at 16 percent annual. And then you go down, day 7 and the last paragraph, beginning of the last paragraph on that page, "On day 60, investor exits partnership and unwinds all trades in partnership." Is that what the document states?

Mr. LARSON. That is what it states, yes, sir.

Chairman COLEMAN. And is there anything equivocal about saying that the investor exits the partnership and unwinds all trades in partnership?

Mr. LARSON. No, that is what it says.

Chairman COLEMAN. So Presidio understood this was a 60-day, get out in 60-day deal?

Mr. LARSON. What Presidio understood, even as the two previous speakers said, that there was a significant likelihood that investors would want to exit after 60 days, but in no way did we understand that this was unequivocally a 60-day investment.

Chairman COLEMAN. In this document, there is no indication of significant likelihood. It says, "on day 60, investor exits partnership and unwinds all trades in partnership," not significant possibility.

[1] See Exhibit No. 69 which appears in the Appendix on page 644.

Mr. LARSON. I agree that that is what it says.

Chairman COLEMAN. Can you tell me what step transactions are?

Mr. LARSON. Well, there is a tax doctrine which you might be referring to called the step transaction doctrine.

Chairman COLEMAN. Is there a prohibition in the tax code against step transactions designed to produce artificial losses?

Mr. LARSON. I am not quite sure what you are referring to.

Chairman COLEMAN. In testimony on Tuesday, we heard that there was a remote chance—remote chance—that BLIPS investors would make a profit of a transaction because they were structuring it, and I believe if you turn to Exhibit 80,[1] that testimony came from Mark Watson, who appeared under subpoena before this Subcommittee. He says, "According to Presidio, the probability of making a profit from this strategy is remote." Was that a fair representation of Presidio's conversations with Mr. Watson?

Mr. LARSON. No, it is not.

Chairman COLEMAN. So did Mr. Watson make this up?

Mr. LARSON. I think Mr. Watson may have misunderstood the presentation and information that was provided to him.

Chairman COLEMAN. Can you tell me how many BLIPS transactions Presidio was involved in?

Mr. LARSON. My recollection is 65 to 70.

Chairman COLEMAN. Do you know if anyone made a profit?

Mr. LARSON. No, the trades were not profitable.

Chairman COLEMAN. So Mr. Watson is saying Presidio says there is a remote possibility. You are saying zero. Of all you were involved in, zero transactions made a profit.

Mr. LARSON. That is correct, although I am also saying that it was our view at the time when we were planning the program and executing it that, in fact, there was a significant possibility of profit. That did not come to pass, but I think we had a well-reasoned view that our strategies could be highly profitable.

Chairman COLEMAN. Was the market in trouble at that time?

Mr. LARSON. We were—under our—the trading strategies that we were implementing were foreign currency transactions, so I guess I am not sure what market you are referring to.

Chairman COLEMAN. I am just trying to understand how you have every transaction in which you are involved, none makes a profit, but you are saying there was a reasonable possibility for profit.

Mr. LARSON. The trading strategies, the primary ones that we were implementing were, I guess, based on our expectation that a specific event would take place in the market, and by that, what I mean is the largest positions that we took in the BLIPS trades, we were shorting the Argentina peso and we were shorting the Hong Kong dollar and we were taking positions of very significant size. By taking those positions, what we were speculating was that one or both of those currencies would be forced to break its trading peg and devalue, and if that took place, then we had an expectation that, in particular that with Argentina, that Argentina was likely—in fact, we thought very nearly certain—to devalue its currency.

[1] See Exhibit No. 80 which appears in the Appendix on page 664.

Had that happened while our trades were open, the profits would have been extremely significant.

Chairman COLEMAN. And what percentage of the loans were at risk, of the loans that were involved in these transactions?

Mr. LARSON. The expected risk, but not the certain risk, was approximately equal to the equity invested by the investors. However, there was always a possibility of a catastrophic loss in any of the partnerships.

Chairman COLEMAN. Let me ask the question this way. An investor took out a $15 million loan—a $20 million loan from Deutsche Bank, or a $50 million loan from Deutsche Bank. How much of that was at risk? How much of that was involved in the risk of loss?

Mr. LARSON. The most likely scenarios and the ones that came to pass was that amount would not be at significant risk during the initial part of the trade.

Chairman COLEMAN. Sixty days?

Mr. LARSON. Yes. That was the most likely.

Chairman COLEMAN. The period in which they got out.

Mr. LARSON. Yes. However, what I would go on to say is that there was also a possibility, not a likelihood by any means, but a possibility that if our foreign currency trades had moved against us, and in particular if the value of the either Hong Kong or Argentina currencies had gone up, then there could have been very significant losses which would have hit the collateral.

Chairman COLEMAN. So the standard now is not a likelihood.

Mr. LARSON. Standard—I am sorry.

Chairman COLEMAN. You were saying that there was not a likelihood of profit being made.

Mr. LARSON. I am sorry, could you repeat the question?

Chairman COLEMAN. I am trying to use the phrase there. I was trying to understand what the expectation was during 60 days. In other words, how much of a $50 million loan, how much was at risk? A very minimal amount. What was then the likelihood of the investor suffering any loss?

Mr. LARSON. Using your example, during the initial 60-day period of our trading program, it was unlikely that there would be any loss that would affect the $50 million of collateral.

Chairman COLEMAN. Let me ask you one other question. I will pursue this line of questioning afterwards. According to the testimony of KPMG's Lawrence DeLap on Tuesday, he was of the view that BLIPS transactions should be registered and Presidio should have registered the transactions. Did Presidio register their BLIPS transactions?

Mr. LARSON. We did not.

Chairman COLEMAN. Mr. Greenstein, did Quadra—at that time, you were Quadra—did you register the FLIP transactions with Pricewaterhouse Coopers?

Mr. GREENSTEIN. Yes, we did. We took registration very seriously and followed the advice of the tax advisor.

Chairman COLEMAN. Mr. Larson, did Presidio do some FLIP transactions?

Mr. LARSON. Yes, we did.

Chairman COLEMAN. Did you register those?

Mr. LARSON. We did not.

Chairman COLEMAN. I will turn the questioning over to Senator Levin at this time, but there will be a second round.

Senator LEVIN. Thank you. If you take a look at Exhibit 137,[1] Mr. Larson, this is the memo that was written by Mr. Pfaff shortly before he left KPMG. When he wrote that memo, he went, as you have indicated, to join you at Presidio. You were partners with him. This is the road map that KPMG followed in its efforts to mass market tax shelters, or as Mr. Pfaff notes, develop a turnkey package tax product business and that Presidio was the instrument to do that.

Now, Mr. Larson, was there a "Tax Advantaged Transaction Practice" at KPMG at the time that this memo was written, in July 1997? Do you see that? There was a "Tax Advantaged Transaction Practice"?

Mr. LARSON. I do. There may have been an informal group that used that acronym, but I am not certain.

Senator LEVIN. Well, you were there, weren't you?

Mr. LARSON. Yes, but I think this was written 6 or 7 years ago.

Senator LEVIN. So you are saying that—was it called TAT?

Mr. LARSON. KPMG loved acronyms and——

Senator LEVIN. Was it called TAT?

Mr. LARSON. I am not sure whether I remember a TAT group, although I see it referred to here.

Senator LEVIN. All right. Were you part of a Tax Advantaged Transaction Practice, formal or informal, at KPMG?

Mr. LARSON. I was certainly part of a tax products—some informal groups, yes.

Senator LEVIN. But you are not familiar with the term Tax Advantaged Transaction Practice? That is not something you remember participating in at KPMG?

Mr. LARSON. I was personally assigned to the international tax services group during virtually my entire career.

Senator LEVIN. Was there also this informal or formal group called Tax Advantaged Transaction Practice that you were part of?

Mr. LARSON. I may have seen this acronym or name before or not. I don't really recall.

Senator LEVIN. All right. Were you part of the effort to complete the FLIP tax opinion before you left KPMG to go with Presidio?

Mr. LARSON. I was one of the people that worked on the initial opinion, yes.

Senator LEVIN. Was FLIP designed primarily for tax reduction?

Mr. LARSON. I would say the FLIP was designed with two purposes in mind, one for the significant expected tax benefits, and second, to make money, for the investment possibility.

Senator LEVIN. And was that true with other products, including BLIPS?

Mr. LARSON. Yes, that was.

Senator LEVIN. The question then becomes as to whether the primary purpose was the tax loss that was created or the possibility, which was indicated as remote, of making a profit, and that becomes, of course, the whole issue.

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[1] See Exhibit No. 137 which appears in the Appendix on page 2735.

Now, take a look at page three of that Exhibit 137. "Logically," Mr. Pfaff wrote, "we would simply issue an edict that any client with an imminent gain of a threshold amount," large enough, in other words, "should contact the Tax Advantaged Transaction Practice. However," he wrote, "after reading this case called *Colgate Palmolive*, it appears that we cannot openly market tax results of an investment. Rather, our clients should be made aware of investment opportunities that are imbued with both commercial reality and favorable tax results. Conversely, we cannot offer investments without running afoul of a myriad of firm and security rules. Ultimately, it was this dilemma that led me to the conclusion that I was in the wrong industry to play the role I enjoy the most, and hence, the firm's need to align with the likes of a Presidio."

Now, this clearly shows that Mr. Pfaff and others at KPMG knew they were marketing tax advantaged products, that key court cases said that you can't market tax shelters as such, so KPMG had to create a facade of investment around the tax advantaged products. And the investments that were part of these products were backfitted, then, into the transactions after the tax schemes were worked out, simply to try to make it look like there was an investment purpose to them.

Now, if you take a look at Exhibit 137 from Mr. Pfaff, again, your partner, which you received a copy of, he talked about approaching only clients who had an "imminent gain." Now, if this is an investment strategy, why would you limit it to approaching clients that were confronting a gain? If its purpose, any significant purpose, was to make a profit, why wouldn't you approach folks who would want to make a profit?

Mr. LARSON. I would say that that is consistent with the dual purpose of the transaction in that since we understood that one of the valuable aspects of this product was the hoped-for tax benefits, it would make sense that logical people to talk to about the combined package would be those who might be receptive to tax planning.

Senator LEVIN. But making a profit would run the other direction. Then they would have to be sold another tax product to create a tax loss.

Mr. LARSON. I think that the two can certainly be reconciled, but you are correct that to the extent that you make a profit on one of these transactions, then your tax benefit shrinks, so I agree with that.

Senator LEVIN. You had two cross-purposes here.

Mr. LARSON. To a degree.

Senator LEVIN. Now, let us look at the financing of the BLIPS deals. This is Exhibit 1Aa.,[1] but there is a chart which I think we can put on here, page 7, that contains a typical BLIPS deal. You were the principal marketer of BLIPS, is that not correct?

Mr. LARSON. I am sorry, which exhibit?

Senator LEVIN. That is Exhibit 1a., page 7.

Mr. LARSON. Excuse me.

Senator LEVIN. Do I have that right? Is that the right number?

Chairman COLEMAN. It is in the white book.

[1] See Exhibit No. 1a. which appears in the Appendix on page 371.

Senator LEVIN. I am sorry, yes, in the white book.

Mr. LARSON. I don't think the pages are numbered, so I am not sure what page you are on.

Senator LEVIN. Well, just go through them and——

Mr. LARSON. Yes. I see.

Senator LEVIN. Now, you were a principal marketer of BLIPS, is that not correct?

Mr. LARSON. I was.

Senator LEVIN. Now, why was it that the loan was initially taken out by the taxpayer? This so-called loan, this purported loan was initially taken out by the taxpayer and almost immediately assigned to this other entity. Why was the loan just not made to the investment group directly?

Mr. LARSON. I think it could have been.

Senator LEVIN. Well, the tax advantages would have been lost, wouldn't they?

Mr. LARSON. Certainly one way of structuring this for the tax advantage was to have the loan drawn down the way it was outside the partnership.

Senator LEVIN. But if the loan were made directly to the partnership instead of to the taxpayer, there wouldn't have been the tax benefit, right? There wouldn't have been that premium.

Mr. LARSON. That is correct.

Senator LEVIN. OK. So it had to go that way. Now, that is for tax reasons. The taxpayer's capital contribution was 7 percent of the loss that was planned to be generated by the BLIPS transaction, is that correct?

Mr. LARSON. That was normally the case.

Senator LEVIN. And if you look at Exhibit 67,[1] this is a page from the Deutsche Bank PowerPoint presentation on the BLIPS program. If you look at the last three lines on that page, it reads as follows. "Seven-point-seven percent of the premium amount will be held in full by Deutsche Bank until the LLC account is closed and the Deutsche Bank has a legal claim on that amount in the credit agreement." Then it says the following. "The 7.7 percent will cover market risks, transaction costs, and DBSI fees."

I think that is fairly clear. So the 7.7 percent put in by the taxpayer in Presidio was the amount set aside and held by Deutsche Bank to cover the risks associated with any currency trades, transaction costs, and Deutsche Bank fees. Now, would you not agree that within that 60-day period that the risk was limited to the capital funds put up by the investor?

Mr. LARSON. Not exactly, no.

Senator LEVIN. Was it true what you told our staff on October 3, that the intent was that the maximum amount put at risk was the cash that the investor had contributed? Was that the intent?

Mr. LARSON. That was the expectation, but what I also told the staff, and I would say here now, is that there was always the possibility which we in the banks were aware of that something could go wrong and that there could be a catastrophic trading loss on the FX positions in excess of that amount.

[1] See Exhibit No. 67 which appears in the Appendix on page 632.

Senator LEVIN. In the absence of a catastrophe, that was the intention. Did that ever happen, that catastrophe?

Mr. LARSON. It did not.

Senator LEVIN. And in the case of every BLIPS transaction, the loss was no more than the amount that was put up by the taxpayer, is that correct?

Mr. LARSON. That is correct.

Senator LEVIN. My time is up. Are we going to have another round?

Chairman COLEMAN. Thank you, Senator Levin.

Mr. Greenstein, according to your statement, Quadra is an investment advisor in clients referred to you by KPMG?

Mr. GREENSTEIN. Pardon me?

Chairman COLEMAN. Clients referred to you by KPMG in connection with the transactions known as FLIP and OPIS, is that correct?

Mr. GREENSTEIN. They were referred, and in many cases, KPMG was their financial advisor based on a power of attorney that the client had executed.

Chairman COLEMAN. It is very clear that advisors cannot be involved in abusive tax shelters, you understood that? There is no question about that?

Mr. GREENSTEIN. Yes.

Chairman COLEMAN. You have KPMG advising a client, issuing opinions, and you are relying on those. Did Quadra ever take any steps to have an independent, uninterested account review the transactions to ensure that you were not engaging in anything that ran afoul of the tax laws?

Mr. GREENSTEIN. At that point, we knew of multiple unrelated premier tax advisory groups, both two accountants and two nationally recognized law firms, that had concluded the same tax issue, and at that point in time, KPMG and Pricewaterhouse Coopers, had tens—potentially tens of thousands of tax professionals and we respected the opinion and the work that they did, and there was no need for us to look elsewhere.

Chairman COLEMAN. What is your understanding of the requirement that a promoter of a tax shelter register such transactions with the IRS?

Mr. GREENSTEIN. My understanding is very limited, and on that issue, we deferred aggressively to the tax advisor, be it KPMG or Pricewaterhouse, for their conclusion on the matter.

Chairman COLEMAN. Did you consider yourself to be a promoter of FLIP and OPIS under your understanding of the term?

Mr. GREENSTEIN. I don't understand the legal definition of the term, and I know there is one. We were certainly involved on certain marketing aspects, but I would say we were not the primary promoter.

Chairman COLEMAN. You were involved in marketing?

Mr. GREENSTEIN. We were involved in describing the investment and structural aspects, yes.

Chairman COLEMAN. Now, for some or all of the FLIP and OPIS transactions that you engaged in with Pricewaterhouse Coopers, I think you indicated that you registered those transactions, is that correct?

Mr. GREENSTEIN. I believe that to be the case, yes.

Chairman COLEMAN. But it is my understanding that for the same transactions that Quadra engaged in with KPMG, Quadra did not register those transactions.

Mr. GREENSTEIN. That is correct, under the guidance of KPMG.

Chairman COLEMAN. Did you ever talk to KPMG and say, hey, we are doing it for Pricewaterhouse, why not you?

Mr. GREENSTEIN. We did, yes.

Chairman COLEMAN. And the response?

Mr. GREENSTEIN. We have done our analysis and it is our opinion that it does not need to be registered and we will not be registering it, they told us.

Chairman COLEMAN. You weren't uncomfortable with that?

Mr. GREENSTEIN. We weren't uncomfortable because it was common certainly in the investment world for two well-respected organizations to reach different conclusions on the same matter, and we had respect for the work that they did in this regard.

Chairman COLEMAN. You know by not registering them, you are not bringing it to the attention of the IRS, right?

Mr. GREENSTEIN. I was aware of that, and again, I would stress how seriously we took the issue, because when PWC told us to register, we did register immediately.

Chairman COLEMAN. But felt you didn't have to do it with KPMG because they told you that they didn't want to do it?

Mr. GREENSTEIN. They told us that they concluded it did not need to be registered as a tax shelter.

Chairman COLEMAN. Are you still involved in tax shelter transactions now, and that would be under, what is it, Quellos, because Quadra is no longer in existence?

Mr. GREENSTEIN. We always focus on maximizing a client's after-tax investment objectives, so in some cases, a simple shelter could be using municipal bonds. So that term, broadly defined, we are always trying to do that. But in terms of the types of strategies that we are talking about here today, no, we are not involved.

Chairman COLEMAN. Help me understand. I have to say, with Presidio, it is very clear. They knew BLIPS was a 60-day transaction. It was very clear what the purpose was. I don't have the paper trail, I must say, Mr. Greenstein, with you, but I have got to believe at the time you were doing this, was there any red light that went on? Pricewaterhouse says register and KPMG says don't register. Isn't there any red light that went on and said, hey, we may be involved in something here that is just not right?

Mr. GREENSTEIN. Again, from our perspective, it was not uncommon for two well-respected firms, after thorough research, to come to different conclusions and we would see that all the time in the investment world where one well-respected group might say a stock is going up and someone else is saying it is going down, looking at the same facts. So no, it was not unusual to receive different opinions.

Chairman COLEMAN. Senator Levin.

Senator LEVIN. Mr. Larson, I think you have already testified that none of the BLIPS taxpayers, the folks who bought BLIPS, made a profit, is that correct?

Mr. LARSON. That is correct.

Senator LEVIN. Is it then true that it was unlikely, based on that experience, that investors would earn a pre-tax profit?

Mr. LARSON. Based on our expectation and observation of the foreign currency markets, and in particular the situation in 1999 with Argentina, we were expecting a devaluation of the Argentina peso at any time and, hence, it was our expectation that very significant profits would be forthcoming. Did we know exactly when Argentina was going to devalue? No, we did not, although within about 12 months, after additional support by the International Monetary Fund eventually failed, Argentina did, in fact, devalue. But we were a little ahead of ourselves.

Senator LEVIN. So that taxpayers who bought BLIPS—taxpayer after taxpayer after taxpayer—how many were there?

Mr. LARSON. I believe we did about 65——

Senator LEVIN. Sixty-five——

Mr. LARSON [continuing]. Or 70.

Senator LEVIN. And every single one of them did not get a profit on the investment. They all made out as they should not have made out in terms of the tax loss, that they made huge gains in terms of their tax losses. But in terms of that investment of that 7 percent, over 60 in a row did not make a profit, right?

Mr. LARSON. Many of those were going on simultaneously.

Senator LEVIN. But 60 of them did not make a profit?

Mr. LARSON. That is correct.

Senator LEVIN. And yet you represented that there was still the reasonable opportunity to make a profit?

Mr. LARSON. Yes, we did.

Senator LEVIN. Now finally, in terms of your fee, Exhibit 121[1] has at the bottom an e-mail from Kerry Bratton at Presidio. The title of the e-mail message here is, "Regarding BLIPS, seven percent." And as her message states—is Kerry Bratton a man or a woman?

Mr. LARSON. She is a she.

Senator LEVIN. As her message states, the e-mail shows how in a typical BLIPS deal the 7 percent put in by the taxpayer gets divided up, and here is what the typical deal does. Ten percent of the taxpayer's money, 0.7 percent, in other words, went to currency trading losses. Most of the 7 percent, as a matter of fact, 5.5 percent of the 7 percent, went to the fees—your fees, the bank's fees, KPMG's fees. So only a small part of the taxpayer's funds went to the currency transactions, is that correct, went to pay the losses on the currency transactions? Most of that 7 percent went for fees?

Mr. LARSON. In her example, yes.

Senator LEVIN. Not in her example, typically. They were typical.

Mr. LARSON. Yes.

Senator LEVIN. OK. So that was the typical breakdown of the 7 percent? Was she right?

Mr. LARSON. Actually, I think she left out the financing cost on the loan.

Senator LEVIN. Well, it says here the breakout for a typical deal is as follows. Do you see that in the middle of that page——

Mr. LARSON. I do.

[1] See Exhibit No. 121 which appears in the Appendix on page 2701.

Senator LEVIN. OK. Was this a typical breakout?

Mr. LARSON. I would say yes.

Senator LEVIN. OK. Now, the bottom line, then, is this, that the greater the loss, the greater the fees that you would receive, is that true?

Mr. LARSON. Correct.

Senator LEVIN. Your fee wasn't part of the profit. It wasn't based on profit.

Mr. LARSON. Actually, excuse me. Greater—which loss, the tax loss or——

Senator LEVIN. Yes. Is that right? The greater the loss that this taxpayer had in this deal, this paper loss, the greater your fee, is that correct?

Mr. LARSON. I think our—the advisory fee, I believe was charged as a percentage of the assets under management inside the strategic investment funds.

Senator LEVIN. And that typically was the premium?

Mr. LARSON. Yes, correct.

Senator LEVIN. All right. And that premium was the same as the loss, is that correct, to the taxpayer?

Mr. LARSON. It would be close——

Senator LEVIN. Close enough?

Mr. LARSON. Yes.

Senator LEVIN. And the greater that loss would be, the greater your premium would be, the greater your fee would be, is that not correct?

Mr. LARSON. That is correct.

Senator LEVIN. Your fee was not based on profit from an investment, is that correct?

Mr. LARSON. That is correct.

Senator LEVIN. Your fee was based on what that loss would be to the taxpayer, is that correct?

Mr. LARSON. Correct.

Senator LEVIN. And the greater the loss, the greater your fee?

Mr. LARSON. I agree.

Senator LEVIN. If anything demonstrates the purpose of this whole transaction simply—I think all these other documents prove it as well—but it is that the whole structure of the fees that went to the folks who cooked up this tax transaction was that the tax loss which the taxpayer achieved would determine the fee, and the greater the loss, the greater your fee. That, it seems to me, dramatizes what this is all about.

I am not going to ask you to respond because I think you would probably give me some rhetoric about profit was possible and there was always a possibility that something would happen. But just strip away all of the gobbledy-gook and just take a look at how the fees of the folks who designed this tax shelter were achieved, and the fees were based on the loss to the taxpayer and the fees increased as the losses increased. They weren't related to the profit for obvious reasons. There were no profits. None were expected. In fact, if it were based on profits, there wouldn't have been any fees.

I just have one more question of Mr. Greenstein, Mr. Chairman. I don't know if you want to——

Chairman COLEMAN. No, we are not going to have another round. I was going to make a comment, and I would give you an opportunity to make the last comment, the last question, Senator. I just wanted to make sure—I never did too well in math and I just want to make sure we understand this, because we have talked a lot about the taxpayer didn't make a profit and generated a loss, and so if you are short-selling Argentine pesos and there isn't a catastrophe, in fact, none of these taxpayers made a profit. They made a loss.

But the loss we are talking about here is not the loss in the transactions about pesos. The loss is when you set this deal up, if you got a $50 million loan, you got a $20 million premium. The loss is the loss you are going to write off when you cash out after 60 days of $20 million. So I don't want to be confused then, right. The loss is not the loss that the transaction—your fee is not a percentage of what was lost in the Argentina peso transaction. Your fee is a percentage of what the taxpayer was able to write off, is that correct?

Senator LEVIN. Is that a yes?

Chairman COLEMAN. Is that a yes?

Mr. LARSON. Yes.

Chairman COLEMAN. Senator Levin.

Senator LEVIN. Just one question, Mr. Greenstein. I don't have the exhibit handy. Perhaps my staff can get it. But you basically were told, were you not, by KPMG that whether or not you registered the FLIP was your decision?

Mr. GREENSTEIN. They did mention that to us and we deferred again to their decision, viewing them as the primary promoter, that if they decided that it did not need to be registered for themselves that we would go with that assessment.

Senator LEVIN. And then you wrote them in Exhibit 135,[1] I believe, on the last page—excuse me, they wrote you. Gregg Ritchie wrote you that the analysis of the tax shelter registration requirements which may be applicable to Quadra must be made by your firm in conjunction with your own tax counsel. You didn't do that, did you?

Mr. GREENSTEIN. We did not, and I think this letter was—they had communicated other things to us different than what this letter said and I think this was to absolve them of any liability that they may have for our decision.

Senator LEVIN. Do you know what CYA means?

Mr. GREENSTEIN. Yes, sir. [Laughter.]

Senator LEVIN. Was this a CYA letter, in your judgment?

Mr. GREENSTEIN. I believe it was.

Senator LEVIN. Thank you, Mr. Chairman.

Chairman COLEMAN. Thank you. The witnesses are excused.

I would now like to welcome our last panel to today's important hearing: The Honorable Mark Everson, Commissioner at the Internal Revenue Service; William McDonough, Chairman of the Public Company Accounting Oversight Board; and Richard Spillenkothen, Director of Banking Supervision and Regulation of the Federal Re-

[1] See Exhibit No. 135 which appears in the Appendix on page 2729.

serve. I thank each of you for your attendance at today's hearing and look forward to hearing your testimony.

Before we begin, pursuant to Rule 6, all witnesses who testify before the Subcommittee are required to be sworn. At this time, I would ask you to please stand and raise your right hand.

Do you swear that the testimony you give before the Subcommittee will be the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. EVERSON. I do.

Mr. MCDONOUGH. I do.

Mr. SPILLENKOTHEN. I do.

Chairman COLEMAN. As you would have heard from the earlier panels, we would like all statements to be 5 minutes. Your entire written statement will be entered as part of the permanent record.

Mr. Everson, we will have you go first this morning, followed by Mr. McDonough, and finish up with Mr. Spillenkothen. After we have heard all your testimony, we will proceed to questions. You may proceed, Mr. Everson.

TESTIMONY OF MARK EVERSON,[1] COMMISSIONER, INTERNAL REVENUE SERVICE, WASHINGTON, DC

Mr. EVERSON. Thank you. Good morning, Mr. Chairman and Senator Levin. I commend you for your interest in this important subject of abusive tax shelters.

Abusive tax avoidance transactions have a corrosive influence on our tax administration system and the very rule of law itself. Senator Grassley recently noted, "The IRS should be able to enforce the tax code and respect taxpayer rights at the same time. We can't have people abusing the tax code and we can't have the IRS abusing taxpayers. It is as simple as that."

I agree. The IRS must demonstrate and execute a balanced approach of service and enforcement if taxpayers are to remain faithful to our system of self-assessment, and we can't allow manipulation of the tax system through abusive shelters to undermine taxpayers' faith that if they pay their share of taxes, others will, as well.

I would like to mention four factors which I believe have contributed to the proliferation of abusive tax shelters and are depicted on that chart.[2]

First, the complexity of the tax code. Abusive tax avoidance transactions are designed to take advantage of the complexity of the tax code to obtain benefits that Congress never intended. Complexity becomes the shelter promoters' camouflage. Promoters hope that both the taxpayer and the IRS will be confused by a shelter's complexity, while the transaction's apparent viability is bolstered by legal opinions secured from reputable law firms.

To address this complexity, the Treasury Department and the IRS have significantly increased and accelerated the issuance of published guidance concerning potentially abusive transactions and the IRS has vigorously pursued compliance with the promoter reg-

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[1] The prepared statement of Mr. Everson with an attached chart appears in the Appendix on page 338.

[2] Chart entitled "Son of Boss Promoter Relationships" attached to Commissioner Everson's prepared statement which appears in the Appendix on page 348.

istration, list maintenance, and disclosure rules. These measures complement our increased examinations of tax shelters in taxpayer returns.

Second, the cozy relationship among sophisticated promoters. You have identified the relationships that exist among the various promoters and facilitators who peddle abusive tax transactions. I would like to draw your attention to this chart, which depicts promoter relationships for just one type of transaction, in this case, the Son of Boss.

The chart shows the reinforcing network of commercial interests that design, develop, and market these sophisticated products, including investment advisors, CPA firms, law firms, banks, and brokers. At the bottom, the chart indicates the linkages of these players to other tax shelter products of concern to the IRS.

The IRS is currently investigating over 100 promoters, including accounting firms, law firms, and financial institutions. Most have complied with our request for documents, but some have not, so in the last 6 months, the Department of Justice has filed summons enforcement actions against six of these promoters, including accounting firms and, for the first time, law firms. In addition, we are auditing thousands of individuals and corporations who have entered into questionable transactions.

Third, the erosion in professional ethics. At my confirmation hearing last March, I stated that attorneys and accountants should be the pillars of our system of taxation, not the architects of its circumvention. Based on what I have seen while on the job since May and what you have uncovered in your own investigation, I believe as strongly as ever in that statement.

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

Fourth, nominal penalties undermine the regulation of abusive transactions. The penalties that are currently on the books with respect to the promotion of abusive tax transactions constitute a nominal cost of doing business to organizations determined to generate large fees by promoting abusive tax avoidance transactions. De minimis penalties are no more than a speed bump on a single-minded road to professional riches.

Legislative proposals were announced in March 2002 to establish meaningful penalties for failure to comply with the promoter registration, disclosure, and list maintenance requirements of the code. We need significantly increased penalties to hit the promoters who don't get the message where it counts, in their wallets.

Mr. Chairman, I want to assure you and Senator Levin that the problem of abusive tax transactions is and will remain a high priority for the IRS. Thank you.

Chairman COLEMAN. Thank you very much, Commissioner. Chairman McDonough.

TESTIMONY OF WILLIAM J. McDONOUGH,[1] CHAIRMAN, PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD, WASHINGTON, DC

Mr. McDONOUGH. Chairman Coleman, Ranking Member Senator Levin, and Members of the Subcommittee, I am pleased to appear before you today on behalf of the Public Company Accounting Oversight Board, and I would like to begin by commending the Subcommittee's investigation of the role of professional firms, including accounting firms, in the development and marketing of abusive tax shelters. Indeed, the evidence you have accumulated has served as a wake-up call that we all, whether corporate leader, legislator, or regulator, must heed.

The financial scandals at Enron, Adelphia, WorldCom, HealthSouth, and elsewhere left the impression that public company financial reporting is not to be trusted and that professional advisors, including investment bankers, lawyers, and even a company's independent auditors, will help unscrupulous executives cook the books.

Congress responded to that breach of trust by enacting the Sarbanes-Oxley Act of 2002. That Act established the PCAOB and charged it with "oversee[ing] the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports."

To carry out that charge, the Act gives the Board significant powers over the practice of auditing the financial statements of public companies, including: To register public accounting firms that audit public companies; to inspect the audits and quality controls of such firms; to conduct investigations and disciplinary proceedings; and to establish auditing quality control, ethics, independence, and other standards relating to the preparation of audit reports or issuers.

Now, of course, much of the tax work done by accounting firms falls outside of the audit-oriented focus that Congress has assigned to the PCAOB. Nevertheless, the PCAOB has a variety of tools that may help address some of the problems caused by those abusive tax shelters that are designed to make financial statements look better.

First, the Board will be conducting a program of annual inspections of the largest registered firms' audits of public companies' financial statements and triennial inspections of smaller registered firms. In those inspections, we will conduct reviews of engagement work papers, which will put us in a position to identify and examine how firms audit questionable, tax-oriented transactions that are reflected in public companies' financial statements. We will also look for auditors' involvement in structuring such transactions for public company audit clients.

Because we are only beginning our inspections program, we cannot today assess the current extent of promotion and use of corporate tax shelters and products to public company audit clients. We will, however, scrutinize the accounting and presentation of the

[1] The prepared statement of Mr. McDonough appears in the Appendix on page 349.

transactions that we discover through our inspections program, specifically through our reviews of selected audit engagements.

In addition, by looking at auditor compensation, promotion, and retention, our inspections will identify a firm's policies and practices that create incentives for firm audit personnel to promote such transactions to their public company clients.

Therefore, while existing laws and regulations may not ban auditors from promoting and giving tax opinions on such transactions to their audit clients, both auditors and public companies should expect heightened scrutiny of such transactions. The prospect of that scrutiny may give pause to corporate management, audit committees, and auditors that may consider such transactions.

Second, through our authority to discipline registered firms and associated persons, we may impose stiff penalties for failing to adequately and impartially audit such transactions undertaken by public companies.

Finally, the Board has the authority to commence a standard-setting project to address at least a part of the problem. Specifically, the Board has authority to add to the statutory list of non-audit services that a registered firm may not provide to audit clients. Such regulation, of course, would not prohibit a registered firm from selling tax shelters to non-audit clients.

The Board also has the authority to develop and impose additional auditing procedures. While ferreting out tax avoidance is not directly within our purview, auditors ought to follow appropriate standards for identifying and auditing transactions whose main purpose is to create the impression of enhanced earnings in the financial statements.

Congress gave the PCAOB the responsibility and the tools to build a new future for auditing through independent standard setting, registration inspection, investigations, and discipline. As we move forward to employ those tools in the public interest, my fellow Board members and I look forward to a long and constructive relationship with this Subcommittee. Thank you.

Chairman COLEMAN. Thank you, Chairman McDonough. Mr. Spillenkothen.

TESTIMONY OF RICHARD SPILLENKOTHEN,[1] DIRECTOR, DIVISION OF BANKING SUPERVISION AND REGULATION, THE FEDERAL RESERVE, WASHINGTON, DC

Mr. SPILLENKOTHEN. I, too, thank you, Mr. Chairman, for the opportunity to testify today on the Federal Reserve's continuing efforts to advance corporate governance, risk management, and internal controls at banking organizations.

Numerous corporate governance and legal compliance failings over the last 2 years, including those delineated by this Subcommittee, highlight once again the critical need for effective risk management and internal controls to guide firms', both banks' and commercial firms', business practices and activities.

Federal Reserve staff have not reviewed the specific tax structures that I understand to be the focus of today's hearings, and as you know, bank supervisors are not tax experts nor are they re-

[1] The prepared statement of Mr. Spillenkothen appears in the Appendix on page 361.

sponsible for the oversight of tax compliance by banking organizations or their customers.

However, I appreciate the opportunity to talk to you today about our supervisory requirements and expectations for banks involved in complex transactions and about some of the steps we have taken to address banks' risk management and internal control infrastructures.

At the outset, I should point out that the primary focus of the Federal Reserve's supervision is promoting an institution's safety and soundness, as well as compliance with banking and consumer laws and regulations in a way that protects depositors, the FDIC insurance fund, and the rights of consumers.

Some basic principles and expectations for banking organizations guide our work in assessing business activities and risks, including banks' involvement in complex structured transactions.

First, and obviously most important, banking organizations must obey the law. They must have policies and procedures in place to ensure compliance with all laws and regulations and that they are not knowingly facilitating illegal activities by their customers or business associates. Banks should not engage in borderline transactions that are likely to result in significant reputational or operational risk to the organization.

Second, banks should perform thorough due diligence on the transactions or business activities that they are involved in and check with key legal, accounting, and tax authorities within their organizations, as well as independent third party experts, when appropriate. Banking organizations ordinarily should not be held legally responsible for the judgments, actions, or malfeasance of their customers or third party professional advisors. Such an expectation would require banks to assume management responsibilities outside their span of control, create potential legal liabilities that would compromise their ability to perform as financial intermediaries, or threaten their safety and soundness, and place additional significant cost on banking organizations.

Finally, banking organizations must recognize that although they are not directly accountable for the actions of their customers or third party legal and accounting professionals, to the extent that their names or products are implicitly associated with misconduct by those parties, additional legal and reputational risks may arise.

With these principles in mind and in light of recent events of the last couple of years, the Federal Reserve has taken steps to enhance the supervision of complex structured transactions and refine its supervisory programs.

During the past year, we have conducted special reviews of banking organizations engaged in complex structured transactions. Where we have found deficiencies, we have been clear on the need for banks to develop effective internal controls that comprehensively assess the risks associated with legal compliance. Formal Enron-related supervisory enforcement actions taken publicly by the Federal Reserve last summer underscore the expectations of bank supervisors on the need for banks to address internal weaknesses relating to complex structured transactions.

In addition to these efforts, we are working with our colleagues at the other bank agencies and the SEC to develop supervisory guidance on appropriate controls and risk management systems pertaining to complex structured transactions, including those that may have a tax component or dimension. During this period, we have increased our supervisory emphasis on the management of legal and reputational risks.

We are focusing increased attention on the adequacy of new product approval processes, the management of large or highly profitable customer relationships, and controls over the use of special purpose entities. Examiners are also stepping up efforts to review corporate governance and internal control infrastructures, including board and management oversight, corporate-wide compliance activities, and internal audit functions.

Banks appear to be responding to the lessons of recent years and the actions of supervisors. They are implementing better processes for subjecting transactions with heightened risk profiles to additional levels of scrutiny. This includes more thorough written policies and procedures, as well as processes for due diligence reviews by appropriate internal control functions, including accounting, legal, tax, prior to the execution of more complex or risky transactions. Most organizations have established new or reconstituted senior-level review committees and have fortified their new product approval processes.

Firms have also increased staff training around the identification and control of legal and reputational risks. Where necessary, banks should continue to strengthen these systems and bank management must work to ensure that the new processes are effective over time.

In closing, supervisors will continue to focus on risk management and control processes in order to foster safety and soundness, financial stability, and compliance with applicable laws and regulations. Supervisory activities will reinforce recent actions taken by banks to address weaknesses, and where necessary, supervisors will take appropriate corrective and enforcement action.

Of course, no system of official oversight is failsafe and supervisors cannot detect and prevent all control or management failures. However, strong and effective supervision, including the use of supervisory enforcement tools, management steps to strengthen corporate governance, risk management, and internal control infrastructures, and the incentives provided by marketplace discipline can contribute to better compliance and continued improvements in management of legal and reputational risks.

Chairman COLEMAN. I would ask you to summarize.

Mr. SPILLENKOTHEN. Thank you. I am finished, Mr. Chairman, and I would be happy to attempt to answer any questions you have.

Chairman COLEMAN. Thank you very much, Mr. Spillenkothen.

Let me just kind of go in reverse order here. Did you have a chance, Mr. Spillenkothen, to listen to the testimony today?

Mr. SPILLENKOTHEN. I did not have a chance to listen to all of it, Mr. Chairman. I tried to stay involved in some of it, but not all of it.

Chairman COLEMAN. If I can do a very brief summary, basically we have a situation where banks are issuing loans for these BLIPS, FLIP, and OPIS transactions, issuing loans ostensibly for 7-year periods but clearly being informed that these folks are getting out in 60 days. There is a premium piece in the loan structure, that when it is then part of an investment package, of which, by the way, very little is at risk, when it is pulled out, the investor claims loss. So you have folks, in effect, putting in very little. And, by the way, all these bank loans are collateralized at 101 percent.

So these are clearly tax shelters. There is no question about them. These are not 7-year high-interest loans, they are 60-day deals, in and out. And yet the banks' basic assertion is, well, we are not tax experts. We relied upon the KPMGs of the world.

Do you see any problems with that kind of operation?

Mr. SPILLENKOTHEN. Mr. Chairman, I have not had a chance to look at the specifics of these transactions and so I would be reluctant to try to opine on them.

Chairman COLEMAN. I am not asking you to opine on the transaction. I am asking you to opine on the actions of the bank. I mean, how much more do they have to know?

Mr. SPILLENKOTHEN. I think banks, as I tried to say, need to have internal systems to make sure that they are in compliance with all laws, including tax laws. I think the lesson of the last couple of years, which I think many banks have learned in part through the assistance of this Subcommittee and other market events, is that banks should avoid borderline transactions or transactions that have a high probability of resulting in legal problems or significant reputational risk. Banks need to ensure that they have systems in place to comply with the law, and ensure that they are not facilitating illegal activities by outside third parties.

Chairman COLEMAN. One of the kind of common denominators of all these transactions is that they are not registered. In some cases, they are limiting the scope of them. They are geographically distributing them, keeping everything below the radar. Talk to me about expanding reporting requirements in a way that would allow IRS to identify loans that are being used for questionable tax shelters. Can you talk to me about that imposing burdensome additional costs? How would you evaluate the efficacy and cost impact of such requirements? Mr. Spillenkothen.

Mr. SPILLENKOTHEN. Well, I think whenever you impose additional reporting requirements, there is potential burden, but one of the things that you have to do when you are developing reporting requirements is to be able to define what you are trying to collect information on. You have to be able to define the activity or transactions that you are trying to collect information on. I would leave it to my colleagues at other agencies, the IRS, to describe and deal with how you would define some of these things, but a clearly important element of getting reporting is to be able to define what activities one is trying to collect information on.

Chairman COLEMAN. Commissioner Everson, how do you react to the IRS being described as a toothless paper tiger?

Mr. EVERSON. I am sure that everyone who has come before this Subcommittee or before the Finance Committee in the hearing several weeks ago would not agree with that characterization, given their current problems. But I think what you are perhaps suggesting is that there has been concern that we need to have increased tools to do our job and perhaps more resources.

I will comment on both of these areas, I have mentioned the penalties. I think the penalties are central to assuring that we learn what is going on in this whole arena. The question you just asked to my colleague gets to getting information from yet another source. If we can just get the information from the practitioners and from the taxpayers themselves, I think that will be very helpful.

In terms of the resource question, I would point out both you and Senator Levin have spoken to this question most recently in your speech in New York. We are not an agency that gets topped up in the appropriations process. Yet again, we are sitting with a mark before the Senate right now that is $245 million below the President's request, and this is something that has happened under Republican Presidents, Democratic Presidents, Republican Congresses, and Democratic Congresses. We tend to fall short.

This is compounded in this case, because some 70 percent of our costs are personnel related and the pay raise is 2 percent greater than was budgeted. So we are more squeezed. And if there is an across-the-board non-defense, non-homeland recision of a percent or two on discretionary spending, that will cause further problems that are very significant for us.

So in this area, the first thing I would like to see is for the funding request to be honored.

Chairman COLEMAN. I think one of the concerns in dealing with the IRS is always about focus. I know you have the server, the wait person who worried about getting audited for her tips. You have the small business person worried about getting audited for whatever. And we are sitting at this hearing here and we are hearing about, over 6 years, $80-something billion potentially lost to taxpayers and the IRS being a toothless paper tiger in regard to these kinds of transactions. So I would say the issue is focus and what the policy makers would want to say is, yes, we are going to focus on those things that generate maximum return for the people who are massively committing tax fraud.

Mr. EVERSON. I agree with that 100 percent, and in fact, if you look at the request that the President made for the 2004 budget, he did provide for additional funds particularly in this area. The first priority of the budget request was to devote more enforcement resources to high-end taxpayers and to address these corporate shelters, and we are prioritizing.

We have shifted over a lot of our resources into this area, as the GAO and others have noted, in tracking all of our efforts, which include, as I mentioned, accelerating guidance. It includes enhancement of audits. We have got thousands of audits working right now for the taxpayers, businesses, and individuals alike in this area, including criminal investigations.

We are also extending our leverage and our reach. We have reached an agreement with 42 States around the country. I think you heard testimony from the State of California about this agreement. We are sharing information, jointly managing the caseload. Already, California has given us information, for instance, that gave us new participants in one of the shelters we are investigating. So we are really trying to provide the focus to this subject that you have suggested is appropriate.

Chairman COLEMAN. Just for me to try to get a sense of the scope of this, from your perspective, there was an article, I believe, in *American Lawyer* entitled "Still in the Shadows," October 1, 2003. It says, "as of June 2002, according to the IRS, 186 people had avoided $4.4 billion in taxes from BLIPS transactions. Another 57 people had avoided $1.4 billion from FLIP and OPIS." Are these numbers accurate, to the best of your knowledge?

Mr. EVERSON. I won't comment on particular numbers because the way some of these transactions are tracked by the originator of the transaction are a little bit different from the way we track them, sir. But overall, clearly, this problem runs into the billions of dollars.

The difficulty here, if you will, is that there are potentially abusive transactions, families of transactions that we have identified. We have already listed over two dozen of them. There are general criteria based on the amount of tax avoided vis-a-vis the investment, the same kinds of questions you have been asking, that also compel disclosure. And clearly, some of those disclosure requirements are now just coming into effect for the tax year, calendar year 2003. We will see a lot of that information next year. But this problem runs into the billions of dollars.

Chairman COLEMAN. And there are a range of these, COBRA, BOSS, Son of Boss, and other things that you laid out.

Mr. EVERSON. Yes, sir.

Chairman COLEMAN. One other question and then I will turn it over to my colleague, and there will be a second round. I have other questions I want to get to.

I am concerned about the finger pointing that we saw here in regard to reporting, almost as if there was some lack of clear, common definition. Ernst & Young says, or PWC says we should report FLIP, but KPMG doesn't. And then the advisors say, well, we are advised by these big accounting firms. It just seems obvious that the purpose of reporting—the ethical thing, the right thing to do is to give you notice and then people can make judgments about that. But there appears to be some legal basis or question, however questionable, that says you don't have to report. How do you clarify that to make sure it is very clear that these kind of transactions have to be reported?

Mr. EVERSON. I am not sure we need to clarify it. I do believe we need to increase the penalties so that the guidance which is already out there and in law is taken seriously.

Chairman COLEMAN. Switch, being the switch that you may use to hit somebody, that kind of switch.

Mr. EVERSON. I hate to say it, but not everybody has approached this from a point of view of the first objective which is to comply with the law.

Chairman COLEMAN. I appreciate that. Senator Levin.

Senator LEVIN. Let me first join you in welcoming our witnesses, thanking you for your work. It is critically important, and that is dramatized every day, but in 2 days of hearings here by what has been presented, pretty shocking, disturbing, sorry testimony.

I also would urge you, if you haven't had a chance, to read our staff report. It is an extraordinary report. I think perhaps your staffs have already had a chance to look at it, but in any event, we would be interested in your comments on the factual material which is set forth in that report. Perhaps for the record, Mr. Chairman, if it is appropriate, I would ask that they give us a comment about what they read in that report after they or their staffs have had a chance to do so.

Chairman COLEMAN. That request will be made and the answers will become part of the official record.

Senator LEVIN. I thank you.

First, Mr. Everson, the fines that you made reference to, I couldn't agree with you more. The current fine structure is really absurd, a $1,000 fine. It is not even a slap on the wrist. It is a slap on the finger or a slap on a nail on the finger. It is nothing. It is not even a cost of doing business. It is nothing compared to the rip-off that is going on and the amount of money that is made by those rip-offs.

So just looking here at Section 6700, a person who organizes or assists in the organization of a partnership, any investment plan, causes to make another person to make or furnish an arrangement which the person knows or has reason to know is false or fraudulent shall pay a penalty equal to $1,000. It might as well not be here. In fact, I would prefer it not be there.

Mr. EVERSON. It is chump change.

Senator LEVIN. Yes. What we have got to do is find a way to move in the direction that you have talked about, and I will be introducing a bill to do exactly that which will even go beyond what Senator Grassley and others have done, because what they do is take away part or all of the rip-off amount, but they don't penalize people.

So if somebody makes money they should not have made, a fee of $50 million, to say that you have to give back part of what you improperly got, or even all as the maximum penalty, which is what is in the other bill, seems to me isn't truly a penalty. It just says, give part of your ill-begotten gain back to us, or pay it to the government. It seems to me there has got to be a real penalty above and beyond what that person got improperly if we are going to really have a deterrent.

But in any event, I welcome the comment that you made, because we are going to need support to go at least as far as the Grassley bill and, I hope, beyond that. I happen to believe that, for instance, the promoter of these illegal schemes should pay the same as the taxpayer to whom they sold the illegal scheme, and if the taxpayer has to pay Uncle Sam $40 million because that is what they cheated Uncle Sam of, that the promoter of that tax scheme that resulted in that cheating pay the same amount. That will be a deterrent if we can go that far. That is a real deterrent.

Again, I won't ask you to comment on specific penalties, but I do hope you will take a look at these various approaches to penalties.

Now, Commissioner Everson, let me ask you this question relative to the enforcement problems that exist. Let us assume that the IRS gets wind of an illegal tax shelter, one that does not comply with Federal law, and it finds out that it is being promoted by a certain bank, a certain accounting firm, a certain investment advisory firm. Can the IRS tell the Federal Reserve about the bank's involvement?

Mr. EVERSON. Senator, one of the very important premises of the tax code is the confidentiality of taxpayer information. We respect that and we think that is very important. One of the results of that standard is that we are precluded from sharing information with others unless it reaches a point where we take it over, say, to the Justice Department because it becomes a full-fledged criminal matter.

Senator LEVIN. If it is a crime that there is evidence of, you can take it to the FBI or the Justice Department, is that correct?

Mr. EVERSON. We have a Criminal Investigations Division. If you may remember, they took care of Al Capone some decades ago.

Senator LEVIN. Right.

Mr. EVERSON. They would do the work and then they would bring it over. After it is ready, it goes over to the Tax Division at Justice and they look at it and they make the determination, and we do work with other agencies, yes, exactly as we did in the Scruchie indictment last week in corporate governance.

Senator LEVIN. But you cannot, for instance, share information about civil violations——

Mr. EVERSON. That is correct.

Senator LEVIN [continuing]. With, for instance, the SEC relative to an investment advisor. You can't do it with the Public Company Accounting Oversight Board relative to an accounting firm's involvement, and you can't do it with the Federal Reserve relative to a bank's involvement, even though you think the law has been violated, is that correct?

Mr. EVERSON. That is correct. To use one of your examples, if my fellow panelist, Chairman of the Public Company Accounting Oversight Board, if we are working on one of the firms, the accounting firms, and we have discovered or we believe that there is a pattern of abuse in this area, I can't turn to Bill and say, you ought to consider this in your risk assessment and your approach as to how you are governing the agency.

Likewise, we audit thousands of companies every year, and if we determine that 10 or 20 or whatever, some small percentage, are operating at the edge from a corporate governance point of view in the tax arena, we cannot originate a discussion with the SEC.

I do believe that what you are putting your finger on is an important subject that merits discussion because it is a gap in the governance structure. I want to make clear, however, that I do not believe in the routine sharing of individual tax return information. But in the case of some of these large corporations or the firms that you are discussing, I believe that there is a gap there that should be considered to be addressed.

Senator LEVIN. I think we would welcome any thoughts, further comments that you have on that subject, and the same from our other witnesses. It is a very important subject. I agree with you. You don't want any routine sharing here or else we are going to lose the great benefit, it seems to me, of our tax system, which is that we have got the confidence of taxpayers that they can pay their taxes and not worry about being turned over to the SEC, generally, unless they are committing a crime, in which case they will be turned over to the FBI. But short of that, there is an understanding among our taxpayers that is important to maintain. On the other hand, you point out there is a gap here, which perhaps can be addressed in an appropriate way.

The Federal Reserve has done a review of financial products and I just am wondering, who should be doing the same kind of review here of these tax shelters that you did of the financial products? It requires a review here, and I think if you have any of your staff that were here during this hearing or the Finance Committee hearings, I think you probably got more than a drift as to how deep and significant a problem that we have.

I am just wondering, who would be the appropriate agency to do the same kind of review of these kind of tax shelters, the ones that do not have a business purpose but whose primary purpose is to create a tax deduction? Would that be the Federal Reserve, would it be the Oversight Board, or would it be the IRS, or all three of you, or the SEC?

Mr. MCDONOUGH. Senator, we at the PCAOB would certainly think that we have a piece of the action. Anything that an accounting firm is doing vis-a-vis its audit clients, we feel would fall within our purview and we would be, through our inspection process, pursuing it very aggressively.

Even in the area which is not our direct responsibility, that is, the activities of accounting firms with their non-audit clients, what we are saying to them is that their real task is to restore the faith of the American people in their profession, and if you are running a firm, well, the place to start is in restoring public confidence in your firm.

What we are saying as a Board, and what I am saying as a rather outspoken Chairman of the Board, is if you really want the American people to restore their confidence in your profession, you should be very thoughtful about what kinds of products you are offering, and if it is likely to hurt the reputation of your firm or not rebuild the reputation of your firm, you shouldn't be doing it, even if it is legal.

Senator LEVIN. OK. Mr. Spillenkothen, can you make a commitment to us that you would work with the Accounting Board and with the IRS to make a thorough review of these kinds of transactions which spawn these abusive tax shelters? Could you give us that kind of commitment?

Mr. SPILLENKOTHEN. Senator Levin, we have, as you indicated, in the last year looked at bank involvement in complex structured transactions, a subset of which is transactions that have a tax component. We have, in doing that, focused on the banks' internal controls and systems for identifying risky or suspect transactions; for having internal checks and balances that involve review by independent tax accounting, and legal people; for escalating questionable transactions to appropriate decisionmakers, and for ensuring adequate documentation and controls. As I indicated in my statement, where we found some deficiencies, we have given feedback to organizations. We have also taken some formal enforcement actions.

So we have endeavored to focus on the risk management and internal controls of these organizations and I think we have already reviewed these transactions and we have worked into our ongoing supervisory processes procedures to focus on complex structured transactions. So I think we have tried to do that. We are working, as I indicated, on additional guidance that would provide risk management guidance on structured transactions, including those that have a tax dimension to them.

So we have focused on complex structured transactions. Obviously, our expertise is not taxes and our focus is on safety and soundness and internal controls for compliance with all laws and regulations.

Chairman COLEMAN. Thank you, Mr. Spillenkothen.

Mr. McDonough, just a few things I would like to focus on. First, I totally agree in this post-Enron world, restoring confidence is absolutely critical. It is critical for the economy, critical obviously just on a personal level, you would think, for the firms involved. The question is, how do we do that and how do we ensure it and what role?

My question, in part, is for you. The Public Company Accounting Oversight Board gets set up. Principally, you are looking at the quality of company audits, and the issues here that affect the reputation of these companies go beyond the audits.

Mr. MCDONOUGH. Sure.

Chairman COLEMAN. And I think we need more hands on deck in order to deal with this. I would hope that you would give some thought to how you can play a greater role in this. You have the bully pulpit, and that is important. You can remind people again and again. But beyond that, I just think the non-audit role of accounting firms today has certainly been called into great question, and though we have received a number—and I was certainly pleased to hear the companies come forth and say, we have changed our practice and changed our standards and changed personnel, but is that enough? So I would just hope that you would give that thought.

The other question, and I think you addressed it somewhat in your testimony but I would like to kind of go back over it, Senator Levin raised questions about the degree to which accounting firms should be allowed to offer tax advice to the offices and the directors of the companies they audit. We have got this whole issue of you are auditing and you are offering tax advice. Could you describe the Board's current views on that subject?

Mr. MCDONOUGH. Right. Well, as you are aware and as you have just said, Mr. Chairman, the accounting firms have long provided tax advice to their audit clients and both the Sarbanes-Oxley Act and what the SEC had to say in January in a rule continue to make that possible.

But having said that, we will use our inspections to do as much as we conceivably can. We will watch for whenever firms put pressure on auditors to sell non-audit services, including tax services, to executives. We will get at this issue through our examination of auditor compensation and promotion practices, and when we find inappropriate influences that may have an effect on audit quality, we will call the firm to bear on it.

Essentially, what we are trying to say is we want audit firms to reward really good, tough auditors for being good tough auditors, not for other stuff. If we see that they are rewarding auditors or getting a little tax advice work or anything else, we will be very heavy-handed in our discussions with them.

Chairman COLEMAN. Getting back to one other of the kind of the non-audit functions that came into question here, and that is fee generated by the percentage of loss that could be written off, is there anything inherently questionable about that? Perhaps, Commissioner, you might want to address this. Clearly, it raised red flags, it should have for the banks, it should have for the advisors, and certainly for the accounting firms. But is there anything inherently questionable about that and how would you deal with that issue in the future?

Mr. EVERSON. One of the things that the Subcommittee report, and I have had a chance to read at least the summary of it, correctly highlights is the revision in fee structures over time at the accounting firms, which I think has very much contributed to this decline in ethics. That is to say that instead of billing for time, they bill for value added. That is a change in the professional construct.

When I started out in accounting, you had the investment banks. They took fees and they had a stake in the action and they took, in many of these transactions, commercial risk, whereas the lawyers and the accountants were compensated based on time. That has drifted and changed over the decades so that the incentive, if you will, to gain riches as a professional is to change the value creation for the client. The last witness you had, the discussion you were having, in this case, it is not really value creation, it is value destruction from the government's interest. That is a different construct for lawyers and accountants than what it once was and I don't think it is a healthy one.

Chairman COLEMAN. Chairman McDonough, would you respond to that?

Mr. MCDONOUGH. Yes. I think it is clearly completely inappropriate for such arrangements to exist between an accounting firm and its audit clients. You mentioned earlier that we have the bully pulpit to deal with the accounting firms in areas which do not involve audit clients. That is being used, if I may say so, Mr. Chairman, very broadly and very effectively.

I was down in Atlanta, Georgia, last night talking to the Georgia State Society of CPAs. I am spending a lot of my time out and I can tell you the message is very direct and it is not very subtle. It is, "we will have to have the accounting profession reach a new standard of culture, ethics, responsibility so they regain the confidence of the American people, and they can either do it voluntarily, which is the best way, or if they don't do it voluntarily, we will make them do it." That is pretty direct.

Chairman COLEMAN. I appreciate those efforts, Mr. McDonough. Senator Levin.

Senator LEVIN. Thank you. Mr. McDonough, you have indicated you are looking at adopting a national rule prohibiting the contingent fee. Is that where you are at?

Mr. MCDONOUGH. I believe that all of the rules necessary to prohibit contingent fees for audit clients already exist. I will do a double-check and if they don't, you can be very sure that we will be looking at any new audit standard setting or rulemaking we will need in the area, but I think it is already there.

Senator LEVIN. I think most States have it, but I don't know that there is a national rule. But in any event, if you could double-check that——

Mr. MCDONOUGH. We will do that.

Senator LEVIN [continuing]. And your commitment that it should be a national prohibition is helpful.

Mr. MCDONOUGH. Yes.

Senator LEVIN. Now, Senators Baucus, McCain, and I have introduced S. 1767, which would ban auditors from providing tax shelter services to clients that they audit. I am wondering whether you have had a chance to examine that legislation, and if so, what your reaction is to it.

Mr. MCDONOUGH. Senator, I haven't had an opportunity to review the legislation, but based on just the brief description you gave of it, it seems to me that it is highly unlikely that an accounting firm could be giving an audit client tax shelter advice and not flunk the independence test. Independence, as you know, is an absolute requirement for an auditor to maintain in order to carry out his or her professional responsibilities.

But even if permitted by the audit committee, which all tax work really has to be and should be, if it came into the area of actually recommending and advising tax shelters, I think it would be quite clear. We would have to look at it in the individual case, but generically, that auditor would be evaluating his or her own work and that would flunk the independence test.

Senator LEVIN. That is what we are trying to get at and trying to prohibit—that exact activity, where the accountant is auditing his own product, his own work product. If you could take a look at that bill and give us a response to it, that would be very helpful.

The only thing I really want to say in conclusion, if I could just take a minute here, Mr. Chairman, is that basically, Uncle Sam is getting ripped off by the promoters of sham transactions which produce tax deductions and tax losses as their principal goal. These are abusive. They are costing us perhaps $10 or $15 billion a year.

We have had really an extraordinary staff report, and I want to thank my staff, and your staff has been very supportive, Mr. Chairman, and I want to thank them for that support.

The report that we have issued is probably the most detailed report on these sham transactions that we are aware of. In any event, it is a very disturbing picture. I think if the average taxpayer out there could somehow or other get through these complicated machinations, that the level of disgust and abhorrence would be so high that you as regulators and we as legislators would be forced to take very strong, very urgent action against the people who promote these shelters.

They are aided and abetted in that process by professionals. It is similar to what happened with Enron. Enron was the engine, but professionals, including banks, stockbrokers, and lawyers, aided and abetted Enron. It could not have happened without them.

In this case, we have the aiders and abetters. We also have the engine here being the designers of the tax shelters who are professional people.

So we are going to do, I hope, everything that we can do legislatively to tighten up the law on economic substance, if necessary—

there is a bill which does that which has passed the Senate—to adopt penalties, I won't say stricter penalties because I consider the ones that are in existence a joke and, for all intents and purposes, nonexistent, so adopt really tough penalties and real penalties for people who aid and abet these sham transactions which produce these tax shelters.

The regulatory agencies that you represent are playing a critical role and we need you to work together to coordinate better, to use your resources in a targeted way, as I think our Chairman pointed out.

But we also, frankly, need the professions to help clean up their own act. This is a pretty shameful exposition that we have witnessed here of professional failure. If it is a true profession, the immorality that we have seen, the shocking testimony of purposeful deceptive transactions which have no real purpose other than to create a tax deduction should really shake up our professions. But I don't think we can count on that, unhappily. Even if the top-level folks who run these professions adopt good codes of ethics and enforce them, there are still going to be those folks who will try to evade those codes of ethics, and for that we need regulators, and for that, we need tough penalties.

I am determined to do whatever I can, and I know our Chairman joins me in this, to do whatever we can to put an end to the kind of abuses that we have seen dramatized this week.

Thank you, Mr. Chairman.

Chairman COLEMAN. Thank you, Senator Levin. Senator Levin, I want to also reiterate my commitment to doing what we need to do to make sure that these sham abusive transactions are a thing of the past.

I do want to thank our staffs, and thank my staff for all the work they have done to catch up with all the work that your staff did. They did an extraordinary job. These are complex transactions and that is one of the challenges certainly the IRS has in dealing with them. But they are also pretty simple. I mean, you don't need to be a rocket scientist to figure out if somebody made $20 million and somebody comes up to you and says, hey, we will get that as a loss and then you will not have to pay taxes, limit tax liability on it. The complexity is how you get from A to Z, but the concept is very simple.

What struck me, Senator Levin, as I listened, where otherwise very bright, smart people, not just in the accounting firms but all the others involved who just turned a blind eye to what was so obvious, and to me, it was obvious. I think everybody knew what they were doing and what they did was wrong, and it is not just Uncle Sam that gets ripped off. It is the little guy. The fact that there is $85 billion less being paid into the government coffers over 6 years means that those folks who are paying the taxes, doing the right thing, working hard, they are the ones who are really suffering and we have got to make sure that doesn't happen.

You have a lot of responsibility. You have a lot of challenges. We will certainly work with you and support your efforts. Clearly, I look forward to working with you, Senator Levin, on your legislation and some of the recommendations proposed by the Commissioner.

Hopefully, what we saw was a thing of the past. I think we have a responsibility to make sure it doesn't happen again. I fear that, in part, we are nowhere out of the high-flying 1990's. We are not generating just barrels of cash anymore from all these transactions, and in part, that may be why the activity has slowed up. I do accept the statements from the firms involved they have changed their ways, but the climate is different.

I just want to make sure that—and I hope we get back to the economy rolling. I don't want to get back to the ethical standards or the lack thereof, but when we get back to the economy rolling, I just want to make sure that if that should happen, that we don't face the same problems. That is our challenge and we will do everything we can to make sure it doesn't happen and still do the things we can to promote growth and promote economy and promote opportunity in this country.

Before adjourning, I would like to add for the record a written statement submitted by Tom Lopez, the Chief Investment Officer with the Fire and Police Pension System of Los Angeles.[1]

With that, this hearing is adjourned.

[Whereupon, at 1:10 p.m., the Subcommittee was adjourned.]

[1] The prepared statement of Mr. Lopez appears in the Appendix as Exhibit No. 153 on page 3016.

APPENDIX

U.S. TAX SHELTER INDUSTRY: THE ROLE OF ACCOUNTANTS, LAWYERS, AND FINANCIAL PROFESSIONALS

FOUR KPMG CASE STUDIES: FLIP, OPIS, BLIPS, AND SC2

I. Introduction

In 2002, the U.S. Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, at the direction of Senator Carl Levin, then its Chairman, initiated an in-depth investigation into the development, marketing, and implementation of abusive tax shelters by professional organizations such as accounting firms, banks, investment advisors, and law firms. The information in this Report is based upon the ensuing bipartisan investigation conducted jointly by the Subcommittee's Democratic and Republican staffs, with the support of Subcommittee Chairman Norm Coleman.

During the course of its investigation, the Subcommittee issued numerous subpoenas and document requests, and the Subcommittee staff reviewed over 235 boxes, and several electronic compact disks, containing hundreds of thousands of pages of documents, including tax product descriptions, marketing material, transactional documents, manuals, memoranda, correspondence, and electronic mail. The Subcommittee staff also conducted numerous, lengthy interviews with representatives of accounting firms, banks, investment advisory firms, and law firms. In addition, the Subcommittee staff reviewed numerous statutes, regulations, legal pleadings, reports, and legislation, dealing with federal tax shelter law. The staff consulted with federal and state agencies and various accounting, tax and financial experts, including the U.S. Department of the Treasury, U.S. Internal Revenue Service (IRS), Public Company Accounting Oversight Board (PCAOB), California Franchise Tax Board, tax experts on the staffs of the Joint Commission on Taxation, Senate Committee on Finance, and House Committee on Ways and Means, various tax professionals, and academic experts, and other persons with relevant information.

The evidence reviewed by the Subcommittee establishes that the development and sale of potentially abusive and illegal tax shelters have become a lucrative business in the United States, and professional organizations like major accounting firms, banks, investment advisory firms, and law firms have become major developers and promoters. The evidence also shows that respected professional firms are spending substantial resources, forming alliances, and developing the internal and external infrastructure necessary to design, market, and implement hundreds of complex tax shelters, some of which are illegal and improperly deny the U.S. Treasury of billions of dollars in tax revenues.

The term "tax shelter" has come to be used in a variety of ways depending upon the context. In the broadest sense, a tax shelter is a device used to reduce or eliminate the tax liability of the tax shelter user. Some tax shelters are specific tax benefits explicitly enacted by Congress to advance a legitimate endeavor, such as the low income housing tax credit. Those types of legitimate tax shelters are not the focus of this Report. The tax shelters under investigation by the Subcommittee are complex transactions used by corporations or individuals to obtain significant tax benefits in a manner never intended by the tax code. These transactions have no economic substance or business purpose other than to reduce or eliminate a person's tax liability. These abusive tax shelters can be custom-designed for a single user or prepared as a generic "tax product" available for sale to multiple clients. The Subcommittee investigation focuses on the abusive tax shelters sold as generic tax products available to multiple clients.

Under current law, generic tax shelters are not illegal *per se*; they are potentially illegal depending upon how purchasers actually use them and calculate their tax liability on their tax returns. Over the last 5 years, the IRS has begun publishing notices identifying certain generic tax shelters as "potentially abusive" and warning taxpayers that use of such "listed transactions" may lead to an audit and assessment of back taxes, interest, and penalties for using an illegal tax shelter. As used in this Report, "potentially abusive" tax shelters are those that come within the scope of an IRS "listed transaction," while "illegal" tax shelters are those with respect to which the IRS has taken actual enforcement action against taxpayers for violating federal tax law.

The Subcommittee investigation perceives an important difference between selling a potentially abusive or illegal tax shelter and providing routine tax planning services. None of the transactions examined by the Subcommittee derived from a request by a specific corporation or individual for tax planning advice on how to structure a specific business transaction in a tax-efficient way; rather all of the transactions examined by the Subcommittee involved generic tax products that had been affirmatively developed by a firm and then vigorously marketed to numerous, in some cases thousands, of potential buyers. There is a bright line difference between responding to a single client's tax inquiry and aggressively developing and marketing a generic tax shelter product. While the tax shelter industry of today may have sprung from the former, it is now clearly driven by the latter.

In order to gain a deeper understanding of the issues, the Subcommittee conducted four in-depth case studies examining tax products sold by a leading accounting firm, KPMG, to individuals or corporations to help them reduce or eliminate their U.S. taxes. KPMG is one of the largest accounting firms in the world, and it had built a reputation as a respected auditor and expert tax advisor. KPMG vigorously denies being a tax shelter promoter, but the evidence obtained as a result of the Subcommittee investigation is overwhelming in demonstrating KPMG's active and, at times, aggressive role in promoting and profiting from generic tax products sold to individuals and corporations, including tax products later determined by the IRS to be potentially abusive or illegal tax shelters.

Earlier this year, KPMG informed the Subcommittee that it maintained an inventory of over 500 "active tax products" designed to be offered to multiple clients for a fee. The four KPMG case studies featured in this Report are the Bond Linked Issue Premium Structure (BLIPS), Foreign Leveraged Investment Program (FLIP), Offshore Portfolio Investment Strategy (OPIS), and the S-Corporation Charitable Contribution Strategy (SC2). KPMG sold these four tax products to more than 350 individuals from 1997 to 2001. All four generated significant fees for the firm, producing total revenues in excess of $124 million.[1] The IRS later determined that three of the products, BLIPS, FLIP, and OPIS, were potentially abusive or illegal tax shelters, while the fourth, SC2, is still under review. As of June 2002, an IRS analysis of just some of the tax returns associated with BLIPS, FLIP, and OPIS had identified 186 people who had used BLIPS to claim losses on their tax returns totaling $4.4 billion, and 57 people who had used FLIP or OPIS to claim tax losses of $1.4 billion, for a grand total of $5.8 billion.[2] Evidence made available to the Subcommittee suggests that lost tax revenues are also significant, including documents which show that, for 169 out of 186 BLIPS participants for which information was recorded, federal tax revenues were reduced by $1.4 billion.

Some members of the U.S. tax profession are apparently claiming that the worst tax shelter abuses are already over, so there is no need for investigations, reforms, or stronger laws. The Subcommittee investigation, however, indicates just the opposite: while a few tax shelter promoters have ended their activities, the tax shelter industry as a whole remains active, developing new products, marketing dubious tax shelters to numerous individuals and corporations, and continuing to wrongfully deny the U.S. Treasury billions of dollars in revenues, leaving average U.S. taxpayers to make up the difference.

II. Findings

Based upon its investigation to date, the Subcommittee Minority staff recommends that the Subcommittee make the following findings of fact.

(1) The sale of potentially abusive and illegal tax shelters has become a lucrative business in the United States, and some professional firms such as accounting firms, banks, investment advisory firms, and law firms are

[1] Letter dated 9/12/03, from KPMG's legal counsel, Wilkie Farr & Gallagher, to the Subcommittee, at 2. According to KPMG information provided to the Subcommittee in this letter and a letter dated 8/8/03, FLIP was sold to 80 persons, in 63 transactions, and produced total gross revenues for the firm of about $17 million over a 4-year period, 1996–1999. OPIS was sold to 111 persons in 79 transactions, and produced about $28 million over a 2-year period, 1998–1999. BLIPS, the largest revenue generator, was sold to 186 persons in 186 transactions, and produced about $53 million over a 1-year period from about October 1999 to about October 2000. SC2 was sold to 58 S corporations in 58 transactions, and produced about $26 million over an 18-month period from about March 2000 to about September 2001. Other information presented to the Subcommittee suggests these revenue figures may be understated and that, for example, BLIPS generated closer to $80 million in fees for the firm, OPIS generated over $50 million, and SC2 over $30 million.

[2] *United States v. KPMG,* Case No. 1:02MS00295 (D.D.C. 7/9/02), "Declaration of Michael A. Halpert," Internal Revenue Agent, at ¶ 37.

major participants in the mass marketing of generic "tax products" to multiple clients.

(2) Although KPMG denies being a tax shelter promoter, the evidence establishes that KPMG has devoted substantial resources to, and obtained significant fees from, developing, marketing, and implementing potentially abusive and illegal tax shelters that U.S. taxpayers might otherwise have been unable, unlikely or unwilling to employ, costing the Treasury billions of dollars in lost tax revenues.

(3) KPMG devotes substantial resources and maintains an extensive infrastructure to produce a continuing supply of generic tax products to sell to multiple clients, using a process which pressures its tax professionals to generate new ideas, move them quickly through the development process, and approve, at times, potentially abusive or illegal tax shelters.

(4) KPMG uses aggressive marketing tactics to sell its generic tax products, including by turning tax professionals into tax product salespersons, pressuring its tax professionals to meet revenue targets, using telemarketing to find clients, using confidential client tax data to identify potential buyers, targeting its own audit clients for sales pitches, and using tax opinion letters and insurance policies as marketing tools.

(5) KPMG is actively involved in implementing the tax shelters which it sells to its clients, including by enlisting participation from banks, investment advisory firms, and tax exempt organizations; preparing transactional documents; arranging purported loans; issuing and arranging opinion letters; providing administrative services; and preparing tax returns.

(6) Some major banks and investment advisory firms have provided critical lending or investment services or participated as essential counter parties in potentially abusive or illegal tax shelters sold by KPMG, in return for substantial fees or profits.

(7) Some law firms have provided legal services that facilitated KPMG's development and sale of potentially abusive or illegal tax shelters, including by providing design assistance or collaborating on allegedly "independent" opinion letters representing to clients that a tax product would withstand an IRS challenge, in return for substantial fees.

(8) Some charitable organizations have participated as essential counter parties in a highly questionable tax shelter developed and sold by KPMG, in return for donations or the promise of future donations.

(9) KPMG has taken steps to conceal its tax shelter activities from tax authorities and the public, including by refusing to register potentially abusive tax shelters

with the IRS, restricting file documentation, and using improper tax return reporting techniques.

III. Executive Summary

The Subcommittee's investigation into the role of professional organizations in the tax shelter industry has identified two fundamental, relatively recent changes in how the industry operates.

First, the investigation has found that the tax shelter industry is no longer focused primarily on providing individualized tax advice to persons who initiate contact with a tax advisor. Instead, the industry focus has expanded to developing a steady supply of generic "tax products" that can be aggressively marketed to multiple clients. In short, the tax shelter industry has moved from providing one-on-one tax advice in response to tax inquiries to also initiating, designing, and mass marketing tax shelter products.

Secondly, the investigation has found that numerous respected members of the American business community are now heavily involved in the development, marketing, and implementation of generic tax products whose objective is not to achieve a business or economic purpose, but to reduce or eliminate a client's U.S. tax liability. Dubious tax shelter sales are no longer the province of shady, fly-by-night companies with limited resources. They are now big business, assigned to talented professionals at the top of their fields and able to draw upon the vast resources and reputations of the country's largest accounting firms, law firms, investment advisory firms, and banks.

The four case studies featured in this Report examine tax products developed by KPMG, a respected auditor and tax expert and one of the top four accounting firms in the United States. In the latter half of the 1990's, according to KPMG employees interviewed by Subcommittee staff, KPMG's Tax Services Practice underwent a fundamental change in direction by embracing the development of generic tax products and pressing its tax professionals to sell them. KPMG now maintains an inventory of more than 500 active tax products and routinely presses its tax professionals to participate in tax product marketing campaigns.

Three of the tax products examined by the Subcommittee, FLIP, OPIS, and BLIPS, are similar in nature. In fact, BLIPS was developed as a replacement for OPIS which was developed as a replacement for FLIP.[3] All three tax products function as "loss generators," meaning they generate large paper losses that the purchaser of the product then uses to offset other income, and shelter it from taxation.[4] All three products have generated hundreds of millions of dollars in phony paper losses for taxpayers, using a series of complex, orchestrated transactions involving shell corporations, structured finance, purported multi-million dollar loans, and deliberately obscure investments.[5] All three also generated substantial fees for KPMG, with BLIPS and OPIS winning slots among

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[3] See, e.g., document dated 5/18/01, "PFP Practice Reorganization Innovative Strategies Business Plan—DRAFT," authored by Jeffrey Eischeid, Bates KPMG 0050620–23, at 1.

[4] *Id.* See also document dated 7/21/99, entitled "Action Required," authored by Jeffrey Eischeid, Bates KPMG 0006664 (In the case of BLIPS, "a key objective is for the tax loss associated with the investment structure to offset/shelter the taxpayer's other, unrelated, economic profits.").

[5] See Appendix A for a more detailed explanation of BLIPS.

KPMG's top ten revenue producers in 1999 and 2000, before sales were discontinued. All three tax products are also covered by the "listed transactions" that the IRS has published and declared to be potentially abusive tax shelters.[6] In all three cases, the IRS has already begun requiring taxpayers who used these products to pay back taxes, interest, and penalties. Over a dozen taxpayers penalized by the IRS for using these tax products have subsequently filed suit against KPMG for selling them an illegal tax shelter.[7]

The fourth tax product, SC2, is described by KPMG as a "charitable contribution strategy."[8] It is directed at individuals who own profitable corporations organized under Chapter S of the tax code (hereinafter "S corporations"), which means that the corporation's income is attributed directly to the corporate owners and taxable as personal income. SC2 is intended to generate a tax deductible charitable donation for the corporate owner and, more importantly, to defer and reduce taxation of a substantial portion of the income produced by the S corporation, essentially by "allocating" but not actually distributing that income to a tax exempt charity holding the corporation's stock. Like BLIPS, FLIP, and OPIS, SC2 requires a series of complex, orchestrated transactions to obtain the promised tax benefits. Among other measures, these transactions involve the issuance of non-voting stock and warrants, a corporate non-distribution resolution, and a stock redemption agreement; a temporary donation of the non-voting stock to a charity; and various steps to "allocate" but not distribute corporate income to the tax exempt charity.[9] Early in its development, KPMG tax professionals referred to SC2 as "S-CAEPS," pronounced "escapes." The name was changed after a senior tax official pointed out: "I think the last thing we or a client would want is a letter in the files regarding a tax planning strategy for which the acronym when pronounced sounds like we are saying 'escapes.'"[10] In 2000 and 2001, SC2 was one of KPMG's top ten revenue producers. SC2 is not covered by one of the "listed transactions" issued by the IRS, but is currently undergoing IRS review.[11]

Together, these four case histories, BLIPS, FLIP, OPIS, and SC2, provide an in-depth portrait of how a professional organization like KPMG, and the professional organizations it allies itself with, end up developing, marketing, and implementing highly questionable or illegal tax products. The evidence also sheds light on the critical roles played by other professional organizations to make suspect tax products work.

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[6] FLIP and OPIS are covered by IRS Notice 2001–45 (2001–33 IRB 129) (8/13/01); while BLIPS is covered by IRS Notice 2000–44 (2000–36 IRB 255) (9/5/00). See also *United States v. KPMG,* Case No. 1:02MS00295 (D.D.C. 9/6/02).

[7] See, e.g., *Jacoboni v. KPMG,* Case No. 6:02–CV–510 (M.D. Fla. 4/29/02) (OPIS); *Swartz v. KPMG,* Case No. C03–1252 (W.D. Wash. 6/6/03) (BLIPS); *Thorpe v. KPMG,* Case No. 5–030CV–68 (E.D.N.C. 1/27/03) (FLIP/OPIS).

[8] The formal title of the tax product is the S-Corporation Charitable Contribution Strategy.

[9] See Appendix B for a more detailed explanation of SC2.

[10] Email dated 3/24/00, from Mark Springer to multiple KPMG tax professionals, "RE: S-corp Product," Bates KPMG 0016515. See also email dated 3/24/00, from Mark Springer to multiple KPMG tax professionals, "Re: S-corp Product," Bates 0016524 (suggesting replacing "all S-CAEPS references with something much more benign").

[11] See email dated 4/10/02, from US-Tax Innovation Center to multiple KPMG tax professionals, "IRS Summons Information Request for SC2," Bates XX 001433 ("The IRS has requested certain information from the Firm related to SC2."); undated KPMG document entitled, "April 18 IRS Summons Response."

A. Developing New Tax Products

The Subcommittee investigation has found that the tax product development and approval process used at KPMG was deeply flawed and led, at times, to the approval of tax products that the firm knew were potentially abusive or illegal. Among other problems, the evidence shows that the KPMG approval process has been driven by market considerations, such as consideration of a product's revenue potential and "speed to market," as well as by intense pressure that KPMG supervisors have placed on subordinates to "sign-off" on the technical merits of a proposed product even in the face of serious questions about its compliance with the law.

The case of BLIPS illustrates the problems. Evidence obtained by the Subcommittee discloses an extended, unresolved debate among KPMG tax professionals over whether BLIPS met the technical requirements of federal tax law. In 1999, the key KPMG technical reviewer resisted approving BLIPS for months, despite repeated expressions of dismay from superiors. He finally agreed to withdraw his objections to the product in this email sent to his supervisor: "I don't like this product and would prefer not to be associated with it [but] I can reluctantly live with a more-likely-than-not opinion being issued for the product." This assessment is not exactly the solid endorsement that might be expected for a tax product sold by a major accounting firm.

The most senior officials in KPMG's Tax Services Practice exchanged emails which frankly acknowledged the problems and reputational risks associated with BLIPS, but nevertheless supported putting it on the market for sale to clients. One senior tax professional summed up the pending issues with two questions:

> "(1) Have we drafted the opinion with the appropriate limiting bells and whistles . . . and (2) Are we being paid enough to offset the risks of potential litigation resulting from the transaction? . . . My own recommendation is that we should be paid a lot of money here for our opinion since the transaction is clearly one that the IRS would view as falling squarely within the tax shelter orbit."

No one challenged the analysis that the risky nature of the product justified the firm's charging "a lot of money" for a tax opinion letter predicting it was more likely than not that BLIPS would withstand an IRS challenge. When the same KPMG official observed, "I do believe the time has come to shit and get off the pot," the second in command at the Tax Services Practice responded, "I believe the expression is shit OR get off the pot, and I vote for shit."

BLIPS, like its predecessors OPIS and FLIP, was sold by KPMG to numerous clients before the IRS issued notices declaring them potentially abusive tax shelters that did not meet the requirements of federal tax law. Other professional firms have also sold potentially abusive or illegal tax products such as the Currency Options Brings Reward Alternatives (COBRA) and Contingent Deferred Swap (CDS) sold by Ernst & Young, the FLIP tax product and Bond and Option Sales Strategy (BOSS) sold by PricewaterhouseCoopers, the Customized Adjustable Rate Debt Facility (CARDS) sold by Deutsche Bank, the FLIP tax product sold by Wachovia Bank, and the Slapshot tax product sold by J.P. Morgan Chase.[12] The sale of these abusive tax shelters by other firms clearly demonstrates that flawed approval procedures are not confined to a single firm or a single profession. Many other professional firms are also developing and selling dubious tax products.

B. Mass Marketing Tax Products

A second striking aspect of the Subcommittee investigation was the discovery of the substantial effort KPMG has expended to market its tax products to potential buyers. The investigation found that KPMG maintains an extensive marketing infrastructure to sell its tax products, including a market research department, a Sales Opportunity Center that works on tax product "marketing strategies," and even a full-fledged telemarketing center staffed with people trained to make cold calls to find buyers for specific tax products. When investigating SC2, the Subcommittee discovered that KPMG used its telemarketing center in Fort Wayne, Indiana, to contact literally thousands of S corporations across the country and help elevate SC2 to one of KPMG's top ten revenue-producing tax products.

The evidence also uncovered a corporate culture in KPMG's Tax Services Practice that condoned placing intense pressure on the firm's tax professionals—CPAs and lawyers included—to sell the firm's generic tax products. Numerous internal emails by senior KPMG tax professionals exhorted colleagues to increase their sales efforts. One email thanked KPMG tax professionals for a team effort in developing SC2 and then instructed these professionals to "SELL, SELL, SELL!!" Another email warned KPMG partners: "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." A third email asked all partners in KPMG's premier technical tax group, Washington National Tax (WNT), to "temporarily defer non-revenue producing activities" and concentrate for the "next 5 months" on meeting WNT's revenue goals for the year. The email stated: "Listed below are the tax products identified by the functional teams as having significant revenue potential over the next few months. . . . Thanks for help in this critically important matter. As [the Tax Services Practice second in command] said, 'We are dealing with ruthless execution—hand to hand combat—blocking and tackling.' Whatever the mixed metaphor, let's just do it."

The four case studies featured in this Report provide detailed evidence of how KPMG pushed its tax professionals to meet revenue targets, closely monitored their sales efforts, and even, at times, advised them to use questionable sales techniques. For example, in the case of SC2, KPMG tax professionals were directed to contact existing clients about the product, including KPMG's own audit clients. In a written document offering sales advice on SC2, KPMG advised its employees, in some cases, to make misleading statements to potential buyers, such as claiming that SC2 was no longer available for sale, even though it was, apparently hoping that reverse psychology would then cause the client to want

[12] Slapshot is an abusive tax shelter that was examined in a Subcommittee hearing last year. See "Fishtail, Bacchus, Sundance, and Slapshot: Four Enron Transactions Funded and Facilitated by U.S. Financial Institutions," S. Prt. 107–82 (107th Congress 1/2/03).

to buy the product. KPMG also utilized confidential and sensitive client data in an internal database containing information used by KPMG to prepare client tax returns in order to identify potential targets for its tax products.

KPMG also used opinion letters and insurance policies as selling points to try to convince uncertain buyers to purchase a tax product. For example, KPMG tax professionals were instructed to tell potential buyers that opinion letters provided by KPMG and Sidley Austin Brown & Wood would protect the buyer from certain IRS penalties, if the IRS were later to invalidate the tax product. In the case of SC2, KPMG tax professionals were instructed to tell buyers that, "for a small premium," they could buy an insurance policy from AIG, Hartford Insurance, or another firm that would reimburse the buyer for any back taxes or penalties actually assessed by the IRS for using the tax product. These selling points suggest KPMG was trying to present its tax products as a risk free gambit for its clients. They also suggest that KPMG was pitching its tax products to persons with limited interest in the products and who likely would not have used them to avoid paying their taxes, absent urging by KPMG to do so.

C. Implementing Tax Products

Developing and selling a tax product to a client did not, in many cases, end KPMG's involvement with the product, since the product often required the purchaser to carry out complex financial and investment activities in order to realize the promised tax benefits. In the four cases examined by the Subcommittee, KPMG enlisted a bevy of other professionals, including lawyers, bankers, investment advisors and others, to carry out the required transactions. In the case of SC2, KPMG actively found and convinced various charitable organizations to participate. Charities told the Subcommittee staff that KPMG had contacted the organizations "out of the blue," convinced them to participate in SC2, facilitated interactions with the SC2 "donors," and supplied drafts of the transactional documents.

The Subcommittee investigation found that BLIPS, OPIS, FLIP, and SC2 could not have been executed without the active and willing participation of the law firms, banks, investment advisory firms, and charitable organizations that made these products work. In the case of BLIPS, OPIS, and FLIP, law firms and investment advisory firms helped draft complex transactional documents. Major banks, such as Deutsche Bank, HVB, UBS, and NatWest, provided purported loans for tens of millions of dollars essential to the orchestrated transactions. Wachovia Bank initially provided client referrals to KPMG for FLIP sales, then later began its own efforts to sell FLIP to clients. Two investment advisory firms, Quellos Group LLC ("Quellos") and Presidio Advisory Services ("Presidio"), participated directly in the FLIP, OPIS, or BLIPS transactions, even entering into partnerships with the clients. In the case of SC2, several pension funds agreed to accept corporate stock donations and sign redemption agreements to "sell" back the stock to the corporation after a specified period of time. In all four cases, Sidley Austin Brown & Wood agreed to provide a legal opinion letter attesting to the validity of the relevant tax product. Other law firms, such as Sherman and Sterling, prepared transactional documents and helped carry out specific transactions. In return, each of the professional firms was paid lucrative fees.

In the case of BLIPS, documents and interviews showed that banks and investment advisory firms knew the BLIPS transactions and "loans" were structured in an unusual way, had no reasonable potential for profit, and were designed instead to achieve specific tax aims for KPMG clients. For example, the BLIPS transactions required the bank to lend, on a non-recourse basis, tens of millions of dollars to a shell corporation with few assets and no ongoing business, to give the same shell corporation an unusual "loan premium" providing additional tens of millions of dollars, and to enter into interest rate swaps that, in effect, reduced the "loan's" above-market interest rate to a much lower floating market rate.

Documents and interviews also disclosed that the funds "loaned" by the banks were never really put at risk. The so-called loan proceeds were instead deemed "collateral" for the "loan" itself under an "overcollateralization" provision that required the "borrower" to place 101% of the loan proceeds on deposit with the bank. The loan proceeds serving as cash collateral were then subject to severe investment restrictions and closely monitored by the bank. The end result was that only a small portion of the funds in each BLIPS transaction was ever placed at risk in true investments. Moreover, the banks were empowered to unilaterally terminate a BLIPS "loan" under a variety of circumstances including, for example, if the cash collateral were to fall below the 101% requirement. The banks and investment advisory firms knew that the BLIPS loan structure and investment restrictions made little economic sense apart from the client's tax objectives, which consisted primarily of generating huge paper losses for KPMG clients who then used those losses to offset other income and shelter it from taxation.

Documents and interviews showed that the same circumstances existed for the FLIP and OPIS transactions—banks and investment advisory firms financed and participated in structured and tightly controlled financial transactions and "loans" primarily designed to generate tax losses on paper for clients, while protecting bank assets.

A professional organization that knowingly participates in an abusive tax shelter with no real economic substance violates the tax code's prohibition against aiding or abetting tax evasion.[13] A related issue is whether and to what extent lawyers, bankers, investment advisors, tax exempt organizations, and others have an obligation to evaluate the transactions they are asked to carry out and refrain from participating in potentially abusive or illegal tax shelters. Another issue is whether professional organizations that participate in these types of transactions qualify as tax shelter promoters and, if so, are obliged under U.S. law to register the relevant transactions as tax shelters and maintain client lists.

These issues are particularly pressing for several professional firms involved in the KPMG transactions that may be tax shelter promoters in their own right. For example, Sidley Austin Brown & Wood is under investigation by the IRS for issuing more than 600 legal opinion letters supporting 13 questionable tax products, in-

[13] 26 U.S.C. 6701.

cluding BLIPS, FLIP, and OPIS.[14] Deutsche Bank has sponsored a Structured Transactions Group that, in 1999, offered an array of tax products to U.S. and European clients seeking to "execute tax driven deals" or "gain mitigation" strategies.[15] Internal bank documents indicate that Deutsche Bank was aggressively marketing its tax products to large U.S. corporations and individuals, and planned to close billions of dollars worth of transactions.[16] At least two of the tax products being pushed by Deutsche Bank, BLIPS and the Customized Adjustable Rate Debt Facility (CARDS), were later determined by the IRS to be potentially abusive tax shelters.

Another set of issues arising from KPMG's enlistment of other professionals to implement its tax products involves the role played by tax opinion letters. A tax opinion letter, sometimes called a legal opinion letter when issued by a law firm, is intended to provide written advice to a client on whether a particular tax product is permissible under the law and, if challenged by the IRS, how likely it would be that the challenged product would survive court scrutiny. Traditionally, such opinion letters were supplied by an independent tax expert with no financial stake in the transaction being evaluated, and an individualized letter was sent to a single client. The mass marketing of tax products to multiple clients, however, has been followed by the mass production of opinion letters by a professional firm that, for each letter sent to a client, is paid a handsome fee. The attractive profits available from such an arrangement have placed new pressure on the independence of the tax opinion letter provider.

In the four case histories featured in this Report, the Subcommittee investigation uncovered disturbing evidence related to how tax opinion letters were being developed and used in connection with KPMG's tax products. In each of the four case histories, the Subcommittee investigation found that KPMG had drafted its own prototype tax opinion letter supporting the product and used this prototype as a template for the letters it actually sent to its clients. In addition, in all four case histories, KPMG arranged for an outside law firm to provide a second favorable opinion letter. Sidley Austin Brown & Wood, for example, issued hundreds of opinion letters supporting BLIPS, FLIP, and OPIS.[17] The evidence indicates that KPMG either directed its clients to Sidley Austin Brown & Wood to obtain the second opinion letter, or KPMG itself obtained the client's opinion letter from the law firm and delivered it to the client, apparently without the client's actually speaking to any of the lawyers at the firm.

The evidence raises serious questions about the independent status of Sidley Austin Brown & Wood in issuing the legal opinion letters supporting the KPMG tax products. The evidence indicates, for example, that KPMG collaborated with the law firm ahead of time to ensure it would supply a favorable opinion letter. In the case of

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

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

[16] *Id.* at 6345–46.

[17] In the case of SC2, KPMG also arranged for Bryan Cave to issue a legal opinion supporting the tax product, but it is unclear whether Bryan Cave ever issued one.

BLIPS, KPMG and Sidley Austin Brown & Wood actually exchanged copies of their drafts, eventually issuing two, allegedly independent opinion letters that contain numerous, virtually identical paragraphs. Moreover, Sidley Austin Brown & Wood provided FLIP, OPIS, and BLIPS clients with nearly identical opinion letters that included no individualized legal advice. In many cases, the law firm apparently issued its letter without ever speaking with the client to whom the tax advice was directed. By routinely directing its clients to Sidley Austin Brown & Wood to obtain a second opinion letter, KPMG produced a steady stream of income for the law firm, further undermining its independent status. One document even indicates that Sidley Austin Brown & Wood was paid a fee in every case in which a client was told during a FLIP sales pitch about the availability of a second opinion letter from an outside law firm, whether or not the client actually purchased the letter. This type of close, ongoing, and lucrative collaboration raises serious questions about the independence of both parties and the value of their opinion letters in light of the financial stake that both firms had in the sale of the tax product being analyzed.

A second set of issues related to the tax opinion letters involves the accuracy and reliability of their factual representations. The tax opinion letters prepared by KPMG and Sidley Austin Brown & Wood in BLIPS, FLIP, and OPIS typically included a set of factual representations made by the client, KPMG, the participating investment advisory firm, and the participating bank. These representations were critical to the accounting firm's analysis upholding the validity of the tax product. In all three cases, the Subcommittee investigation discovered that KPMG had itself drafted the factual representations attributed to other parties. The evidence shows that prior to attributing factual representations to other professional firms involved in the transactions, KPMG presented draft statements to the parties beforehand and negotiated the wording. But in the case of the factual representations attributed to its client, the evidence indicates KPMG did not consult with the client beforehand and, in some cases, even refused, despite client objections, to allow the client to alter the KPMG-drafted representations.

Equally disturbing is that some of the key factual representations that KPMG made or attributed to its clients appear to contain false or misleading statements. For example, KPMG wrote in the prototype BLIPS opinion letter that the client "has represented to KPMG . . . [that the client] independently reviewed the economics underlying the [BLIPS] Investment Fund before entering into the program and believed there was a reasonable opportunity to earn a reasonable pre-tax profit from the transactions." In fact, it is doubtful that many BLIPS clients "independently reviewed" or understood the complicated BLIPS transactions or the "economics" underlying them. In addition, KPMG knew there was only a remote possibility—not a reasonable possibility—of a client's earning a pre-tax profit in BLIPS. Nevertheless, since the existence of a reasonable opportunity to earn a reasonable profit was central to BLIPS' having economic substance and complying with federal tax law, KPMG included the client representation in its BLIPS tax opinion letter.

D. Avoiding Detection

In addition to the many development, marketing, and implementation problems just described, the Subcommittee investigation uncovered disturbing evidence of measures taken by KPMG to hide its tax product activities from the IRS and the public. Despite its 500 active tax product inventory, KPMG has never registered, and thereby disclosed to the IRS the existence of, a single one of its tax products. KPMG has explained this failure by claiming that it is not a tax promoter and does not sell any tax products that have to be registered under the law. The evidence suggests, however, that KPMG's failure to register may not be attributable to a good faith analysis of the technical merits of the tax products.

Five years ago, in 1998, a senior KPMG tax professional advocated in very explicit terms that, for business reasons, KPMG ought to ignore federal tax shelter requirements and not register the OPIS tax product with the IRS, even if required by law. In an email sent to several senior colleagues, this KPMG tax professional explained his reasoning. In that email, he assumed that OPIS qualified as a tax shelter, and then explained why the firm should not, even in this case, register it with the IRS as required by law. Among other reasons, he observed that the IRS was not vigorously enforcing the registration requirement, the penalties for noncompliance were much less than the potential profits from selling the tax product, and "industry norms" were not to register any tax products at all. The KPMG tax professional coldly calculated the penalties for noncompliance compared to potential fees from selling OPIS: "Based upon our analysis of the applicable penalty sections, we conclude that the penalties would be no greater than $14,000 per $100,000 in KPMG fees. . . . For example, our average [OPIS] deal would result in KPMG fees of $360,000 with a maximum penalty exposure of only $31,000." The senior tax professional also warned that if KPMG were to comply with the tax shelter registration requirement, this action would place the firm at such a competitive disadvantage in its sales that KPMG would "not be able to compete in the tax advantaged products market." In short, he urged KPMG to knowingly, purposefully, and willfully violate the federal tax shelter law.

The evidence obtained by the Subcommittee indicates that, over the following 5 years, KPMG rejected several internal recommendations by tax professionals to register a tax product as a tax shelter with the IRS. For example, the Subcommittee investigation learned that, on at least two occasions, the head of KPMG's Department of Professional Practice, a very senior tax official, had recommended that BLIPS and OPIS be registered as tax shelters, only to be overruled each time by the head of the entire Tax Services Practice.

Instead of registering tax products with the IRS, KPMG instead apparently devoted resources to devising rationales for not registering them. For example, a fiscal year 2002 draft business plan for a KPMG tax group described two tax products that were under development, but not yet approved, in part due to tax shelter registration issues. With respect to the first product, POPS, the business plan stated: "We have completed the solution's technical review and have almost finalized the rationale for not registering POPS as a tax shelter." With respect to the second product, described as a "conversion transaction . . . that halves the taxpayer's effective tax rate by effectively converting ordinary income to long term capital gain," the business plan states: "The most significant open issue is tax shelter registration and the impact registration will have on the solution."

KPMG's concealment efforts did not stop with its years-long refusal to register any tax shelter with the IRS. KPMG also appears to have used improper reporting techniques on client tax returns to minimize the return information that could alert the IRS to the existence of its tax products. For example, in the case of OPIS and BLIPS, some KPMG tax professionals advised their clients to participate in the transactions through "grantor trusts" and then file tax returns in which all of the capital gains and losses from the transactions were "netted" at the grantor trust level, instead of each gain or loss being reported individually on the return. The intended result was that only a single, small net capital gain or loss would appear on the client's personal income tax return.

A key KPMG tax expert objected to this netting approach when it was first suggested within the firm in 1998, writing to his colleagues in one email: "When you put the OPIS transaction together with this 'stealth' reporting approach, the whole thing stinks." He wrote in a separate email: "You should all know that I do not agree with the conclusion . . . that capital gains can be netted at the trust level. I believe we are filing misleading, and perhaps false, returns by taking this reporting position." Despite these strongly worded emails from the KPMG tax professional with authority over this tax return issue, several KPMG tax professionals apparently went ahead and prepared client tax returns using grantor trust netting. In September 2000, in the same notice that declared BLIPS to be a potentially abusive tax shelter, the IRS explicitly warned against grantor trust netting: "In addition to other penalties, any person who willfully conceals the amount of capital gains and losses in this manner, or who willfully counsels or advises such concealment, may be guilty of a criminal offense." In response, KPMG apparently contacted some OPIS or BLIPS clients and advised them to re-file their returns.

KPMG used a variety of tax return reporting techniques in addition to grantor trust netting to avoid detection of its activities by the IRS. In addition, in the four cases examined by the Subcommittee, KPMG required some potential purchasers of the tax products to sign "nondisclosure agreements" and severely limited the paperwork used to explain the tax products. Client presentations were done on chalkboards or erasable whiteboards, and written materials were retrieved from clients before leaving a meeting. Another measure taken by senior KPMG tax professionals was to counsel staff not to keep certain revealing documentation in their files or to clean out their files, again, to limit detection of firm activity. Still another tactic discussed in several KPMG documents was explicitly using attorney-client or other legal privileges to limit disclosure of KPMG documents. For example, one handwritten document by a KPMG tax professional discussing OPIS issues states under the heading, "Brown & Wood": "Privilege B&W can play a big role at providing protection in this area." None of these actions to conceal its activities seems consistent with what should be the practices of a leading public accounting firm.

E. Disregarding Professional Ethics

In addition to all the other problems identified in the Subcommittee investigation, troubling evidence emerged regarding how KPMG handled certain professional ethics issues, including issues related to fees and auditor independence. The fees charged to KPMG clients raise several concerns. Some appear to be "contingency fees," meaning fees which are paid only if a client obtains specified results from the services offered, such as achieving specified tax savings. More than 20 states prohibit the payment of contingency fees to accountants, and SEC, AICPA, and other rules constrain their use in various ways. Internal KPMG documents suggest that, in at least some cases, KPMG deliberately manipulated the way it handled certain tax products to circumvent contingency fee prohibitions. A document discussing OPIS fees, for instance, identifies the states that prohibit contingency fees and, then, rather than prohibit OPIS transactions in those states or require an alternative fee structure, directs KPMG tax professionals to make sure the OPIS engagement letter is signed, the engagement is managed, and the bulk of services is performed "in a jurisdiction that does not prohibit contingency fees."

In the case of BLIPS, clients were charged a single fee equal to 7% of the "tax losses" to be generated by the BLIPS transactions. The client fee was typically paid to Presidio, an investment advisory firm, which then apportioned the fee amount among various firms according to certain factors. The fee recipients typically included KPMG, Presidio, a participating bank, and Sidley Austin Brown & Wood. This fee splitting arrangement may violate restrictions on contingency fees, client referral fees, and fees paid jointly to lawyers and non-lawyers.

KPMG's tax products also raise auditor independence issues. Three of the banks involved in BLIPS, FLIP, and OPIS (Deutsche Bank, HVB, and Wachovia Bank), employ KPMG to audit their financial statements. SEC rules state that auditor independence is impaired when an auditor has a direct or material indirect business relationship with an audit client. KPMG apparently attempted to address the auditor independence issue by giving its clients a choice of banks to use in the transactions, including at least one bank that was not a KPMG audit client. It is unclear, however, whether individuals actually could choose what bank to use. Moreover, it is unclear how providing clients with a choice of banks alleviated KPMG's conflict of interest, since it still had a direct or material, indirect business relationship with a bank whose financial statements were certified by KPMG auditors.

A second set of auditor independence issues involves KPMG's decision to market tax products to its own audit clients. By engaging in this marketing tactic, KPMG not only took advantage of its auditor-client relationship, but also created a conflict of interest in those cases where it successfully sold a tax product to an audit client. The conflict of interest arises when the KPMG auditor reviewing the client's financial statements is required, as part of that review, to examine the client's tax return and its use of unusual tax strategies. In such situations, KPMG is, in effect, auditing its own work.

A third set of professional ethics issues involves conflict of interest concerns related to the legal representation of clients who, after purchasing a tax product from KPMG, have come under IRS scrutiny. The issues include whether KPMG should be referring these clients to a law firm that represents KPMG itself on unrelated matters, and whether a law firm that has a longstanding, close, and ongoing relationship with KPMG, representing it on unrelated matters, should also represent KPMG clients. While KPMG and the client have an immediate joint interest in defending the tax product that KPMG sold and the client purchased, their interests could quickly diverge if the suspect tax product is found to be in violation of federal tax law. This divergence in interests has been demonstrated repeatedly since 2002, as growing numbers of KPMG clients have filed suit against KPMG seeking a refund of past fees they paid to the firm and additional damages for KPMG's selling them an illegal tax shelter.

The following pages provide more detailed information about these and other problems uncovered during the Subcommittee investigation into the role of professional firms in the tax shelter industry.

The tax products featured in this Report were developed, marketed, and executed by highly skilled professionals in the fields of accounting, law, and finance. Historically, such professionals have been distinguished by their obligation to meet a higher standard of conduct in business than ordinary occupations. When it came to decisions by these professionals on whether to approve a questionable tax product, employ telemarketers to sell tax services, or omit required information from a tax return, one might have expected a thoughtful discussion or analysis of the firm's fiduciary duties, its ethical and professional obligations, or what should be done to protect the firm's good name. Unfortunately, evidence of those thoughtful discussions was virtually non-existent, and considerations of professionalism seem to have had little, if any, effect on KPMG's mass marketing of its tax products.

IV. Recommendations

Based upon its investigation to date and the above findings, the Subcommittee Minority staff recommends that the Subcommittee make the following policy recommendations.

(1) Congress should enact legislation to increase penalties on promoters of potentially abusive and illegal tax shelters, clarify and strengthen the economic substance doctrine, and bar auditors from providing tax shelter services to their audit clients.

(2) Congress should increase funding of IRS enforcement efforts to stop potentially abusive and illegal tax shelters, and the IRS should dramatically increase its enforcement efforts against tax shelter promoters.

(3) The IRS and PCAOB should conduct a joint review of tax shelter activities by accounting firms, and take steps to clarify and strengthen federal and private sec-

tor procedures and prohibitions to prevent accounting firms from aiding or abetting tax evasion, promoting potentially abusive or illegal tax shelters, or engaging in related unethical or illegal conduct. The PCAOB should consider banning public accounting firms from providing tax shelter services to their audit clients and others.

(4) The IRS and federal bank regulators should conduct a joint review of tax shelter activities at major banks, clarify and strengthen bank procedures and prohibitions to prevent banks from aiding or abetting tax evasion, promoting potentially abusive or illegal tax shelters, or engaging in related unethical or illegal conduct.

(5) The U.S. Department of Justice and IRS should conduct a joint review of tax shelter activities at major law firms, and take steps to clarify and strengthen federal and private sector rules to prevent law firms from aiding or abetting tax evasion, promoting potentially abusive or illegal tax shelters, or engaging in related unethical or illegal conduct. The U.S. Treasury Department should clarify and strengthen professional standards of conduct and opinion letter requirements in Circular 230 and explicitly address tax shelter issues.

(6) Federal and private sector regulators should clarify and strengthen federal and private sector rules related to opinion letters advising on tax products, including setting standards for letters related to mass marketed tax products, requiring fair and accurate factual representations, and barring collaboration between a tax product promoter and a firm preparing an allegedly independent opinion letter.

(7) The American Institute of Certified Public Accountants (AICPA), American Bar Association, and American Bankers Association should establish standards of conduct and procedures to prevent members of their professions from aiding or abetting tax evasion, promoting abusive or illegal tax shelters, or engaging in related unethical or illegal conduct, including by requiring a due diligence review of any tax-related transaction in which a member is asked to participate. Tax exempt organizations should adopt similar standards of conduct and procedures.

(8) The AICPA, American Bar Association, and American Bankers Association should strengthen professional standards of conduct and ethics requirements to stop the development and mass marketing of tax products designed to reduce or eliminate a client's tax liability, and should prohibit their members from using aggressive sales tactics to market tax products, including by prohibiting use of cold calls and telemarketing, explicit

revenue goals, and fees contingent on projected tax savings.

(9) The AICPA and American Bar Association should strengthen professional standards of conduct and ethics requirements to prohibit the issuance of an opinion letter on a tax product when the independence of the author has been compromised by providing accounting, legal, design, sales, or implementation assistance related to the product, by having a financial stake in the tax product, or by having a financial stake in a related or similar tax product.

V. Overview of U.S. Tax Shelter Industry

A. Summary of Current Law on Tax Shelters

The definition of an abusive tax shelter has changed and expanded over time to encompass a wide variety of illegal or potentially illegal tax evasion schemes. Existing legal definitions are complex and appear in multiple sections of the tax code.[18] These tax shelter definitions refer to transactions, partnerships, entities, investments, plans, or arrangements which have been devised, in whole or significant part, to enable taxpayers to eliminate or understate their tax liability. The General Accounting Office (GAO) recently summarized these definitions by describing "abusive shelters" as "very complicated transactions promoted to corporations and wealthy individuals to exploit tax loopholes and provide large, unintended tax benefits."[19]

Over the past 10 years, Federal statutes and regulations prohibiting illegal tax shelters have undergone repeated revision to clarify and strengthen them. Today, key tax code provisions not only prohibit tax evasion by taxpayers, but also penalize persons who knowingly organize or promote illegal tax shelters[20] or who knowingly aid or abet the filing of tax return information that understates a taxpayer's tax liability.[21] Additional tax code provisions now require taxpayers and promoters to disclose to the IRS information about certain potentially illegal tax shelters.[22]

Recently, the IRS issued regulations to clarify and strengthen the law's definition of a tax shelter promoter and the law's requirements for tax shelter disclosure.[23] For example, these regulations now make it clear that tax shelter promoters include "persons principally responsible for organizing a tax shelter as well as persons who participate in the organization, management or sale of a tax shelter" and any person who is a "material advisor" on a tax shel-

[18] See, e.g., 26 U.S.C. §§ 461(i)(3) (defining tax shelter for certain tax accounting rules); 6111(a), (c) and (d) (defining tax shelter for certain registration and disclosure requirements); and 6662(d)(2)(C)(iii) (defining tax shelter for application of understatement penalty).

[19] "Challenges Remain in Combating Abusive Tax Shelters," testimony by Michael Brostek, Director, Tax Issues, GAO, before the U.S. Senate Committee on Finance, No. GAO–04–104T (10/21/03) (hereinafter "GAO Testimony") at 1.

[20] 26 U.S.C. § 6700.

[21] 26 U.S.C. § 6701.

[22] See, e.g., 26 U.S.C. §§ 6011 (taxpayer must disclose reportable transactions); 6111 (organizers and promoters must register potentially illegal tax shelters with IRS), 6112 (promoters must maintain lists of clients who purchase potentially illegal tax shelters and, upon request, disclose such client lists to the IRS).

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

ter transaction.[24] Disclosure obligations, which apply to both taxpayers and tax shelter promoters, require disclosure to the IRS, under certain circumstances, of information related to six categories of potentially illegal tax shelter transactions. Among others, these disclosures include any transaction that is the same or similar to a "listed transaction," which is a transaction that the IRS has formally determined, through regulation, notice, or other published guidance, "as having a potential for tax avoidance or evasion" and is subject to the law's registration and client list maintenance requirements.[25] The IRS has stated in court that it "considers a 'listed transaction' and all substantially similar transactions to have been structured for a significant tax avoidance purpose" and refers to them as "potentially abusive tax shelters."[26] The IRS has also stated in court that "the IRS has concluded that taxpayers who engaged in such [listed] transactions have failed or may fail to comply with the internal revenue laws."[27] As of October 2003, the IRS had published 27 listed transactions.

In addition to statutory and regulatory requirements and prohibitions, federal courts have developed over the years a number of common law doctrines to identify and invalidate illegal tax shelters, including the economic substance,[28] business purpose,[29] substance-over-form,[30] step transaction,[31] and sham transaction[32] doctrines. A study by the Joint Committee on Taxation concludes that

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[24] Petition dated 10/14/03, "United States' *Ex Parte* Petition for Leave to Serve IRS 'John Doe' Summons on Sidley Austin Brown & Wood," (D.N.D. Ill.), at ¶ 8.

[25] *Id.* at ¶ 11. See also "Background and Present Law Relating to Tax Shelters," Joint Committee on Taxation (JCX–19–02), 3/19/02 (hereinafter "Joint Committee on Taxation report"), at 33; GAO Testimony at 7. The other five categories of transactions subject to disclosure are transactions offered under conditions of confidentiality, including contractual protections to the "investor", resulting in specific amounts of tax losses, generating a tax benefit when the underlying asset is held only briefly, or generating differences between financial accounts and tax accounts greater than $10 million. GAO Testimony at 7.

[26] Petition dated 10/14/03, "United States' *Ex Parte* Petition for Leave to Serve IRS 'John Doe' Summons on Sidley Austin Brown & Wood," (D.N.D. Ill.), at ¶¶ 11–12.

[27] *Id.* at ¶ 16.

[28] See, e.g., *Gregory v. Helvering,* 293 U.S. 465 (1935); *ACM Partnership v. Commissioner,* 157 F.3d 231 (3d Cir. 1998), *cert. denied* 526 U.S. 1017 (1999); *Bail Bonds by Marvin Nelson, Inc. v. Commissioner,* 820 F.2d 1543, 1549 (9th Cir. 1987) ("The economic substance factor involves a broader examination of . . . whether from an objective standpoint the transaction was likely to produce economic benefits aside from a tax deduction.").

[29] See, e.g., *Gregory v. Helvering,* 293 U.S. 465 (1935); *Commissioner v. Transport Trading & Terminal Corp.,* 176 F.2d 570, 572 (2nd Cir. 1949), *cert. denied* 339 U.S. 916 (1949) (Judge Learned Hand) ("The doctrine of *Gregory v. Helvering* . . . means that in construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation.")

[30] See, e.g., *Weiss v. Stearn,* 265 U.S. 242, 254 (1924) ("Questions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participants; and when applying the provisions of the Sixteenth Amendment and income laws . . . we must regard matters of substance and not mere form.")

[31] See, e.g., *Commissioner v. Court Holding Co.,* 324 U.S. 331, 334 (1945) ("The transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another using the latter as a conduit through which to pass title."); *Palmer v. Commissioner,* 62 T.C. 684, 692 (1974).

[32] See, e.g., *Gregory v. Helvering,* 293 U.S. 465 (1935); *Rice's Toyota World v. Commissioner,* 752 F.2d 89, 91–92 (4th Cir. 1985); *United Parcel Service of America, Inc. v. Commissioner,* 78 T.C.M. 262 at n. 29 (1999), *rev'd* 254 F.3d 1014 (11th Cir. 2001) ("Courts have recognized two basic types of sham transactions. Shams in fact are transactions that never occur. In such shams, taxpayers claim deductions for transactions that have been created on paper but which never took place. Shams in substance are transactions that actually occurred but which lack the substance their form represents.").

"[t]hese doctrines are not entirely distinguishable" and have been applied by courts in inconsistent ways.[33]

Bipartisan legislation to clarify and strengthen the economic substance and business purpose doctrines, as well as other aspects of federal tax shelter law, has been developed by the Senate Finance Committee. This legislation has been twice approved by the Senate during the 108th Congress, but has yet to become law.[34]

B. U.S. Tax Shelter Industry and Professional Organizations

Finding: The sale of potentially abusive and illegal tax shelters has become a lucrative business in the United States, and some professional firms such as accounting firms, banks, investment advisory firms, and law firms are major participants in the mass marketing of generic "tax products" to multiple clients.

Illegal tax shelters sold to corporations and wealthy individuals drain the U.S. Treasury of billions of dollars in lost tax revenues each year. According to GAO, a recent IRS consultant estimated that for the 6-year period, 1993–1999, the IRS lost on average between $11 and $15 billion each year from abusive tax shelters.[35] In actual cases closed between October 1, 2001, and May 6, 2003, involving just 42 large corporations, GAO reports that the IRS proposed abusive shelter-related adjustments for tax years, 1992 to 2000, totaling more than $10.5 billion.[36] GAO reports that an IRS database tracking unresolved, abusive tax shelter cases over a number of years estimates potential tax losses of about $33 billion from listed transactions and another $52 billion from nonlisted abusive transactions, for a combined total of $85 billion.[37]

GAO has also reported that IRS data provided in October 2003, identified about 6,400 individuals and corporations that had bought abusive tax shelters and other abusive tax planning products, as well as almost 300 firms that appear to have promoted them.[38] According to GAO, as of June 2003, the IRS had approved investigations of 98 tax shelter promoters, including some directed at accounting or law firms.[39]

IRS Commissioner Mark Everson testified at a recent Senate Finance Committee hearing that: "A significant priority in the Service's efforts to curb abusive transactions is our focus on promoters."[40] He stated, "The IRS has focused its attention in the area of tax shelters on accounting and law firms, among others. The IRS has focused on these firms because it believes that, in the instances in which the IRS has acted, these firms were acting as promoters of tax shelters, and not simply as tax or legal advisers."

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[33] Joint Committee on Taxation report at 7.
[34] See, e.g., S. 476, the CARE Act of 2003 (108th Congress, first session), section 701 et seq.
[35] GAO Testimony at 12.
[36] *Id.* at 11.
[37] *Id.* at 10.
[38] Id. at 11.
[39] *Id.* at 16.
[40] Testimony of Mark Everson, IRS Commissioner, before the Senate Committee on Finance, "Tax Shelters: Who's Buying, Who's Selling and What's the Government Doing About It?" (10/21/03), at 7.

Mr. Everson also described the latest generation of abusive tax shelters as complex, difficult-to-detect transactions developed by extremely sophisticated people:

"The latest generation of abusive tax transactions has been facilitated by the growth of financial products and structures whose own complexity and non-transparency have provided additional tools to allow those willing to design transactions intended to generate unwarranted tax benefits. . . . [A]busive transactions that are used by corporations and individuals present formidable administrative challenges. The transactions themselves can be creative, complex and difficult to detect. Their creators are often extremely sophisticated, as are many of their users, who are often financially prepared and motivated to contest the Service's challenges."[41]

The Commissioner stated that due to the "growth in the volume of abusive transactions" and "a disturbing decline in corporate conduct and governance," among other factors, the IRS has enhanced its response to abusive transactions in general, and abusive tax shelters in particular.[42] He said that the Office of Tax Shelter Analysis (OTSA), first established in February 2000 within the Large and Mid-Size Business Division, is continuing to lead IRS tax shelter efforts. He stated that, "OTSA plans, centralizes and coordinates LMSB's tax shelter operations and collects, analyzes, and distributes within the IRS information about potentially abusive tax shelter activity."[43] Mr. Everson described a number of ongoing IRS tax shelter initiatives including efforts to increase enforcement resources, conduct promoter audits, enforce IRS document requests against accounting and law firms, implement global settlements for persons who used certain illegal tax shelters, develop proposed regulations to improve tax opinion letters and ethics rules for tax professionals appearing before the IRS, and issue additional notices to identify illegal tax shelters.

The Commissioner warned:

"[A]busive transactions can and will continue to pose a threat to the integrity of our tax administration system. We cannot afford to tolerate those who willfully promote or participate in abusive transactions. The stakes are too high and the effects of an insufficient response are too corrosive."[44]

Professional organizations like accounting firms, banks, investment advisers, and law firms are now key participants in the tax shelter industry. These firms specialize in producing tax shelters that utilize complex structured finance transactions, multi-million dollar loans, novel tax code interpretations, and expensive professional services requiring highly skilled professionals. These firms routinely enlist assistance from other respected professional firms

[41] *Id.* at 2.
[42] *Id.* at 3.
[43] *Id.* at 8.
[44] *Id.* at 16.

and financial institutions to provide the accounting, investment, financing or legal services needed for the tax shelters to work.

During the past 10 years, professional firms active in the tax shelter industry have expanded their role, moving from selling individualized tax shelters to specific clients, to developing generic tax products and mass marketing them to existing and potential clients. No longer content with responding to client inquiries, these firms are employing the same tactics employed by disreputable, tax shelter hucksters: churning out a continuing supply of new and abusive tax products, marketing them with hard sell techniques and cold calls; and taking deliberate measures to hide their activities from the IRS.

VI. Four KPMG Case Histories

A. KPMG In General

KPMG International is one of the largest public accounting firms in the world, with over 700 offices in 152 countries.[45] In 2002, it employed over 100,000 people and had worldwide revenues of $10.7 billion. KPMG International is organized as a Swiss "non-operating association," functions as a federation of partnerships around the globe, and maintains its headquarters in Amsterdam.

KPMG LLP (hereinafter "KPMG") is a U.S. limited liability partnership and a member of KPMG International. KPMG is the third largest accounting firm in the United States, and generates more than $4 billion in annual revenues. KPMG was formed in 1987, from the merger of two long-standing accounting firms, Peat Marwick and Klynveld Main Goerdeler, along with their individual member firms. KPMG maintains its headquarters in New York and numerous offices in the United States and other countries. KPMG is run by a "Management Committee" made up of 15 individuals drawn from the firm's senior management and major divisions.[46] KPMG's Chairman and CEO is Eugene O'Kelly, who joined KPMG in 1972, became partner in 1982, and was appointed Chairman in 2002. KPMG's Deputy Chairman is Jeffrey M. Stein, who was also appointed in 2002. From 2000 until 2002, Mr. Stein was the Vice Chairman for Tax heading KPMG's Tax Services Practice, and prior to that he served as head of operations, or second in command, of the Tax Services Practice.

KPMG's Tax Services Practice is a major division of KPMG. It provides tax compliance, tax planning, and tax return preparation services. The Tax Services Practice employs more than 10,300 tax professionals and generates approximately $1.2 billion in annual revenues for the firm. These revenues have been increasing rapidly

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[45] The general information about KPMG is drawn from KPMG documents produced in connection with the Subcommittee investigation; Internet websites maintained by KPMG LLP and KPMG International; and a legal complaint filed by the U.S. Securities and Exchange Commission (SEC) in *SEC v. KPMG LLP,* Civil Action No. 03–CV–0671 (D.S.D.N.Y. 1/29/03), alleging fraudulent conduct by KPMG and certain KPMG audit partners in connection with audits of certain Xerox Corporation financial statements.

[46] The 15 Management Committee members are the Chairman, Deputy Chairman, Chief Financial Officer, General Counsel, head of the Department of Professional Practice, head of the Department of Marketing and Communications, head of the Department of Human Resources, the two most senior officials in the Tax Services Practice, the two most senior officials in the Assurance Practice, and the most senior official in each of four industry-related "lines of business," such as telecommunications and energy. Subcommittee interview of Jeffrey Stein (10/31/03).

in recent years, including a 45% cumulative increase over 4 years, from 1998 to 2001.[47] The Tax Services Practice is headquartered in New York, has 122 U.S. offices, and maintains additional offices around the world. The current head of the Tax Service is Vice Chairman for Tax, Richard Smith.

The Tax Services Practice has over two dozen subdivisions, offices, "practices" or "groups" which over the years have changed missions and personnel. Many have played key roles in developing, marketing, or implementing KPMG's generic tax products, including the four products featured in this Report. One key group is the Washington National Tax Practice (WNT) which provides technical tax expertise to the entire KPMG firm. A WNT subgroup, The Tax Innovation Center, leads KPMG's efforts to develop new generic tax products. Another key group is the Department of Professional Practice (DPP) for Tax, which, among other tasks, reviews and approves all new KPMG tax products for sale to clients. KPMG's Federal Tax Practice addresses federal tax compliance and planning issues. KPMG's Personal Financial Planning (PFP) Practice focuses on selling "tax-advantaged" products to high net worth individuals and large corporations.[48] Through a subdivision known as the Capital Transaction Services (CaTS) Practice, later renamed the Innovative Strategies (IS) Practice, PFP led KPMG's efforts on FLIP, OPIS, and BLIPS.[49] KPMG's Stratecon Practice, which focuses on "business based" tax planning and tax products, led the firm's efforts on SC2. Innovative Strategies and Stratecon were disbanded in 2002, and their tax professionals assigned to other groups.[50]

Several senior KPMG tax professionals interviewed by the Subcommittee staff, when asked to describe KPMG's overall approach to tax services, indicated that the firm made a significant change in direction in the late 1990's, when it made a formal decision to begin devoting substantial resources to developing and marketing tax products that could be sold to multiple clients. The Subcommittee staff was told that KPMG made this decision, in part, due to the success other accounting firms were experiencing in selling tax products; in part, due to the large revenues earned by the firm from selling a particular tax product to banks;[51] and, in part, due to new tax leadership that was enthusiastic about increasing tax product sales. Among other actions to carry out this decision, the firm established the Tax Innovation Center which was dedicated to generating new generic tax products. One senior KPMG tax professional told the Subcommittee staff that some KPMG partners considered it "important" for the firm to become an industry leader in producing generic tax products. He said that, of the many new products KPMG developed, some were "relatively plain va-

[47] Internal KPMG presentation dated 7/19/01, by Rick Rosenthal and Marsha Peters, entitled "Innovative Tax Solutions," Bates XX 001340–50. A chart included in this presentation tracks increases in the Tax Service's gross revenues from 1998 until 2001, showing a cumulative increase of more than 45% over the 4-year period, from 1998 gross revenues of $830 million to 2001 gross revenues of $1.24 billion.

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

[49] Document dated 5/18/01, "PFP Practice Reorganization Innovative Strategies Business Plan—DRAFT," Bates KPMG 0050620–23, at 1.

[50] Stratecon appears to have been very active until its dissolution. See, e.g., email dated 4/8/02, from Larry Manth to multiple KPMG tax professionals, "Stratecon Final Results for March 2002," Bates XX 001732 (depicting Stratecon's March 2002 revenues and operating expenses).

[51] For information about this tax product, see Appendix C, "Sham Mutual Fund Investigation."

nilla," while others were "aggressive." He said that the firm's policy was to offer only tax products which met a "more likely than not" standard, meaning the product had a greater than 50 percent probability of withstanding a challenge by the IRS, and that KPMG deliberately chose a higher standard than required by the AICPA, which permits firms to offer tax products with a "realistic possibility of success," or a one-in-three chance of withstanding an IRS challenge.[52]

In recent years, KPMG has become the subject of IRS, SEC, and state investigations and enforcement actions in the areas of tax, accounting fraud, and auditor independence.[53] These enforcement actions include ongoing litigation by the IRS to enforce tax shelter related document requests and a tax promoter audit of the firm; SEC, California, and New York investigations into a potentially abusive tax shelter involving at least 10 banks that are allegedly using sham mutual funds established on KPMG's advice; SEC and Missouri investigations or enforcement actions related to alleged KPMG involvement in accounting fraud at Xerox Corporation or General American Mutual Holding Co.; and auditor independence concerns leading to an SEC censure of KPMG for investing in AIM mutual funds while AIM was an audit client, and to an ongoing SEC investigation of tax product client referrals from Wachovia Bank to KPMG while Wachovia was a KPMG audit client. In addition, a number of taxpayers have filed suit against KPMG for allegedly selling them an illegal tax shelter or improperly involving them in work on illegal tax shelters.

B. KPMG's Tax Shelter Activities

Finding: Although KPMG denies being a tax shelter promoter, the evidence establishes that KPMG has devoted substantial resources to, and obtained significant fees from, developing, marketing, and implementing potentially abusive and illegal tax shelters that U.S. taxpayers might otherwise have been unable, unlikely or unwilling to employ, costing the Treasury billions of dollars in lost tax revenues.

KPMG has repeatedly denied being a tax shelter promoter. KPMG has denied it in court when opposing IRS document requests for information related to tax shelters,[54] and denied it in response to Subcommittee questions. KPMG has never registered any tax product with the IRS as a potentially abusive tax shelter.

KPMG does not refer to any of its tax products as "tax shelters" and objects to using that term to describe its tax products. Instead, KPMG refers to its tax products as "tax solutions" or "tax strategies." The KPMG Tax Services Manual defines a "tax solution" as "a tax planning idea, structure, or service that potentially is appli-

[52] KPMG's policy is included in the KPMG Tax Services Manual—U.S., May 2002, KPMG Accounting & Reporting Publication, (hereinafter "KPMG Tax Services Manual"), § 24.5.2, at 24–3.

[53] Brief summaries of some of these matters are included in Appendix C.

[54] See *United States v. KPMG,* Case No. 1:02MS00295 (D.D.C. 9/6/02), "Answer to Petition to Enforce Internal Revenue Summonses," at ¶ 1 ("KPMG asserts that it is not a tax shelter organizer, but a professional firm whose tax professionals provide advice and counseling on a one-on-one basis to clients and prospective clients concerning the clients' tax situations.")

cable to more than one client situation and that is reasonable to believe will be the subject of leveraged deployment," meaning sales to multiple clients.[55]

In response to a Subcommittee inquiry, KPMG provided the Subcommittee with a list of over 500 "active tax products" designed to be offered to multiple clients for a fee.[56] When the Subcommittee asked KPMG to identify the ten tax products that produced the most revenue for the firm in 2000, 2001, and 2002, KPMG denied having the ability to reliably track revenues associated with individual tax products and thus to identify with certainty its top revenue producers.[57] To respond to the Subcommittee's request, KPMG indicated that it had "undertaken a good faith, reasonable effort to estimate the tax strategies that were likely among those generating the most revenues in the years requested."[58] KPMG identified a total of 19 tax products that were top revenue-producers for the firm over the 3-year period.

The Subcommittee staff's preliminary review of these 19 top revenue-producing tax products determined that six, OPIS, BLIPS, 401(k)ACCEL, CARDS, CLAS, and CAMPUS, are either within the scope of "listed transactions" already determined by the IRS to be potentially abusive tax shelters or within the scope of IRS document requests in an ongoing IRS review of KPMG's tax shelter activities.[59] The Subcommittee determined that many, if not all, of the 19 tax products were designed to reduce the tax liability of corporations or individuals, and employed features such as structured transactions, complex accounting methods, and novel tax law interpretations, often found in illegal tax shelters. The Subcommittee staff briefly reviewed a number of other KPMG tax products as well[60] and found that they, too, carried indicia of a potentially abusive tax shelter.

KPMG insists that all of its tax products are the result of legitimate tax planning services. In legal pleadings seeking KPMG documents, however, the IRS has stated that a number of KPMG's tax products appear to be "tax shelters" and requested related documentation to determine whether the firm is complying with federal tax shelter laws.[61] The IRS specifically identified as "tax shelters" FLIP, OPIS, BLIPS, TRACT, IDV, 401(k) ACCEL, Contested Liabilities, Economic Liability Transfer, CLAS, CAMPUS, MIDCO, certain "Tax Treaty" transactions, PICO, and FOCUS.[62] The IRS also alleged that, according to information from a confidential source, "KPMG continues to hide from the IRS information about tax shelters it is now developing and marketing" and "KPMG con-

[55] KPMG Tax Services Manual, § 24.1.1, at 24–1.

[56] Untitled document, produced by KPMG on 2/10/03, Bates KPMG 0000009–91.

[57] See chart entitled, "Good Faith Estimate of Top Revenue-Generating Strategies," attached to letter dated 4/22/03, from KPMG's legal counsel to the Subcommittee, Bates KPMG 0001801 ("[B]ecause each tax strategy is tailored to a client's particular circumstances, the firm does not maintain any systematic, reliable method of recording revenues by tax product on a national basis, and therefore is unable to provide any definitive list or quantification of revenues for a 'top ten tax products', as requested by the Subcommittee.").

[58] *Id.*

[59] Compare 19 tax products listed in the chart produced by KPMG on 8/8/03, Bates KPMG 0001801, to the tax products identified in *United States v. KPMG,* Case No. 1:02MS00295 (D.D.C. 7/9/02), "Petition to Enforce Internal Revenue Service Summonses."

[60] These tax products included OTHELLO, TEMPEST, RIPSS, and California REIT.

[61] *United States v. KPMG,* Case No. 1:02MS00295 (D.D.C. 7/9/02), "Petition to Enforce Internal Revenue Service Summonses."

[62] *Id.*

tinues to develop and aggressively market dozens of possibly abusive tax shelters."[63]

The Subcommittee staff selected three of KPMG's 19 top revenue producing tax products for more intensive study, OPIS, BLIPS and SC2, as well as an earlier tax product, FLIP, which KPMG had stopped selling after 1999, but which was the precursor to OPIS and BLIPS, and the subject of lawsuits filed in 2002 and 2003, by persons claiming KPMG had sold them an illegal tax shelter. All four of these tax products were explicitly designed to reduce or eliminate the tax liability of corporations or individuals. Three, FLIP, OPIS, and BLIPS, have already been determined by the IRS to be illegal or potentially abusive tax shelters, and the IRS has penalized taxpayers for using them. A number of these taxpayers have, in turn, sued KPMG for selling them illegal tax shelters.[64] It is these four products that are featured in this Report.

The dispute over whether KPMG sells benign "tax solutions" or illegal "tax shelters" is more than a linguistic difference; it goes to the heart of whether respected institutions like this one have crossed the line of acceptable conduct. Shedding light is a memorandum prepared 5 years ago, in 1998, by a KPMG tax professional advising the firm not to register what was then a new tax product, OPIS, as a "tax shelter" with the IRS.[65] Here is the advice this tax professional gave to the second most senior Tax Services Practice official at KPMG:

> "For purposes of this discussion, I will *assume* that we will conclude that the OPIS product meets the definition of a tax shelter under IRC section 6111(c).
>
> "Based on this assumption, the following are my conclusions and recommendations as to why KPMG should make the business/strategic decision not to register the OPIS product as a tax shelter. My conclusion*s* and resulting recommendation [are] based upon the immediate negative impact on the Firm's strategic initiative to develop a sustainable tax products practice and the long-term implications of establishing . . . a precedent *in registering such a product.*
>
> "**First, the financial exposure to the Firm is minimal.** Based upon our analysis of the applicable penalty sections, we conclude that the penalties would be no greater than $14,000 per $100,000 in KPMG fees. . . . For example, our average deal would result in KPMG fees of $360,000 with a maximum penalty exposure of only $31,000.
>
> "This further assumes that KPMG would bear 100 percent of the penalty. In fact . . . the penalty is *joint and several*

[63] *United States v. KPMG,* Case No. 1:02MS00295 (D.D.C. 7/9/02), "Declaration of Michael A. Halpert," Internal Revenue Agent, at ¶ 38.

[64] See, e.g., *Jacoboni v. KPMG,* Case No. 6:02–CV–510 (M.D. Fla. 4/29/02) (OPIS); *Swartz v. KPMG,* Case No. C03–1252 (W.D. Wash. 6/6/03) (BLIPS); *Thorpe v. KPMG,* Case No. 5–030CV–68 (E.D.N.C. 1/27/03) (FLIP/OPIS). In addition, a KPMG tax professional has sued KPMG for defamation in "retaliation for the Plaintiff's refusal to endorse or participate in [KPMG's] illegal activities and for his cooperation with government investigators." *Hamersley v. KPMG,* Case No. BC297905 (Los Angeles Superior Court 6/23/03).

[65] Memorandum dated 5/26/98, from Gregg Ritchie to Jeffrey Stein, then head of operations in the Tax Services Practice, "OPIS Tax Shelter Registration," Bates KPMG 0012031–33. Emphasis in original.

with respect to anyone involved in the product who was required to register. Given that, at a minimum, Presidio would also be required to register, our share of the penalties could be viewed as being only one-half of the amounts noted above. If other OPIS participants (e.g., Deut[s]che Bank, Brown & Wood, etc.) were also found to be promoters subject to the registration requirements, KPMG's exposure would be further minimized. Finally, any ultimate exposure to the penalties are abatable if it can be shown that we had reasonable cause. . . .

"To my knowledge, the Firm has never registered a product under section 6111. . . .

"**Third, the tax community at large continues to avoid registration of all products.** Based upon my knowledge, the representations made by Presidio and Quadra, and Larry DeLap's discussions with his counterparts at other Big 6 firms, *there are no tax products marketed to individuals by our competitors which are registered.* This includes income conversion strategies, loss generation techniques, and other related strategies.

"Should KPMG decide to begin to register its tax products, I believe that it will position us with a severe competitive disadvantage in light of industry norms to such degree that we will not be able to compete in the tax advantaged products market.

"**Fourth, there has been (and, apparently, continues to be) a lack of enthusiasm on the part of the Service to enforce section 6111.** In speaking with KPMG individuals who were at the Service . . . the Service has apparently *purposefully* ignored enforcement efforts related to section 6111. In informal discussions with individuals currently at the Service, WNT has confirmed that there are not many registration applications submitted and they do not have the resources to dedicate to this area.

"**Finally, the guidance from Congress, the Treasury, and the Service is minimal, unclear, and extremely difficult to interpret when attempting to apply it to 'tax planning' products. . . .**

"I believe the rewards of a successful marketing of the OPIS product . . . far exceed the financial exposure to penalties that may arise. Once you have had an opportunity to review this information, I request that we have a conference with the persons on the distribution list . . . to come to a conclusion with respect to my recommendation. As you know, we must immediately deal with this issue in order to proceed with the OPIS product."

This memorandum assumes that OPIS qualifies as a tax shelter under federal law and then advocates that KPMG not register it with the IRS as required by law. The memorandum advises KPMG to knowingly violate the law requiring tax shelter registration, because the IRS is not vigorously enforcing the registration requirement, the penalties for noncompliance are much less than the potential profits from the tax product, and "industry norms" are not to register any tax products at all. The memorandum warns that if KPMG were to comply with the tax shelter registration requirement, this action would place the firm at such a competitive disadvantage that KPMG would "not be able to compete in the tax advantaged products market."

The Subcommittee has learned that some KPMG tax professionals agreed with this analysis,[66] while other senior KPMG tax professionals provided the opposite advice to the firm.[67] but the head of the Tax Services Practice, the Vice Chairman for Tax, ultimately decided not to register the tax product as a tax shelter. KPMG authorized the sale of OPIS in the fall of 1998.[68] Over the next 2 years, KPMG sold OPIS to more than 111 individuals. It earned fees in excess of $28 million, making OPIS one of KPMG's top ten tax revenue producers in 2000. KPMG never registered OPIS as a tax shelter with the IRS. In 2001, the IRS issued Notice 2001–45 declaring tax products like OPIS to be potentially abusive tax shelters.

The following sections of this Report describe the systems, procedures, and corporate culture behind KPMG's efforts to develop, market, and implement its tax products, as well as steps KPMG has taken to avoid detection of its activities by tax authorities and others. Each of these sections includes specific evidence drawn from the BLIPS, SC2, OPIS, and FLIP case histories. Appendices A and B provide more detailed descriptions of how BLIPS and SC2 worked.

(1) Developing New Tax Products

Finding: KPMG devotes substantial resources and maintains an extensive infrastructure to produce a continuing supply of generic tax products to sell to multiple clients, using a process which pressures its tax professionals to generate new ideas, move them quickly through the development process, and approve, at times, potentially abusive or illegal tax shelters.

KPMG prefers to describe itself as a tax advisor that responds to client inquiries seeking tax planning services to structure legitimate business transactions in a tax efficient way. The Subcommittee investigation has determined, however, that KPMG has also developed and supports an extensive internal infrastructure of offices, programs, and procedures designed to churn out a continuing supply of new tax products unsolicited by a specific client and ready for mass marketing.

Drive to Produce New Tax Products. In 1997, KPMG established the Tax Innovation Center, whose sole mission is to push the

[66] See, e.g., email dated 5/26/98, from Mark Springer to multiple KPMG tax professionals, "Re: OPIS Tax Shelter Registration," Bates KPMG 0034971 ("I would still concur with Gregg's recommendation. . . . I don't think we want to create a competitive DISADVANTAGE, nor do we want to lead with our chin." Emphasis in original.)

[67] Lawrence DeLap, then DPP head, told the Subcommittee he had advised the firm to register OPIS as a tax shelter. Subcommittee interview of Lawrence DeLap (10/30/03).

[68] See email dated 11/1/98, from Larry DeLap to William Albaugh and other KPMG tax professionals, "OPIS," Bates KPMG 0035702.

development of new KPMG tax products. Located within the Washington National Tax (WNT) Practice, the Center is staffed with about a dozen full-time employees and assisted by others who work for the Center on a rotating basis. A 2001 KPMG overview of the Center states that "[t]ax [s]olution development is one of the four priority activities of WNT" and "a significant percentage of WNT resources are dedicated to [t]ax [s]olution development at any given time." [69]

Essentially, the Tax Innovation Center works to get KPMG tax professionals to propose new tax product ideas and then provides administrative support to develop the proposals into approved tax products and move them successfully into the marketing stage. As part of this effort, the Center maintains a "Tax Services Idea Bank" which it uses to drive and track new tax product ideas. The Center asks KPMG tax professionals to submit new ideas for tax products on "Idea Submission Forms" or "Tax Knowledge Sharing" forms with specified information on how the proposed tax product would work and who would be interested in buying it.[70] The Idea Submission Form asks the submitter to explain, for example, "how client savings are achieved," "the tax, business, and financial statement benefits of the idea," and "the revenue potential of this idea," including "key target markets," "the typical buyer," and an estimated "average tax fee per engagement."

In recent years, the Center has established a firm-wide, numerical goal for new tax idea submissions and applied ongoing pressure on KPMG tax professionals to meet this goal. For example, in 2001, the Center established this overall objective: "Goal: Deposit 150 New Ideas in Tax Services Idea Bank." [71] On May 30, 2001, the Center reported on the Tax Services' progress in meeting this goal as part of a larger power-point presentation on "year-end results" in new tax solutions and ideas development. For each of 12 KPMG "Functional Groups" within the Tax Services Practice, a one-page chart shows the precise number of "Deposits," "Expected Deposits," and "In the Pipeline" ideas which each group had contributed or were expected to contribute to the Tax Services Idea Bank. For example, the chart reports the total number of new ideas contributed by the e-Tax Group, Insurance Group, Passthrough Group, Personal Financial Planning Group, State and Local Tax (SALT) Group, Stratecon, and others. It shows that SALT had contributed the most ideas at 32, while e-Tax had contributed the least, having deposited only one new idea. It shows that, altogether, the groups had deposited 122 new ideas in the idea bank, with 38 more expected, and 171 "in the pipeline."

In addition to reporting on the number of new ideas generated during the year, the Center reported on its efforts to measure and improve the profitability of the tax product development process. The year-end presentation reported, for example, on the Tax Innovation Center's progress in meeting its goal to "Measure Solution Profitability," noting that the Center had developed software sys-

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

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

[71] KPMG presentation dated 5/30/01, "Tax Innovation Center Solution and Idea Development—Year-End Results," Bates XX 001755–56, at 4.

tems that "captured solution development costs and revenue" and "[p]repared quarterly Solution Profitability reports." It also discussed progress in meeting a goal to "Increase Revenue from Tax Services Idea Bank." Among other measures, the Center proposed to "[s]et deployment team revenue goals for all solutions."

Development and Approval Process. Once ideas are deposited into the Tax Services Idea Bank, KPMG has devoted substantial resources to transforming the more promising ideas into generic tax products that could be sold to multiple clients.

KPMG's development and approval process for new tax products is described in its Tax Services Manual and Tax Innovations Center Manual.[72] Essentially, the process consists of three stages, each of which may overlap with another. In the first stage, the new tax idea undergoes an initial screening "for technical and revenue potential."[73] This initial analysis is supposed to be provided by a "Tax Lab" which is a formal meeting, arranged by the Tax Innovations Center, of six or more KPMG tax experts specializing in the tax issues or industry affected by the proposed product.[74] Promising proposals are also assigned one or more persons, sometimes referred to as "National Development Champions" or "Development Leaders," to assist in the proposal's initial analysis and, if warranted, shepherd the proposal through the full KPMG approval process. For example, the lead tax professional who moved BLIPS through the development and approval process was Jeffrey Eischeid, assisted by Randall Bickham, while for SC2, the lead tax professional was Lawrence Manth, assisted by and later succeeded by Andrew Atkin.

If a proposal survives the initial screening, in the second stage, it must undergo a thorough review by the Washington National Tax Practice ("WNT review"), which is responsible for determining whether the product meets the technical requirements of existing tax law.[75] WNT personnel often spend significant time identifying and searching for ways to resolve problems with how the proposed product is structured or is intended to be implemented. The WNT review must also include analysis of the product by the WNT Tax Controversy Services group "to address tax shelter regulations issues."[76] WNT must "sign-off" on the technical merits of the proposal for it to be approved for sale to clients.

In the third and final stage, the product must undergo review and approval by the Department of Practice and Professionalism ("DPP review"). The DPP review must determine that the product

[72] KPMG Tax Services Manual, Chapter 24, pages 24–1 to 24–7.

[73] TIC Manual at 5.

[74] The TIC Manual states that a Tax Lab is supposed to evaluate "the technical viability of the idea, the idea's revenue generation potential above the Solution Revenue threshold, and a business case for developing the solution, including initial target list, marketing considerations, and preliminary technical analysis." TIC Manual at 5.

[75] In an earlier version of KPMG's tax product review and approval procedure, WNT did not have a formal role in the development and approval process, according to senior tax professionals interviewed by the Subcommittee. This prior version of the process, which was apparently the first, firm-wide procedure established to approve new generic tax products, was established in 1997, and operated until mid 1998. In it, a three-person Tax Advantaged Product Review Board, whose members were appointed by and included the head of DPP-Tax, conducted the technical review of new proposals. In 1998, when this responsibility was assigned to the WNT, the Board was disbanded. The earlier process was used to approve the sale of FLIP and OPIS, while the existing procedure was used to approve the sale of BLIPS and SC2. Subcommittee interview of Lawrence DeLap (10/30/03).

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

not only complies with the law, but also meets KPMG's standards for "risk management and professional practice."[77] This latter review includes consideration of such matters as the substantive content of KPMG tax opinion and client engagement letters, disclosures to clients of risks associated with a tax product, the need for any confidentiality or marketing restrictions, how KPMG fees are to be structured, whether auditor independence issues need to be addressed, and the potential impact of a proposed tax product on the firm's reputation.[78]

Each of the three stages takes time, and the entire development and approval process can consume 6 months or longer. The process is labor-intensive, since it requires tax professionals to examine the suggested product, which is often quite complex, identify various tax issues, and suggest solutions to problems. The process often includes consultations with outside professionals, not only on tax issues, but also on legal, investment, accounting, and finance issues, since many of the products require layers of corporations, trusts, and special purpose entities; complex financial and securities transactions using arcane financial instruments; and multimillion-dollar lending transactions, all of which necessitate expert guidance, detailed paperwork, and logistical support.

The KPMG development and approval process is intended to encourage vigorous analysis and debate by the firm's tax experts over the merits of a proposed tax product and to produce a determination that the product complies with current law and does not impose excessive financial or reputational risk for the firm. All KPMG personnel interviewed by the Subcommittee indicated that the final approval that permitted a new tax product to go to market was provided by the head of the DPP. KPMG's Tax Services Manual states that the DPP "generally will not approve a solution unless the appropriate WNT partner(s)/principal(s) conclude that it is at least more likely than not that the desired tax consequences of the solution will be upheld if challenged by the appropriate taxing authority."[79] KPMG defines "more likely than not" as a "greater than 50 percent probability of success if [a tax product is] challenged by the IRS."[80] KPMG personnel told the Subcommittee that the WNT's final sign-off on the technical issues had to come before the DPP would provide its final sign-off allowing a new tax product to go to market.

Once approved, KPMG procedures required a new tax product to be accompanied by a number of documents before its release for sale to clients, including an abstract summarizing the product; a standard engagement letter for clients purchasing the product; an electronic powerpoint presentation to introduce the product to other KPMG tax professionals; and a "whitepaper" summarizing the technical tax issues and their resolution.[81] In addition, to "launch"

[77] *Id.*, § 24.5.2, at 24–3.
[78] Subcommittee interview of Lawrence DeLap (10/30/03). The Subcommittee staff was told that, since 1997, DPP-Tax has had very limited resources to conduct its new product reviews. Until 2002, for example, DPP-Tax had a total of less than ten employees; in 2003, the number increased to around or just above 20. In contrast, DPP-Assurance, which oversees professional practice issues for KPMG audit activity, has well over 100 employees.
[79] KPMG Tax Services Manual, § 24.5.2, at 24–3.
[80] *Id.*, § 41.19.1, at 41–10.
[81] *Id.*, § 24.4.2, at 24–2. See also TIC Manual at 10.

the new product within KPMG, the Tax Innovation Center is supposed to prepare a "Tax Solution Alert" which serves "as the official notification" that the tax product is available for sale to clients.[82] This Alert is supposed to include a "digest" summarizing the product, a list of the KPMG "deployment team" members responsible for "delivering" the product to market, pricing information, and marketing information such as a "Solution Profile" of clients who would benefit from the tax product and "Optimal Target Characteristics" and the expected "Typical Buyer" of the product. The four case histories demonstrated that KPMG personnel sometimes, but not always, complied with the paperwork required by its procedures. For example, while SC2 was the subject of a "Tax Solution Alert," BLIPS was not.

In addition to or in lieu of the required "whitepaper" explaining KPMG's position on key technical issues, KPMG often prepared a "prototype" tax opinion letter laying out the firm's analysis and conclusions regarding the tax consequences of the new tax product.[83] KPMG defines a "tax opinion" as "any written advice on the tax consequences of a particular issue, transaction or series of transactions that is based upon specific facts and/or representations of the client and that is furnished to the client or another party in a letter, a whitepaper, a memorandum, an electronic or facsimile communication, or other form."[84] The tax opinion letter includes, at a minimum under KPMG policy, a statement of the firm's determination that, if challenged by the IRS, it was "more likely than not" that the desired tax consequences of the new tax product would be upheld in court. The prototype tax opinion letter is intended to serve as a template for the tax opinion letters actually sent by KPMG to specific clients for a fee.

In addition to preparing its own tax opinion letter, in some cases KPMG seeks an opinion letter from an outside party, such as a law firm, to provide an "independent" second opinion on the validity of the tax product. KPMG made arrangements to obtain favorable legal opinion letters from an outside law firm in each of the case studies examined by the Subcommittee.

The tax product development and approval process just described is the key internal procedure at KPMG today to determine whether the firm markets benign tax solutions that comply with the law or abusive tax shelters that do not. The investigation conducted by the Subcommittee found that, in the case of FLIP, OPIS, BLIPS, and SC2, KPMG tax professionals were under pressure not only to develop the new products quickly, but also to approve products that the firm's tax experts knew were potentially illegal tax shelters. In several of these cases, top KPMG tax experts participating in the review process expressed repeated concerns about the legitimacy of the relevant tax product. Despite these concerns, all four products were approved for sale to clients.

[82] TIC Manual at 10.

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

[84] *Id.*, § 41.15.1, at 41–8. A KPMG tax opinion often addresses all of the legal issues related to a new tax product and provides an overall assessment of the tax consequences of the new product. See, e.g., KPMG tax opinion on BLIPS. Other KPMG tax opinions address only a limited number of issues related to a new tax product and may provide different levels of assurance on the tax consequences of various aspects of the same tax product. See, e.g., KPMG tax opinions related to SC2.

BLIPS Development and Approval Process. The development and approval process resulting in the marketing of the BLIPS tax product to 186 individuals illustrates how the KPMG process works.[85] BLIPS was first proposed as a KPMG tax idea in late 1998, and the generic tax product was initially approved for sale in May 1999. The product was finally approved for sale in August 1999, after the transactional documentation required by the BLIPS transactions was completed. One year later, in September 2000, the IRS issued Notice 2000–44, determining that BLIPS and other, similar tax products were potentially abusive tax shelters and taxpayers who used them would be subject to enforcement action.[86] After this notice was issued, KPMG discontinued sales of the product.

Internal KPMG emails disclose an extended, unresolved debate among WNT and DPP tax professionals over whether BLIPS met the technical requirements of federal tax law, a debate which continued even after BLIPS was approved for sale. Several outside firms were also involved in BLIPS' development including Sidley Austin Brown & Wood, a law firm, and Presidio Advisory Services, an investment advisory firm run by two former KPMG tax partners. Key documents at the beginning and during a key 2-week period of the BLIPS approval process are instructive.

BLIPS was first proposed in late 1998, as a replacement product for OPIS, which had earned KPMG substantial fees. From the beginning, senior tax leadership put pressure on KPMG tax professionals to quickly approve the new product for sale to clients. For example, after being told that a draft tax opinion on BLIPS had been sent to WNT for review and "we can reasonably anticipate 'approval' in another month or so,"[87] the head of the entire Tax Services Practice wrote:

> "Given the marketplace potential of BLIPS, I think a month is far too long—especially in the spirit of 'first to market'. I'd like for all of you, within the bounds of good professional judgement, to dramatically accelerate this timeline. . . . I'd like to know how quickly we can get this product to market."[88]

Five days later, the WNT technical expert in charge of Personal Financial Planning (PFP) tax products—who had been assigned responsibility for moving the BLIPS product through the WNT review process and was under instruction to keep the head of the Tax Services Practice informed of BLIPS' status—wrote to several colleagues asking for a "progress report." He added a postcript: "P.S. I don't like this pressure any more than you do."[89]

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[85] See Appendix A for more information about BLIPS.

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

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

[88] Email dated 2/10/99, from John Lanning to multiple KPMG tax professionals, "RE: BLIPS," Bates MTW 0001. See also memorandum dated 2/11/99, from Jeffrey Zysik of TIC to "Distribution List," Bates MTW 0002 ("As each of you is by now aware, a product with a very high profile with the tax leadership recently was submitted to WNT/Tax Innovation Center. We are charged with shepherding this product through the WNT 'productization' and review process as rapidly as possible.")

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

A few days later, on February 19, 1999, almost a dozen WNT tax experts held an initial meeting to discuss the technical issues involved in BLIPS.[90] Six major issues were identified, the first two of which posed such significant technical hurdles that, according to the WNT PFP technical reviewer, most participants, including himself, left the meeting thinking the product was "dead."[91] Some of the most difficult technical questions, including whether the BLIPS transactions had economic substance, were assigned to two of WNT's most senior tax partners who, despite the difficulty, took just 2 weeks to determine, on March 5, that their technical concerns had been resolved. The WNT PFP technical reviewer continued to work on other technical issues related to the project. Almost 2 months later, on April 27, 1999, he sent an email to the head of DPP stating that, with respect to the technical issues assigned to him, he would be comfortable with WNT's issuing a more-likely-than-not opinion on BLIPS.

Three days later, at meetings held on April 30 and May 1, a number of KPMG tax professionals working on BLIPS attended a meeting with Presidio to discuss how the investments called for by the product would actually be carried out. The WNT PFP technical reviewer told the Subcommittee staff that, at these meetings, the Presidio representative made a number of troubling comments that led him to conclude that the review team had not been provided all of the relevant information about how the BLIPS transactions would operate, and re-opened concerns about the technical merits of the product. For example, he told the Subcommittee staff that a Presidio representative had commented that "the probability of actually making a profit from this transaction is remote" and the bank would have a "veto" over how the loan proceeds used to finance the BLIPS deal would be invested. In his opinion, these statements, if true, meant the investment program at the heart of the BLIPS product lacked economic substance and business purpose as required by law.

On May 4, 1999, the WNT PFP technical reviewer wrote to the head of the DPP expressing doubts about approving BLIPS:

> "Larry, while I am comfortable that WNT did its job reviewing and analyzing the technical issues associated with BLIPS, based on the BLIPS meeting I attended on April 30 and May 1, I am not comfortable issuing a more-likely-than-not opinion letter [with respect to] this product for the following reasons:
>
> > ". . . [T]he probability of actually making a profit from this transaction is remote (possible, but remote);
> >
> > "The bank will control how the 'loan' proceeds are invested via a veto power over Presidio's investment choices; and
> >
> > "It appears that the bank wants the 'loan' repaid within approximately 60 days. . . .

[90] "Meeting Summary" for meeting held on 2/19/99, Bates MTW 0009.
[91] Subcommittee interview of Mark Watson (11/4/03).

"Thus, I think it is questionable whether a client's representation [in a tax opinion letter] that he or she believed there was a reasonable opportunity to make a profit is a reasonable representation. Even more concerning, however, is whether a loan was actually made. If the bank controls how the loan proceeds are used and when they are repaid, has the bank actually made a bona fide loan?

"I will no doubt catch hell for sending you this message. However, until the above issues are resolved satisfactorily, I am not comfortable with this product."[92]

The DPP head responded: "It is not clear to me how this comports with your April 27 message [expressing comfort with BLIPS], but because this is a PFP product and you are the chief PFP technical resource, the product should not be approved if you are uncomfortable."[93] The WNT PFP technical reviewer responded that he had learned new information about how the BLIPS investments would occur, and it was this subsequent information that had caused him to reverse his position on issuing a tax opinion letter supporting the product.[94]

On May 7, 1999 the head of DPP forwarded the WNT PFP technical expert's email to the leadership of the tax group and noted: "I don't believe a PFP product should be approved when the top PFP technical partner in WNT believes it should not be approved."[95]

On May 8, 1999, the head of KPMG's Tax Services Practice wrote: "I must say that I am amazed that at this late date (must now be six months into this process) our chief WNT PFP technical expert has reached this conclusion. I would have thought that Mark would have been involved in the ground floor of this process, especially on an issue as critical as profit motive. What gives? This appears to be the antithesis of 'speed to market.' Is there any chance of ever getting this product off the launching pad, or should we simply give up???"[96]

On May 9, one of the senior WNT partners supporting BLIPS sent an email to one of the WNT technical reviewers objecting to BLIPS and asked him: "Based on your analysis . . . do you conclude that the tax results sought by the investor are NOT 'more

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

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

[94] Email dated 5/5/99, from Mark Watson to Larry DeLap, Bates KPMG 0011915–16. Mr. Watson was not the only KPMG tax professional expressing serious concerns about BLIPS. See, e.g., email dated 4/6/99, from Steven Rosenthal to Larry DeLap, "RE: BLIPS," Bates MTW 0024; email dated 4/26/99, from Steven Rosenthal to Larry DeLap, "RE: BLIPS Analysis," Bates MTW 0026; email dated 5/7/99, from Steven Rosenthal to multiple KPMG professionals, "Who Is the Borrower in the BLIPS transaction," Bates MTW 0028; email dated 8/19/99, from Steven Rosenthal to Mark Watson, Bates SMR 0045.

[95] Email dated 5/7/99, from Larry Delap to three KPMG tax professionals, with copies to John Lanning, Vice Chairman of the Tax Services Practice, and Jeffrey Stein, second in command of the Tax Services Practice, Bates KPMG 0011905. In the same email he noted that another technical expert, whom he had asked to review critical aspects of the project, had "informed me on Tuesday afternoon that he had substantial concern with the 'who is the borrower' issuer [sic]." Later that same day, May 7, the two WNT technical reviewers expressing technical concerns about BLIPS met with the two senior WNT partners who had earlier signed off on the economic substance issue, to discuss the issues.

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

likely than not' to be realized?" The technical reviewer responded: "Yes."[97]

On May 10, the head of the WNT sent an email to five WNT tax professionals:

> "Gentlemen: Please help me on this. Over the weekend while thinking about WNT involvement in BLIPS I was under the impression that we had sent the transaction forward to DPP Tax on the basis that everyone had signed off on their respective technical issues(s) and that I had signed off on the overall more likely than not opinion. If this impression is correct, why are we revisiting the opinion other than to beef up the technical discussion and further refine the representations on which the conclusions are based. I am very troubled that at this late date the issue is apparently being revisited and if I understand correctly, a prior decision changed on this technical issue?! Richard, in particular, jog my memory on this matter since I based my overall opinion on the fact that everyone had signed off on their respective areas.?"[98]

A few hours later, the head of WNT sent eight senior KPMG tax professionals, including the Tax Services Practice head, DPP head, and the WNT PFP technical reviewer, a long email message urging final approval of BLIPS. He wrote in part:

> "Many people have worked long and hard to craft a tax opinion in the BLIPS transaction that satisfies the more likely than not standard. I believed that we in WNT had completed our work a month ago when we forwarded the [draft] opinion to Larry. . . .
>
> "[T]his is a classic transaction where we can labor over the technical concerns, but the ultimate resolution—if challenged by the IRS—will be based on the facts (or lack thereof). In short, our opinion is only as good as the factual representations that it is based upon. . . . The real 'rubber meets the road' will happen when the transaction is sold to investors, what the investors' actual motive for investing the transaction is and how the transaction actually unfolds. . . . Third, our reputation will be used to market the transaction. This is a given in these types of deals. Thus, we need to be concerned about who we are getting in bed with here. In particular, do we believe that Presidio has the integrity to sell the deal on the facts and representations that we have written our opinion on?! . . .
>
> "Having said all the above, I do believe the time has come to shit and get off the pot. The business decisions to me are primarily two: (1) Have we drafted the opinion with the appropriate limiting bells and whistles . . . and (2) Are we being paid enough to offset the risks of potential litigation resulting from the transaction? . . . My own rec-

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

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

ommendation 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. . . ." [99]

Later the same day, the Tax Services operations head wrote in response to the email from the WNT head: "I think it's shit OR get off the pot. I vote for shit." [100]

The same day, the WNT PFP technical reviewer wrote to the head of the Tax Services Practice: "John, in my defense, my change in heart about BLIPS was based on information Presidio disclosed to me at a meeting on *May 1.* This information raised serious concerns in my mind about the viability of the transaction, and indicated that WNT had not been given complete information about how the transaction would be structured. . . . I want to make money as much as you do, but I cannot ignore information that raises questions as to whether the subject strategy even works. Nonetheless, I have sent Randy Bickham four representations that I think need to be added to our opinion letter. Assuming these representations are made, I am prepared to move forward with the strategy." [101]

A meeting was held on May 10, to determine how to proceed. The WNT head, the senior WNT partner, and the two WNT technical reviewers decided to move forward on BLIPS, and the WNT head asked the technical reviewers to draft some representations that, when relied upon, would enable the tax opinion writers to reach a more likely than not opinion. The WNT head reported the outcome of the meeting in an email:

> "The group of Wiesner, R Smith, Watson and Rosenthal met this afternoon to bring closure to the remaining technical tax issues concerning the BLIPS transaction. After a thorough discussion of the profit motive and who is the borrower issue, recommendations for additional representations were made (Mark Watson to follow up on with Jeff Eischeid) and the decision by WNT to proceed on a more likely than not basis affirmed. Concern was again expressed that the critical juncture will be at the time of the first real tax opinion when the investor, bank and Presidio will be asked to sign the appropriate representations. Finally, it should be noted that Steve Rosenthal expressed his dissent on the who is the investor issue, to wit, 'although reasonable people could reach an opposite result, he could not reach a more likely than not opinion on that issue'." [102]

After receiving this email, the DPP head sent an email to the WNT PFP technical reviewer asking whether he would be com-

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[99] Email dated 5/10/99, from Philip Wiesner to John Lanning and eight other KPMG tax professionals, "RE: BLIPS," Bates KPMG 0011904. See also email response dated 5/10/99, from John Lanning to Philip Wiesner and other KPMG tax professionals, "RE: BLIPS," Bates MTW 0036 ("you've framed the issues well").

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

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

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

fortable with KPMG's issuing a tax opinion supporting BLIPS. The WNT PFP technical reviewer wrote: "Larry, I don't like this product and would prefer not to be associated with it. However, if the additional representations I sent to Randy on May 9 and 10 are in fact made, based on Phil Wiesner's and Richard Smith's input, I can reluctantly live with a more-likely-than-not opinion being issued for the product." [103]

The DPP head indicated to the Subcommittee staff that he did not consider this tepid endorsement sufficient for him to sign off on the product. He indicated that he then met in person with his superior, the head of the Tax Services Practice, and told the Tax Services Practice head that he was not prepared to approve BLIPS for sale. He told the Subcommittee staff that the Tax Services Practice head was "not pleased" and instructed him to speak again with the technical reviewer.[104]

The DPP head told the Subcommittee staff that he then went back to the WNT PFP technical reviewer and telephoned him to discuss the product. The DPP head told the Subcommittee staff that, during this telephone conversation, the technical reviewer made a much clearer, oral statement of support for the product, and it was only after obtaining this statement from the technical reviewer that, on May 19, 1999, the DPP head approved BLIPS for sale to clients.[105] The WNT PFP technical reviewer, however, told the Subcommittee staff that he did not remember receiving this telephone call from the DPP head. According to him, he never, at any time after the May 1 meeting, expressed clear support for BLIPS' approval. He also stated that an oral sign-off on this product contradicted the DPP head's normal practice of requiring written product approvals.[106]

Over the course of the next year, KPMG sold BLIPS to 186 individuals and obtained more than $50 million in fees, making BLIPS one of its highest revenue-producing tax products to date.

The events and communications leading to BLIPS' approval for sale are troubling and revealing for a number of reasons. First, they show that senior KPMG tax professionals knew the proposed tax product, BLIPS, was "clearly one that the IRS would view as falling squarely within the tax shelter orbit." Second, they show how important "speed to market" was as a factor in the review and approval process. Third, they show the interpersonal dynamics that, in this case, led KPMG's key technical tax expert to reluctantly agree to approve a tax product that he did not support or want to be associated with, in response to the pressure exerted by senior Tax Services professionals to approve the product for sale.

The email exchange immediately preceding BLIPS' approval for sale also indicates a high level of impatience by KPMG tax professionals in dealing with new, troubling information about how the BLIPS investments would actually be implemented by the outside investment advisory firm, Presidio. Questions about this outside firm's "integrity" and how it would perform were characterized as questions of risk to KPMG that could be resolved with a pricing ap-

[103] Email dated 5/11/99, from Mark Watson, WNT, to Lawrence DeLap, Bates KPMG 0011911.
[104] Subcommittee interview of Lawrence DeLap (10/30/03).
[105] *Id.*
[106] Subcommittee interview of Mark Watson (11/4/03).

proach that provided sufficient funds "to offset the risks of potential litigation." Finally, the email exchange shows that the participants in the approval process—all senior KPMG tax professionals—knew they were voting for a dubious tax product that would be sold in part by relying on KPMG's "reputation." No one challenged the analysis that the risky nature of the product justified the firm's charging "a lot of money" for a tax opinion letter predicting it was more likely than not that BLIPS would withstand an IRS challenge.

Later documents show that key KPMG tax professionals continued to express serious concerns about the technical validity of BLIPS. For example, in July, 2 months after the DPP gave his approval to sell BLIPS, one of the WNT technical reviewers, objecting to the tax product, sent an email to his superiors in WNT noting that the loan documentation contemplated very conservative instruments for the loan proceeds and it seemed unlikely the rate of return on the investments would equal or exceed the loan and fees incurred by the borrower. He indicated that his calculations showed the planned foreign currency transactions would "have to generate a 240% annual rate of return" to break even. He also pointed out that, "Although the loan is structured as a 7-year loan, the client has a tremendous economic incentive to get out of loan as soon as possible due to the large negative spread." He wrote: "Before I submit our non-economic substance comments on the loan documents to Presidio, I want to confirm that you are still comfortable with the economic substance of this transaction."[107] His superiors indicated that they were.

A month later, in August, after completing a review of the BLIPS transactional documents, the WNT PFP technical reviewer again expressed concerns to his superiors in WNT:

> "However before engagement letters are signed and revenue is collected, I feel it is important to again note that I and several other WNT partners remain skeptical that the tax results purportedly generated by a BLIPS transaction would actually be sustained by a court if challenged by the IRS. We are particularly concerned about the economic substance of the BLIPS transaction, and our review of the BLIPS loan documents has increased our level of concern.
>
> "Nonetheless, since Richard Smith and Phil Wiesner—the WNT partners assigned with the responsibility of addressing the economic substance issues associated with BLIPS—have concluded they think BLIPS is a "more-likely-than-not" strategy, I am prepared to release the strategy once we complete our second review of the loan documents and LLC agreement and our comments thereon (if any) have been incorporated."[108]

The other technical reviewer objecting to BLIPS wrote:

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

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

"I share your concerns. We are almost finished with our technical review of the documents that you gave us, and we recommend some clarifications to address these technical concerns. We are not, however, assessing the economic substance of the transaction (ie., is there a debt? Who is the borrower? What is the amount of the liability? Is there a reasonable expectation of profit?) I continue to be seriously troubled by these issues, but I defer to Phil Wiesner and Richard Smith to assess them." [109]

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

About 6 months after BLIPS tax products had begun to be sold to clients, an effort was begun within KPMG to design a modified "BLIPS 2000." [110] One of the WNT technical reviewers who had objected to the original BLIPS again expressed his concerns:

"I am writing to communicate my views on the economic substance of the Blips, Grandfathered Blips, and Blips 2000 strategies. Throughout this process, I have been troubled by the application of economic substance doctrines . . . and have raised my concerns repeatedly in internal meetings. The facts as I now know them and the law that has developed, has not reduced my level of concern.

"In short, in my view, I do not believe that KPMG can reasonably issue a more-likely-than-not opinion on these issues." [111]

When asked by Subcommittee staff whether he had ever personally concluded that BLIPS met the technical requirements of the federal tax code, the DPP head declined to say that he had. Instead, he said that, in 1999, he approved BLIPS for sale after determining that WNT had "completed" the technical approval process.[112] A BLIPS power point presentation produced by the Personal Financial Planning group in June, a few weeks after BLIPS' approval for sale, advised KPMG tax professionals to make sure that potential clients were "willing to take an aggressive position with a more likely than not opinion letter." The presentation characterized BLIPS as having "about a 10 risk on [a] scale of 1–10." [113]

In September 2000, the IRS identified BLIPS as a potentially abusive tax shelter. The IRS notice characterized BLIPS as a product that was "being marketed to taxpayers for the purpose of generating artificial tax losses. . . . [A] loss is allowable as a deduction . . . only if it is bona fide and reflects actual economic consequences. An artificial loss lacking economic substance is not al-

[109] Email dated 8/4/99, from Steven Rosenthal to Mark Watson and others, Bates SMR 0039.

[110] Senior KPMG tax professionals, again, put pressure on its tax experts to quickly approve the BLIPS 2000 product. See, e.g., email dated 1/17/00, from Jeff Stein to Steven Rosenthal and others, "BLIPS 2000," Bates SMR 0050 (technical expert is urged to analyze new product "so we can take this to market. Your attention over the next few days would be most appreciated.").

[111] Email dated 3/6/00, from Steven Rosenthal to David Brockway, "Blips I, Grandfathered Blips, and Blips 2000," Bates SMR 0056. See also memorandum dated 3/28/00, to David Brockway, "Talking points on significant tax issues for BLIPS 2000," Bates SMR 0117–21 (identifying numerous problems with BLIPS).

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

[113] Power point presentation dated June 1999, by Carol Warley, Personal Financial Planning group, "BLIPS AND TRACT," Bates KPMG 0049639–45, at 496340. Repeated capitalizations in original text not included.

lowable."[114] The IRS' disallowance of BLIPS has not yet been tested in court. Rather than defend BLIPS in court, KPMG and many BLIPS purchasers appear to be engaged in settlement negotiations with the IRS to reduce penalty assessments.

OPIS and FLIP Development and Approval Process. OPIS and FLIP were the predecessors to BLIPS. Like BLIPS, both of these products were "loss generators" intended to generate paper losses that taxpayers could use to offset and shelter other income from taxation,[115] but both used different mechanisms than BLIPS to achieve this end. Because they were developed a number of years ago, the Subcommittee has more limited documentation on how OPIS and FLIP were developed. However, even this limited documentation establishes KPMG's awareness of serious technical flaws in both tax products.

For example, in the case of OPIS, which was developed during 1998, a senior KPMG tax professional wrote a 7-page memorandum filled with criticisms of the proposed tax product.[116] The memorandum states: "In OPIS, the use of debt has apparently been jettisoned. If we can not structure a deal without at least some debt, it strikes me that all the investment banker's economic justification for the deal is smoke and mirrors." At a later point, it states: "The only thing that really distinguishes OPIS (from FLIPS) from a tax perspective is the use of an instrument that is purported to be a swap. . . . However, the instrument described in the opinion is *not* a swap under I.R.C. § 446. . . . [A] fairly strong argument could be made that the U.S. investor has nothing more than a disguised partnership interest."

The memorandum goes on:

> "If, upon audit, the IRS were to challenge the transaction, the burden of proof will be on the investor. The investor will have to demonstrate, among other things, that the transaction was not consummated pursuant to a firm and fixed plan. Think about the prospect of having your client on the stand having to defend against such an argument. The client would have a difficult burden to overcome. . . . The failure to use an independent 3rd party in any of the transactions indicates that the deal is pre-wired."

It also states: "If the risk of loss concepts of Notice 98–5 were applied to OPIS, I doubt that the investor's ownership interest would pass muster." And: "As it stands now, the Cayman company remains extremely vulnerable to an argument that it is a sham." And: "No further attempt has been made to quantify why I.R.C. § 165 should not apply to deny the loss. Instead, the argument is again made that because the law is uncertain, we win." The memorandum observes: "We are the firm writing the [tax] opinions. Ultimately, if these deals fail in a technical sense, it is KPMG which will shoulder the blame."

This memorandum was written in February 1998. OPIS was approved for sale to clients around September 1998. KPMG sold OPIS

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

[115] See document dated 5/18/01, "PFP Practice Reorganization Innovative Strategies Business Plan—DRAFT," Bates KPMG 0050620–23, at 1.

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

to 111 individuals, conducting 79 OPIS transactions on their behalf in 1998 and 1999.

In the case of FLIP, an email written in March 1998, by the Tax Services Practice's second in command, identifies a host of significant technical flaws in FLIP, doing so in the course of discussing which of two tax offices in KPMG deserved credit for developing its replacement, OPIS.[117] The email states that efforts to find a FLIP alternative "took on an air of urgency when [DPP head] Larry DeLap determined that KPMG should discontinue marketing the existing product." The email indicates that, for about 6 weeks, a senior KPMG tax professional and a former KPMG tax professional employed at Presidio worked "to tweak or redesign" FLIP and "determined that whatever the new product, it needed a greater economic risk attached to it" to meet the requirements of federal tax law.

Among other criticisms of FLIP, the email states: "Simon was the one who pointed out the weakness in having the U.S. investor purchase a warrant for a ridiculously high amount of money. . . . It was clear, we needed the option to be treated as an option for Section 302 purposes, and yet in truth the option [used in FLIP] was really illusory and stood out more like a sore thumb since no one in his right mind would pay such an exorbitant price for such a warrant." The email states: "In kicking the tires on FLIP (perhaps too hard for the likes of certain people) Simon discovered that there was a delayed settlement of the loan which then raised the issue of whether the shares could even be deemed to be issued to the Cayman company. Naturally, without the shares being issued, they could not later be redeemed." The email also observes: "[I]t was Greg who stated in writing to I believe Bob Simon that the 'the OPIS product was developed in response to your and DPP tax's concerns over the FLIP strategy. We listened to your input regarding technical concerns with respect to the FLIP product and attempt to work solutions into the new product. . . .'"

This email was written in March 1998, after the bulk of FLIP sales, but it shows that the firm had been aware for some time of the product's technical problems. After the email was written, KPMG sold FLIP to ten more customers in 1998 and 1999, earning more than $3 million in fees for doing so. In August 2001, the IRS issued a notice finding both FLIP and OPIS to be potentially abusive tax shelters.[118] The IRS has since audited and penalized numerous taxpayers for using these illegal tax shelters.[119]

SC2 Development and Approval Process. The Subcommittee investigation also obtained documentation establishing KPMG's awareness of flaws in the technical merits of SC2.[120]

Documents proceeding the April 2000 decision by KPMG to approve SC2 for sale reflect vigorous analysis and discussion of the product's risks if challenged by the IRS. The documents also re-

[117] Email dated 3/14/98, from Jeff Stein to Robert Wells, John Lanning, Larry DeLap, Gregg Ritchie, and others, "Simon Says," concerning FLIP, Bates 638010, filed by the IRS on June 16, 2003, as an attachment to Respondent's Requests for Admission, *Schneider Interests v. Commissioner,* U.S. Tax Court, Docket No. 200–02.

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

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

[120] See Appendix B for more detailed information on SC2.

flect, as in the BLIPS case, pressure to move the product to market quickly. For example, one month before SC2's final approval, an email from a KPMG professional in the Tax Innovation Center stated: "As I was telling you, this Tax Solution is getting some very high level (Stein/Rosenthal) attention. Please review the white-paper as soon as possible. . . ." [121]

On April 11, 2000, in the same email announcing SC2's approval for sale, the head of the DPP wrote:

> "This is a relatively high risk strategy. You will note that the heading to the preapproved engagement letter states that limitation of liability and indemnification provisions are not to be waived. . . . You will also note that the engagement letter includes the following statement: You acknowledge receipt of a memorandum discussing certain risks associated with the strategy. . . . It is essential that such risk discussion memorandum (attached) be provided to each client contemplating entering into an SC2 engagement." [122]

The referenced memorandum, required to be given to all SC2 clients, identifies a number of risks associated with the tax product, most related to ways in which the IRS might successfully challenge the product's legal validity. The memorandum states in part:

> "The [IRS] or a state taxing authority could assert that some or all of the income allocated to the tax-exempt organization should be reallocated to the other shareholders of the corporation. . . . The IRS or a state taxing authority could assert that some or all of the charitable contribution deduction should be disallowed, on the basis that the tax-exempt organization did not acquire equitable ownership of the stock or that the valuation of the contributed stock was overstated. . . . The IRS or a state taxing authority could assert that the strategy creates a second class of stock. Under the [tax code], subchapter S corporations are not permitted to have a second class of stock. . . . The IRS or a court might discount an opinion provided by the promoter of a strategy. Accordingly, it may be advisable to consider requesting a concurring opinion from an independent tax advisor." [123]

Internally, KPMG tax professionals had identified even more technical problems with SC2 than were discussed in the memorandum given to clients. For example, KPMG tax professionals discussed problems with identifying a business purpose to explain the structure of the transaction—why a donor who wanted to make a cash donation to a charity would first donate stock to the charity

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

[122] Email dated 4/11/00, from Larry DeLap to Tax Professional Practice Partners, "S-Corporation Charitable Contribution Strategy (SC2)," Bates KPMG 0052581–82. One of the KPMG tax partners to whom this email was forwarded wrote in response: "Please do not forward this to anyone." Email dated 4/25/00, from Steven Messing to Lawrence Silver, "S-Corporation Charitable Contribution Strategy (SC2)," Bates KPMG 0052581.

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

and then buy it back, instead of simply providing a straightforward cash contribution.[124] They also identified problems with establishing the charity's "beneficial ownership" of the donated stock, since the stock was provided on the clear understanding that the charity would sell the stock back to the donor within a specified period of time.[125] KPMG tax professionals identified other technical problems as well involving assignment of income, reliance on tax indifferent parties, and valuation issues.[126]

More than a year later, in December 2001, another KPMG tax professional expressed concern about the widespread marketing of SC2 because, if the IRS "gets wind of it," the agency would likely mount a vigorous and "at least partially successful" challenge to the product:

> "Going way back to Feb. 2000, when SC2 first reared its head, my recollection is that SC2 was intended to be limited to a relatively small number of large S corps. That plan made sense because, in my opinion, there was (and is) a strong risk of a successful IRS attack on SC2 if the IRS gets wind of it. . . . Call me paranoid, but I think that such a widespread marketing campaign is likely to bring KPMG and SC2 unwelcome attention from the IRS. If so, I suspect a vigorous (and at least partially successful) challenge would result." [127]

Together, the BLIPS, OPIS, FLIP, and SC2 evidence demonstrates that the KPMG development process led to the approval of tax products that senior KPMG tax professionals knew had significant technical flaws and were potentially illegal tax shelters. Even when senior KPMG professionals expressed forceful objections to proposed products, highly questionable tax products received technical and reputational risk sign-offs and made their way to market.

(2) Mass Marketing Tax Products

Finding: KPMG uses aggressive marketing tactics to sell its generic tax products, including by turning tax professionals into tax product salespersons, pressuring its tax professionals to meet revenue targets, using telemarketing to find clients, using confidential client tax data to identify potential buyers, targeting its own audit clients

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

[125] See, e.g., email dated 3/13/00, from Richard Bailene to Phillip Galbreath, "S-CAEPS," Bates KPMG 0015745; KPMG document dated 3/13/00, "S-Corporation Charitable Contribution Strategy—Variation #1," Bates KPMG 0047895 (beneficial ownership is "probably our weakest link in the chain on SC2."); memorandum dated 3/2/00, from William Kelliher to multiple KPMG tax professionals, "Comments on S-CAEPS 'White Paper,'" Bates KPMG 0016853–61.

[126] See, e.g., email dated 3/13/00, from Richard Bailene to Phillip Galbreath, "S-CAEPS," Bates KPMG 0015746, and email from Mark Watson, "S-CAEPS," Bates KPMG 0013790–93 (raising assignment of income concerns); emails dated 3/21/00 and 3/22/00, from Larry DeLap and Lawrence Manth, Bates KPMG 0015739–40 (raising tax indifferent party concerns); various emails between 7/28/00 and 10/25/00, among KPMG tax professionals, Bates KPMG 0015011–14 (raising tax indifferent party concerns); and memorandum dated 2/14/00, from William Kelliher to Richard Rosenthal, "S-Corp Charitable and Estate Planning Strategy ('S-CAEPS')," Bates KPMG 0047693–95 (raising valuation concerns).

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

for sales pitches, and using tax opinion letters and insurance policies as marketing tools.

Until recently, accounting firms were seen as traditional, professional firms that waited for clients to come to them with concerns, rather than affirmatively targeting potential clients for sales pitches on tax products. One of the more striking aspects of the Subcommittee investigation was discovery of the substantial efforts KPMG has expended to market its tax products, including extensive efforts to target clients and, at times, use high-pressure sales tactics. Evidence in the four case studies shows that KPMG compiled and scoured prospective client lists, pushed its personnel to meet sales targets, closely monitored their sales efforts, advised its professionals to use questionable sales techniques, and even used cold calls to drum up business. The evidence also shows that, at times, KPMG marketed tax shelters to persons who appeared to have little interest in them or did not understand what they were being sold, and likely would not have used them to reduce their taxes without being approached by KPMG.

Extensive Marketing Infrastructure. As indicated in the prior section, KPMG's marketing efforts for new tax products normally began long before a product was approved for sale. Potential "revenue analysis" was part of the earliest screening efforts for new products. In addition, when a new tax product is launched within the firm, the "Tax Solution Alert" is supposed to include key marketing information such as potential client profiles, "optimal target characteristics" of buyers, and the expected "typical buyer" of the product.

KPMG typically designates one or more persons to lead the marketing effort for a new tax product. These persons are referred to as the product's "National Deployment Champions," "National Product Champions," or "Deployment Leaders." In the four case studies investigated by the Subcommittee, the National Deployment Champion was the same person who served as the product's National Development Champion and shepherded the product through the KPMG approval process. For example, the tax professional who led the marketing effort for BLIPS was, again, Jeffrey Eischeid, assisted by Randall Bickham, while for SC2 it was, again, Larry Manth, assisted and succeeded by Andrew Atkin.

National Deployment Champions have been given significant institutional support to market their assigned tax product. For example, KPMG maintains a national marketing office that includes marketing professionals and resources "dedicated to tax." [128] Champions can draw on this resource for "market planning and execution assistance," and to assemble a marketing team with a "National Marketing Director" and designated "area champions" to lead marketing efforts in various regions of the United States.[129] These individuals become members of the product's official "deployment team."

Champions can also draw on a Tax Services group skilled in marketing research to identify prospective clients and develop target client lists. This group is known as the Tax Services Marketing

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

and Research Support group. Champions can also make use of a KPMG "cold call center" in Indiana. This center is staffed with telemarketers trained to make cold calls to prospective clients and set up a phone call or meeting with specified KPMG tax or accounting professionals to discuss services or products offered by the firm. These telemarketers can and, at times, have made cold calls to sell specific tax shelters such as SC2.[130]

In addition to a cadre of expert marketing support personnel, National Deployment Champions are supported by powerful software systems that help them identify prospective clients and track KPMG sales efforts across the country. The Opportunity Management System (OMS), for example, is a software system that KPMG tax professionals have used to monitor with precision who has been contacted about a particular tax product, who made the contact on behalf of KPMG, the potential sales revenue associated with the sales contact, and the current status of each sales effort.

An email sent in 2000, by the Tax Services operations and Federal Tax Practice heads to 15 KPMG tax professionals paints a broad picture of what KPMG's National Deployment Champions were expected to accomplish:

> "As National Deployment Champions we are counting on you to drive significant market activity. We are committed to providing you with the tools that you need to support you in your efforts. A few reminders in this regard.
>
> "The Tax Services Marketing and Research Support is prepared to help you refine your existing and/or create additional [client] target lists. . . . Working closely with your National Marketing Directors you should develop the relevant prospect profile. Based on the criteria you specify the marketing and research teams can scour primary and secondary sources to compile a target list. This will help you go to market more effectively and efficiently.
>
> "Many of you have also tapped into the Practice Development Coordinator resource. Our team of telemarketers is particularly helpful . . . to further qualify prospects [redaction by KPMG] [and] to set up phone appointments for you and your deployment team. . . .
>
> "Finally tracking reports generated from OMS are critical to measuring your results. If you don't analyze the outcome of your efforts you will not be in a position to judge what is working and what is not. Toward that end you must enter data in OMS. We will generate reports once a month from OMS and share them with you, your team, Service Line leaders and the [Area Managing Partners]. These will be the focal point of our discussion with you when we revisit your solution on the Monday night call. You should also be using them on your bi-weekly team calls. . . .

[130] See, e.g., SC2 script dated 6/19 (no year provided, but likely 2000) developed for telemarketer calls to identify individuals interested in obtaining more information, Bates KPMG 0050370–71. A telemarketing script was also developed for BLIPS, but it is possible that no BLIPS telemarketing calls were made. BLIPS script dated 7/8/99, Bates KPMG 0025670.

"Thanks again for assuming the responsibilities of a National Deployment Champion. We are counting on you to make the difference in achieving our financial goals." [131]

In 2002, KPMG opened a "Sales Opportunity Center" to make it easier for its personnel to make use of the firm's extensive marketing resources. An email announcing this Center stated the following:

"The current environment is changing at breakneck speed, and we must be prepared to respond aggressively to every opportunity.

"We have created a Sales Opportunity Center to be the 'eye of the needle'—a single place where you can get access to the resources you need to move quickly, knowledgeably, and *effectively*.

"This initiative reflects the efforts of Assurance (Sales, Marketing, and the Assurance & Advisory Services Center) and Tax (Marketing and the Tax Innovation Center), and is intended to serve as our 'situation room' during these fast-moving times. . . .

"The Sales Opportunity Center is a powerful demonstration of the Firm's commitment to giving you what you need to meet the challenges of these momentous times. We urge you to take advantage of this resource as you pursue marketplace opportunities." [132]

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

Champions use a wide variety of tools to make KPMG tax professionals aware of a new tax product. For example, they include product information in KPMG internal newsletters and email alerts, and organize conference calls and video conferences with KPMG tax offices across the country. Champions have also gone on "road shows" to KPMG field offices to make a personal presentation on a particular product. These presentations include how the product works, what clients to target, and how to respond to particular concerns. On some occasions, a presentation is videotaped and included in an office's "video library" to enable KPMG personnel to view the presentation at a later date.

Documentation obtained by the Subcommittee shows that National Deployment Champions and senior KPMG tax officials expend significant effort to convince KPMG personnel to devote time and resources to selling new products. Senior tax professionals use general exhortations as well as specific instructions directed to specific field offices to increase their sales efforts. For example, after SC2 was launched, the head of KPMG's Federal Practice sent the following an email to the SC2 "area champions" around the country:

[131] Email dated 8/6/00 from Jeff Stein and Rick Rosenthal to 15 National Deployment Champions, Bates KPMG 050016.

[132] Email dated 3/14/02, from Rick Rosenthal and other KPMG professionals, to "US Management Group," Bates XX 000141 (Emphasis in original.).

"I want to personally thank everyone for their efforts during the approval process of this strategy. It was completed very quickly and everyone demonstrated true teamwork. Thank you! Now let[']s SELL, SELL, SELL!!" [133]

The Federal Tax head also called specific KPMG offices to urge them to increase their SC2 sales. This type of instruction from a senior KPMG tax official apparently sent a strong message to subordinates about the need to sell the identified tax product. For example, a tax professional in a KPMG field office in Houston wrote the following after participating in a conference call on SC2 in which the Federal Tax head and the SC2 National Deployment Champion urged the office to improve its SC2 sales record:

"I don't know if you were on Larry Manth's call today, but Rosenthal led the initial discussion. There have been several successes. . . . We are behind.

"This is THE STRATEGY that they expect significant value added fees by June 30.

"The heat is on. . . ." [134]

In the SC2 case study examined by the Subcommittee, National Deployment Champions did not end their efforts with phone calls and visits urging KPMG tax professionals to sell their tax product, they also produced detailed marketing plans, implemented them with the assistance of the "deployment team," and pressured their colleagues to increase SC2 sales. For example, one email circulated among two members of the SC2 deployment team and two senior KPMG tax professionals demonstrates the measures used to push sales:

"To memorialize our discussion, we agreed the following:

"*Over the next two weeks, Manth [SC2 National Deployment Champion] will deploy [Andrew] Atkin [on the SC2 deployment team] to call each of the SC2 area solution champions.

"*Andrew will work with the champion to establish a specific action plan for each opportunity. To be at all effective, the plans should [be] very specific as to who is going to do what when. . . . There should be agreement as to when Andrew will next follow-up with them to create a real sense of urgency and accountability.

"*Andrew will involve Manth where he is not getting a response within 24 hours or receiving inappropriate 'pushback.' Manth will enlist [David] Jones or Rick [Rosenthal, senior KPMG tax officials,] to help facilitate responsiveness where necessary given the urgency of the opportunity. . . .

"*Manth believes inadequate resources are currently deployed to exploit the Midwest SCorp client and target

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

population. Craig Pichette has not yet been able to dedicate enough time to this solution. . . . John Schrier (NE Stratecon) or Councill Leak (SE Stratecon) could be effective. . . .

"*Resource[s] will be assigned to adequately address the market opportunity in Florida. . . . Goals must be explicit . . . including a percentage weighting based on expected time commitment. . . .

"Manth will explore with Rick the opportunity to form alliances with other accounting firms to drive distribution." [135]

Senior KPMG tax officials also set overall revenue goals for various tax groups and urged them to increase their sales of designated tax products to meet those goals. For example, in an email alerting nearly 40 tax professionals in the "Stratecon West" group to a conference call on a "Kick Off Plan For '01," a senior Stratecon professional, who was also the SC2 National Deployment Champion, wrote:

"Hello everyone. We will be having a conference call to kick-off our Stratecon marketing efforts to aggressively pursue closed deals by 6/30/01. The main purpose of the call is to discuss our marketing and targeting strategy and to get everyone acquainted with a number of Stratecon's high-end solutions. If you have clients, at least one of these strategies should be applicable to your client base. As you all know, to reach plan in the West, we must aggressively pursue these high-end strategies." [136]

Two months later, a member of the SC2 deployment team, who also worked for Stratecon, sent an email to an even larger group of 60 tax professionals, urging them to try a new, more appealing version of SC2. In a paragraph subtitled, "Why Should You Care?" he wrote:

"In the last 12 months the original SC2 structure has produced $1.25 million in signed engagements for the SE [Southeast]. . . . Look at the last partner scorecard. Unlike golf, a low number is not a good thing. . . . A lot of us need to put more revenue on the board before June 30. SC2 can do it for you. Think about targets in your area and call me." [137]

The steady push for tax product sales continued. For example, three weeks later, the Stratecon tax professional sent an email to his colleagues stating, "Due to the significant push for year-end revenue, all West Region Federal tax partners have been invited to join us on this [conference] call and we will discuss our 'Quick Hit' strategies and targeting criteria." [138] Six weeks after that, the same Stratecon official announced another conference call urging

[135] Email dated 1/30/01, from David Jones to Larry Manth, Richard Rosenthal, and Wendy Klein, "SC2—Follow-up to 1/29 Revisit," Bates KPMG 0050389.
[136] Email dated 12/2/00, from Lawrence Manth to multiple tax professionals, Bates XX 000021.
[137] Email dated 2/22/01, from Councill Leak to multiple tax professionals, Bates KPMG 0050822–23.
[138] Email dated 3/13/01, from Larry Manth to multiple KPMG tax professionals, "Friday's Stratecon Call," Bates XX 001439.

Stratecon professionals to discuss two "tax minimization opportunities for individuals" which will "have a quick revenue hit for us." [139]

Stratecon was not alone in the push for sales. For example, in 2000, the former head of KPMG's Washington National Tax Practice sent an email to all "US-WNT Tax Partners" urging them to "temporarily defer non-revenue producing activities" and concentrate for the "next 5 months" on meeting WNT's revenue goals for the year.[140] The email states in part:

> "Listed below are the tax products identified by the functional teams as having significant revenue potential over the next few months. . . . [T]he functional teams will need . . . WNT champions to work with the National Product champions to maximize the revenue generated from the respective products. . . . Thanks for help in this critically important matter. As Jeff said, 'We are dealing with ruthless execution—hand to hand combat—blocking and tackling.' Whatever the mixed metaphor, let's just do it."

The evidence is clear that selling tax products was an important part of every tax professional's job at KPMG.

Targeting Clients. KPMG's marketing efforts included substantial efforts to identify prospective purchasers for its tax products. KPMG developed prospective client lists by reviewing both its own client base and seeking new clients through referrals and cold calls.

To review its own client base, KPMG has used software systems, including ones known as KMatch and RIA-GoSystem, to identify former or existing clients who might be interested in a particular tax product. KMatch is "[a]n interactive software program that asks a user a series of questions about a client's business and tax situation," uses the information to construct a "client profile," and then uses the profile to identify KPMG tax products that could assist the client to avoid taxation.[141] KPMG's Tax Innovation Center conducted a specific campaign requiring KPMG tax professionals to enter client data into the KMatch database so that, when subsequent tax products were launched, the resulting client profiles could be searched electronically to identify which clients would be eligible for and interested in the new product. RIA-GoSystem is a separate internal KPMG database which contains confidential client data provided to KPMG to assist the firm in preparing client tax returns.[142] This database of confidential client tax information can also be searched electronically to identify prospective clients for new tax products and was actually used for that purpose in the case of SC2.[143]

The evidence indicates that KPMG also uses its assurance professionals—persons who provide auditing and related services to individuals and corporations—to identify existing KPMG audit cli-

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[139] Email dated 4/25/01, from Larry Manth to multiple KPMG tax professionals, "Friday's Stratecon Call," Bates XX 001438.

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

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

[142] See, e.g., email dated 3/6/01, from US-GoSystem Administration to Andrew Atkin of KPMG, "RE: Florida S corporation search," Bates KPMG 0050826; Subcommittee interview of Councill Leak (10/22/03).

[143] *Id.*

ents who might be interested in new tax products. Among other documents evidencing the role of KPMG assurance professionals is the development and marketing of tax products that require the combined participation of both KPMG tax and assurance professionals. In 2000, for example, KPMG issued what it called its "first joint solution" requiring KPMG tax and assurance professionals to work together to sell and implement the product.[144] The tax product is described as a "[c]ollection of assurance and tax services designed to assist companies in . . . realizing value from their intellectual property . . . [d]elivered by joint team of KPMG assurance and tax professionals."[145] Internal KPMG documentation states that the purpose of the new product is "[t]o increase KPMG's market penetration of key clients and targets by enhancing the linkage between Assurance and Tax professionals."[146] Another KPMG document states: "Teaming with Assurance expands tax team's knowledge of client and industry[.] Demonstrates unified team approach that separates KPMG from competitors."[147] Another KPMG document shows that KPMG used both its internal tax and assurance client lists to target clients for a sales pitch on the new product:

> "The second tab of this file contains the draft target list [of companies]. This list was compiled from two sources an assurance and tax list. . . . [W]e selected the companies which are assurance or tax clients, which resulted in the 45 companies on the next sheet. . . . What should you do? Review the suspects with your assurance or tax deployment counterpart. . . . Prioritize your area targets, and plan how to approach them."[148]

Additional tax products which relied in part on KPMG audit partners followed. In 2002, for example, KPMG launched a "New Enterprises Tax Suite" product[149] which it described internally as "a cross-functional element of the Tax Practice that efficiently mines opportunities in the start-up and middle-market, high-growth, high-tech space." A presentation on this new product states that KPMG tax professionals are "[t]eaming with Assurance . . .

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[144] Presentation dated 7/17/00, "Targeting Parameters: Intellectual Property—Assurance and Tax," with attachment dated September 2000, entitled "Intellectual Property Services," at page 1 of the presentation, Bates XX 001567–93.

[145] Presentation dated 10/30/00, "Intellectual Property Services (IPS)," by Dut LeBlanc of Shreveport and Joe Zier of Silicon Valley, Bates XX 001580–93.

[146] Presentation dated 7/17/00, "Targeting Parameters: Intellectual Property—Assurance and Tax," with attachment dated September 2000, entitled "Intellectual Property Services," at page 1 of the attachment, Bates XX 001567–93.

[147] Presentation dated 10/30/00, "Intellectual Property Services (IPS)," by Dut LeBlanc of Shreveport and Joe Zier of Silicon Valley, Bates XX 001580–93.

[148] Presentation dated 7/17/00, "Targeting Parameters: Intellectual Property—Assurance and Tax," with attachment dated September 2000, entitled "Intellectual Property Services," at page 1 of the attachment, Bates XX 001567–93.

[149] See WNT presentation dated 9/19/02, entitled "Innovative Tax Solutions," which, at 18–26, includes a presentation by Tom Hopkins of Silicon Valley, "New Enterprises Tax Suite," Tax Solution Alert 00–31, Bates XX 001636–1706. The Hopkins presentation states that the new product is intended to be used to "[l]everage existing client base (pull-through)," "[d]evelop and use client selection filters to refine our bets and reach higher market success," and "[e]nhance relationships with client decisionmakers." As part of a "Deployment Action Plan," the presentation states that KPMG "[p]artners with revenue goals are given subscriptions to *Venture Wire* for daily lead generation" and that "[t]argeting is supplemented by daily lead generation from Fort Wayne" where KPMG's telemarketing center is located.

[and] fostering cross-selling among assurance and tax professionals."[150]

Other tax products explicitly called on KPMG tax professionals to ask their audit counterparts for help in identifying potential clients. For example, a "Middle Market Initiative" launched in 2001, identified seven tax products to be marketed to mid-sized corporations, including SC2. It explicitly called upon KPMG tax professionals to contact KPMG audit partners to identify appropriate mid-sized corporations, and directed these tax professionals to pitch one or more of the seven KPMG tax products to KPMG audit clients. "In order to maximize marketplace opportunities . . . national and area champions will coordinate with and involve assurance partners and managers in their respective areas."[151]

In addition to electronic searches, National Deployment Champions regularly exhorted KPMG field personnel to review their client lists personally to identify those that might be interested in a new product. In the case of SC2, deployment team members asked KPMG tax professionals to review their client lists, not once, but twice:

> "Attached above is a listing of all potential SC2 engagements that did not fly over the past year. In an effort to ensure we have not overlooked any potential engagement during the revenue push for the last half of [fiscal year] 2001, please review the list which is sorted by estimated potential fees. I'd like to revisit each of these potential engagements, and gather comments from each of you regarding the following. . . . Would further communication/dialogue with any listed potential engagement be welcome? What were the reasons for the potential client's declining the strategy?"[152]

In addition to reviewing its own client base, KPMG worked with outside parties, such as banks, law firms, and other accounting firms, to identify outside client prospects. One example is the arrangement KPMG entered into with First Union National Bank, now part of Wachovia Bank, in which Wachovia referred clients to KPMG in connection with FLIP. In this case, Wachovia told wealthy clients about the existence of the tax product and allowed KPMG to set up appointments at the bank or elsewhere to make client presentations on FLIP.[153] KPMG apparently did not pay Wachovia a direct referral fee for these clients, but if a client eventually agreed to purchase FLIP, a portion of the fees paid by the client to Quellos, a investment advisory firm handling the FLIP transactions, was forwarded by Quellos to Wachovia. KPMG also made arrangements for Wachovia client referrals related to BLIPS and SC2, again using First Union National Bank, but it is unclear whether the bank actually made any referrals for these tax prod-

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[150] Presentation dated 3/6/00, "Post-Transaction Integration Service (PTIS)—Tax," by Stan Wiseberg and Michele Zinn of Washington, D.C., Bates XX 001597–1611 ("Global collaborative service brought to market by tax and assurance . . . May be appropriate to initially unbundle the serves ('tax only,' or 'assurance only') to capture an engagement").

[151] Email dated 8/14/01, from Jeff Stein and Walter Duer to "KPMG LLP Partners, Managers and Staff," "Stratecon Middle Market Initiative," Bates KPMG 0050369.

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

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

ucts.[154] In the case of SC2, KPMG also worked with a variety of other outside parties, such as mid-sized accounting firms and automobile dealers, to locate and refer potential clients.[155] A large law firm headquartered in St. Louis expressed willingness not only to issue a confirming tax opinion for the SC2 transaction, but also to introduce KPMG "to some of their midwestern clients." [156]

In addition to reviewing its own client base and seeking client referrals, KPMG used a variety of other means to identify prospective clients. In the case of SC2, for example, as part of its marketing efforts, KPMG obtained lists of S corporations in the states of Texas, North and South Carolina, New York, and Florida.[157] It obtained these lists from either state government, commercial firms, or its own databases. The Florida list, for example, was compiled using KPMG's internal RIA-GoSystem containing confidential client data extracted from certain tax returns prepared by KPMG.[158] Some of the lists had large blocks of S corporations associated with automobile or truck dealers, real estate firms, home builders, or architects.[159] In some instances, KPMG tax professionals instructed KPMG telemarketers to contact the corporations to gauge interest in SC2.[160] In other cases, KPMG tax professionals contacted the corporations personally.

The lists compiled by KPMG produced literally thousands of potential SC2 clients, and through telemarketing and other calls, KPMG personnel made uncounted contacts across the country searching for buyers of SC2. In April 2001, the DPP apparently sent word to SC2 marketing teams to stop using telemarketing calls to find SC2 buyers,[161] but almost as soon as the no-call policy was announced, some KPMG tax professionals were attempting to circumvent the ban asking, for example, if telemarketers could question S corporations about their eligibility and suitability to buy

[154] See, e.g., email dated 8/30/99, from Tom Newman to multiple First Union professionals, "next strategy," Bates SEN 014622 (BLIPS "[f]ees to First Union will be 50 basis points if the investor is not a KPMG client, 25 bps if they are a KPMG client."); email dated 11/30/01, from Councill Leak to Larry Manth, "FW: First Union Customer Services," Bates KPMG 0050842–44 ("I provide my comments on how we are bringing SC2 into certain First Union customers."). Because KPMG is also Wachovia's auditor, questions have arisen as to whether their client referral arrangements violate SEC's auditor independence rules. See Section VI(B)(5) of this Report for more information on the auditor independence issue.

[155] See, e.g., email dated 1/30/01, from David Jones to Larry Manth, Richard Rosenthal, and Wendy Klein, "SC2—Follow-up to 1/29 Revisit," Bates KPMG 0050389 (working to form accounting firm alliances).

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

[157] See, e.g., email dated 8/14/00, from Postmaster-US to unknown recipients, "Action Required: Channel Conflict for SC2," Bates KPMG 0049125 (S corporation list purchased from Dun & Bradstreet); memorandum dated 2/16/01, from Andrew Atkin to SC2 Marketing Group, "Agenda from Feb 16th call and goals for next two weeks," Bates KPMG 0051135 (Texas S corporation list); email dated 3/7/01, from Councill Leak to multiple KPMG tax professionals, "South Florida SC2 Year End Push," Bates KPMG 0050834 (Florida S corporation list); email dated 3/26/01, from Leonard Ronnie III, to Gary Crew, "RE: S-Corp Carolinas," Bates KPMG 0050818 (North and South Carolina S corporation list); email dated 4/22/01, from Thomas Crawford to John Schrier, "RE: SC2 target list," Bates KPMG 0050029 (New York S corporation list).

[158] Email dated 3/6/01, from US-GoSystem Administration to Andrew Atkin of KPMG, "RE: Florida S corporation search," Bates KPMG 0050826. Subcommittee interview of Councill Leak (10/22/03).

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

[160] See, e.g., email dated 6/27/00, from Wendy Klein to Mark Springer and Larry Manth, "SC2: Practice Development Coordinators Involvement," Bates KPMG 0049116; email dated 11/15/00, from Douglas Duncan to Michael Terracina and Gary Choat, "FW: SW SC2 Progress," Bates KPMG 0048315–17.

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

SC2, without scheduling future telephone contacts.[162] In December 2001, after being sent a list of over 3,100 S corporations targeted for telephone calls, a senior KPMG tax professional sent an email to the head of WNT complaining that the list appeared to indicate "the firm is intent on marketing the SC2 strategy to virtually every S corp with a pulse." [163]

When KPMG representatives were first asked about KPMG's use of telemarketers, they initially told the Subcommittee staff that telemarketing calls were against firm policy.[164] When asked about the Indiana cold call center which KPMG has been operating for years, the KPMG representatives said that the center's telemarketers sought to introduce new clients to KPMG in a general way and did little more than arrange an appointment so that KPMG could explain to a potential client in person all of the services KPMG offers. When confronted with evidence of telemarketing calls for SC2, the KPMG representatives acknowledged that a few calls on tax products might have been made by telemarketers at the cold call center, but implied such calls were few in number and rarely led to sales. In a separate interview, when shown documents indicating that, in the case of SC2, KPMG telemarketers made calls to thousands of S corporations across the country, the KPMG tax professional being interviewed admitted these calls had taken place.[165]

Sales Advice. To encourage sales, KPMG would, at times, provide written advice to its tax professionals on how to answer questions about a tax product, respond to objections, or convince a client to buy a product.

For example, in the case of SC2, KPMG sponsored a meeting for KPMG "SC2 Team Members" across the country and emailed documents providing information about the tax product as well as "Appropriate Answers for Frequently Asked Shareholder Questions" and "Suggested Solutions" to "Sticking Points and Problems." [166] The "Sticking Points" document provided the following advice to KPMG tax professionals trying to sell SC2 to prospective clients:

> "*1) 'Too Good to be true.'* Some people believe that if it sounds too good to be true, it's a sham. Some suggestions for this response are the following:
>
> > "a) This transaction has been through KPMG's WNT practice and reviewed by at least 5 specialty groups. . . . Many of the specialists are ex-IRS employees.
> >
> > "b) Many sophisticated clients have implemented the strategy in conjunction with their outside counsel.
> >
> > "c) At least one outside law firm will give a co-opinion on the transactions. . . .

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

[163] Email dated 12/20/01, from William Kelliher to David Brockway, WNT head, Bates KPMG 0013311. A responsive email from Mr. Brockway on the same document states, "It looks like they have already tried over 2/3rds of possible candidates already, if I am reading the spread sheet correctly."

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

[165] Subcommittee interview of Councill Leak (10/22/03).

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

"e) Absolutely last resort—At least 3 insurance companies have stated that they will insure the tax benefits of the transaction for a small premium. This should never be mentioned in an initial meeting and Larry Manth should be consulted for all insurance conversations to ensure consistency and independence on the transaction.

"2) 'I Need to Think About it.' . . . We obviously do not want to seem too desperate but at the same time we need to keep this moving along. Some suggestions:

"a) 'Get Even' Approach. Perhaps a good time to revisit the strategy is at or near estimated tax payment time when the shareholder is making or has made a large estimated tax payment and is extremely irritated for having done so. . . .

"b) Beenie Baby Approach. . . . We call the client and say that the firm has decided to cap the strategy . . . and the cap is quickly filling up. 'Should I put you on the list as a potential?' This is obviously a more aggressive approach, but will tell you if the client is serious about the deal.

"c) 'Break-up' Approach. This is a risky approach and should only be used in a limited number of cases. This approach entails us calling the client and conveying to them that they should no longer consider SC2 for a reason solely related to KPMG, such as the cap has been reached with respect to our city or region or . . . the demand has been so great that the firm is shutting it down. This approach is used as a psychological tool to elicit an immediate response from the client. . . .

"5) John F. Brown Syndrome. This is named after an infamous attorney who could not get comfortable with anything about the strategy. We have had a number of clients with stubborn outside counsel with respect to the strategy itself, the engagement letter, or other aspects of the transaction. Here are some approaches:

"a. If we . . . know he will not approve of the transaction we should tell this to the client and either walk or convince the client not to use the attorney or law firm for this deal. . . .

"c. If the fee is substantial . . . the last resort is to summarize a transaction with all the possible bells and whistles to make the deal as risk-free as possible. For example: The client does SC2 with the following elements: 1) option to reacquire stock from [tax exempt organization], 2) insurance covering the tax benefits plus penalties . . ., and 3) outside opinion from an independent law firm. If the attorney is still uncomfortable, we need to convey this to the client and they can decide."

This document is hardly the work product of a disinterested tax adviser. In fact, it goes so far as to recommend that KPMG tax professionals employ such hard-sell tactics as making misleading statements to their clients—claims that SC2 will be sold to only a limited number of people or that it is no longer being sold at all in order to "elicit an immediate response from the client." The document also depicts attorneys raising technical concerns about SC2 as "stubborn" naysayers who need to be circumvented, rather than satisfied. In short, rather than present KPMG as a disinterested tax adviser, this type of sales advice is evidence of a company intent on convincing an uninterested or hesitant client to buy a product that the client would apparently be otherwise unlikely to purchase or use.

Using Tax Opinions and Insurance as Marketing Tools. Several documents obtained during the investigation demonstrate that KPMG deliberately traded on its reputation as a respected accounting firm and tax expert in selling questionable tax products to corporations and individuals. As described in the prior section on designing new tax products, the former WNT head acknowledged that KPMG's "reputation will be used to market the [BLIPS] transaction. This is a given in these types of deals." In the SC2 "Sticking Points" document, KPMG instructed its tax professionals to respond to client concerns about the product by pointing out that SC2 had been reviewed and approved by five KPMG tax specialty groups and by specialists who are former employees of the IRS.[167]

KPMG also used opinion letters as a marketing tool. Tax opinion letters are intended to provide written advice explaining whether a particular tax product is permissible under the law and, if challenged by the IRS, the likelihood that the tax product would survive court scrutiny. A tax opinion letter provided by a person with a financial stake in the tax product being analyzed has traditionally been accorded much less deference than an opinion letter supplied by a disinterested expert. As shown in the SC2 "Sticking Points" document just cited, if a client raised concerns about purchasing the product, KPMG instructed its tax professionals to respond that, "At least one outside law firm will give a co-opinion on the transactions."[168] In another SC2 document, KPMG advises its tax professionals to tell clients worried about IRS penalties: "The opinion letters that we issue should get you out of any penalties. However, the Service could try to argue that KPMG is the promoter of the strategy and therefore the opinions are biased and try and assert penalties. We believe there is very low risk of this result. If you desire additional assurance, there is at least one outside law firm in NYC that will issue a co-opinion. The cost ranges between $25k–$40k."[169]

KPMG was apparently so convinced that an outside legal opinion increased the marketability of its tax products, that in the case of

[167] "SC2—Meeting Agenda" and attachments, dated June 19, 2000, at Bates KPMG 0013394.

[168] *Id.* Another document identified Bryan Cave, a law firm with over 600 professionals and offices in St. Louis, New York, and elsewhere, as willing "to issue a confirming tax opinion for the SC2 transaction." Memorandum dated 2/16/01, from Andrew Atkin to SC2 Marketing Group, "Agenda from Feb 16th call and goals for the next two weeks," Bates KPMG 0051135. See also email dated 7/19/00, from Robert Coplan of Ernst & Young to "Dickensg@aol.com," Bates 2003EY011939 ("As you know, we go to great lengths to line up a law firm to issue an opinion pursuant to a separate engagement letter from the client that is meant to make the law firm independent from us.")

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

FLIP, it agreed to pay Sidley Austin Brown & Wood a fee in any sale where a prospective buyer was told that the law firm would provide a favorable tax opinion letter, regardless of whether the opinion was actually provided. A KPMG tax professional explained in an email: “Our deal with Brown and Wood is that if their name is used in selling the strategy they will get a fee. We have decided as a firm that B&W opinion should be given in all deals.”[170] This guaranteed fee arrangement also provided an incentive for Sidley Austin Brown & Wood to refer clients to KPMG.

On occasion, KPMG also used insurance as a marketing tool to convince reluctant buyers to purchase a KPMG tax product. In the case of SC2, the “Sticking Points” document advised KPMG tax professionals to tell clients about the existence of an insurance policy that, for a “small premium,” could guarantee SC2’s promised “tax benefits”:

> “At least 3 insurance companies have stated that they will insure the tax benefits of the transaction for a small premium. This should never be mentioned in an initial meeting and Larry Manth should be consulted for all insurance conversations to ensure consistency and independence on the transaction.”[171]

According to KPMG tax professionals interviewed by Subcommittee staff, the insurance companies offering this insurance included AIG and Hartford.[172] KPMG apparently possessed sample insurance policies that promised to reimburse the policy holder for a range of items, including penalties or fines assessed by the IRS for using SC2, essentially insuring the policy holder against being penalized for tax evasion.[173] Once these policies were available, KPMG tax professionals were asked to re-visit potential clients who had declined the tax product and try again:

> “Attached above is a listing of all potential SC2 engagements that did not fly over the past year. . . . We now have a number of Insurance companies which would like to underwrite the tax risk inherent in the transaction. We may want to revisit those potential clients that declined because of audit risk.”[174]

Evidence obtained by the Subcommittee indicates that at least half a dozen SC2 purchasers also purchased SC2 insurance.

Tracking Sales and Revenue. KPMG repeatedly told the Subcommittee staff that it did not have the technical capability to track the sales or revenues associated with particular tax products.[175] However, evidence gathered by the Subcommittee indicates that KPMG could and did obtain specific revenue tracking information.

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[170] “Declaration of Richard E. Bosch,” IRS Revenue Agent, *In re John Doe Summons to Sidley Austin Brown & Wood* (N.D. Ill. 10/16/03) at ¶ 18, citing an email dated 10/1/97, from Gregg Ritchie to Randall Hamilton. (Capitalizations in original omitted.)

[171] “SC2—Meeting Agenda” and attachments, dated June 19, 2000, Bates KPMG 0013375–96.

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

[173] *Id.*

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

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

The Subcommittee learned, for example, that once a tax product was sold to a client and the client signed an engagement letter, KPMG assigned the transaction an "engagement number," and recorded in an electronic database all revenues resulting from that engagement. This engagement data could then be searched and manipulated to provide revenue information and totals for individual tax products.

Specific evidence that revenue information was collected for tax products was obtained by the Subcommittee during the investigation from parties other than KPMG. For example, an SC2 "update" prepared in mid-2001, includes detailed revenue information, including total nationwide revenues produced by the tax product since it was launched, total nationwide revenues produced during the 2001 fiscal year, and FY01 revenues broken down by each of six regions in the United States: [176]

"Revenue since solution was launched:
$20,700,000

"Revenue this fiscal year only:
$10,700,000

"Revenue by Region this Fiscal Year

* West $7,250,000
* Southeast $1,300,000
* Southwest $850,000
* Mid-Atlantic $550,000
* Midwest $425,000
* Northeast $300,000

KPMG never produced this document to the Subcommittee.[177] However, one email related to SC2 that KPMG did produce states that monthly OMS "tracking reports" were used to measure sales results for specific tax products, and these reports were regularly shared with National Deployment Champions, Tax Service Line leaders, and Area Managing Partners.[178]

Moreover, KPMG's Tax Innovation Center reported in 2001, that it had developed new software that "captured solution development costs and revenue" and that it had begun "[p]repar[ing] quarterly Solution Profitability reports." [179] This information suggests that KPMG was refining its revenue tracking capabilities to be able to track not only gross revenues produced by a tax product, but also net revenues, and that it had begun collecting and monitoring this information on a regular basis. KPMG's statement, "the firm does not maintain any systematic, reliable method of recording revenues

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

[177] Another document provided to the Subcommittee by parties other than KPMG carefully traces the increase in the Tax Services Practice's "gross revenue." It shows a "45.5% Cumulative Growth" in gross revenue over a 4-year period, with $829 million in FY98, $1.001 million in FY99, $1.184 million in FY00, and $1.239 million in FY01. See chart entitled, "Tax Practice Growth Gross Revenue," included in a presentation dated 7/19/01, entitled, "Innovative Tax Solutions," by Marsha Peters of Washington National Tax, Bates XX 001340.

[178] Email dated 8/6/00 from Jeffrey Stein to15 National Deployment Champions, Bates KPMG 050016.

[179] Internal KPMG presentation, dated 5/30/01, by the Tax Innovation Center, entitled "Tax Innovation Center Solution and Idea Development—Year-End Results," Bates XX 001490–1502.

by tax product on a national basis,"[180] was contradicted by the evidence.

No Industry Slow-Down. Some members of the U.S. tax profession have asserted that professional firms are beginning to turn away from marketing illegal tax shelters, so there is no need for investigations, reforms, or stronger laws in this area. KPMG has claimed that it is no longer marketing aggressive tax products designed to be sold to multiple clients. The Subcommittee investigation, however, found that, while a few professional firms have reduced or stopped selling generic tax products in the last 2 years, KPMG and other professional firms appear to be committed to continuing and deepening their efforts to develop and market generic, potentially abusive, tax products to multiple clients.

Evidence of KPMG's commitment to ongoing tax product sales appears throughout this Report. For example, KPMG provided the Subcommittee with a 2003 list of more than 500 "active tax products" it intends to offer to multiple clients for a fee. Just last year, in 2002, KPMG established a "Sales Opportunity Center" which the firm itself has characterized as "a powerful demonstration of the Firm's commitment to giving" KPMG professionals ready access to marketing tools to sell products and services to multiple clients. Also in 2002, the Tax Innovation Center helped develop new software to enable KPMG to track tax product development costs and net revenues, and issue quarterly tax product profitability reports. In 2003, KPMG's telemarketing center in Indiana continued to be staffed and ready for tax product marketing assistance.

Evidence of marketing campaigns shows KPMG sought to expand its tax product sales by targeting new market segments. In August 2001, for example, KPMG launched a "Middle Market Initiative" to increase its tax product sales to mid-sized corporations:

> "Consistent with several other firm initiatives . . . we are launching a major initiative in Tax to focus certain of our resources on the Middle Market. A major step in this initiative is driving certain Stratecon high-end solutions to these companies . . . through a structured, proactive program. . . . National and area champions of this initiative will meet with leadership . . . to discuss solutions, agree on appropriate targets, and develop an area strategy. . . . In order to maximize marketplace opportunities . . . national and area champions will coordinate with and involve assurance partners and managers in their respective areas. . . . [C]hampions will also coordinate with the tax practice's proposed strategic alliance with mid-tier accounting firms. The goal for Stratecon is to close and implement engagements totaling $15 M in revenues over the next 15 month period (FY ending 9/02)."[181]

The Middle Market Initiative identified seven KPMG tax products to be marketed to mid-sized corporations, including SC2. It explicitly called upon KPMG tax professionals to contact KPMG audit

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

[181] Email dated 8/14/01, from Jeff Stein and Walter Duer to "KPMG LLP Partners, Managers and Staff," "Stratecon Middle Market Initiative," Bates KPMG 0050369.

partners to identify appropriate mid-sized corporations, and then to pitch one or more of the seven KPMG tax products to KPMG audit clients. It is the Subcommittee staff's understanding that this marketing campaign is ongoing and successfully increasing KPMG tax product sales to mid-sized corporations across the United States.[182]

In December 2001, KPMG held a "FY02 Tax Strategy Meeting," to discuss "taking market leadership" in 2002. One email described the meeting as follows:

> "Thank you for attending the FY02 Tax Strategy Meeting. It's now time to take action. As you enter the marketplace armed with the knowledge of 'Taking Market Leadership,' please remember to share your thoughts and experiences with us so we can better leverage the three key market pillars—Market Share, Client Centricity, and Market-Driven Solutions. . . .
>
> "[W]e want to hear more about:
>
> * Teaming with Assurance; . . .
> * How clients are responding to our services and solutions;
> * Ideas for new services and solutions; and
> * Best practices." [183]

Additional evidence of KPMG's continued involvement in the marketing of generic tax products comes from the chart prepared by KPMG, at the Subcommittee's request, listing its top ten revenue producing tax products in 2000, 2001, and 2002.[184] The list of ten tax products for 2002 includes, among others, the "Tax-Efficient Minority Preferred Equity Sale Transaction" (TEMPEST) and the "Optional Tax-Deductible Hybrid Equity while Limiting Local Obligation" (OTHELLO).[185] Another KPMG chart, listing Strat econ's tax products as of January 1, 2002, describes TEMPEST as a product that "creates capital loss," [186] while OTHELLO "[c]reates a basis step-up in built-in gain asset and potential for double benefit of built-in losses." [187] The minimum fee KPMG intends to charge clients for each of these products, TEMPEST and OTHELLO, is $1 million.[188] KPMG has also indicated that each of the tax products listed on the Stratecon chart remained an "active tax product" as of February 10, 2003.[189]

A final example of evidence of KPMG's ongoing commitment to selling generic tax products is a draft business plan for fiscal year 2002, prepared for the Personal Financial Planning (PFP) tax prac-

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[182] Subcommittee interview of Jeffrey Stein (10/31/03).

[183] Email dated 12/12/01, from Dale Affonso to "Tax Personnel—LA & PSW," Bates XX 001733.

[184] KPMG chart entitled, "Good Faith Estimate of Top Revenue-Generating Strategies," attached to letter dated 4/22/03, from KPMG's legal counsel to the Subcommittee, Bates KPMG 0001801.

[185] *Id.*

[186] KPMG chart entitled "StrateconWest/FSG Solutions and Solution WIP—As of January 1, 2002," Bates XX 001009–25.

[187] *Id.* at 2.

[188] *Id.* at 2 and 4.

[189] See undated document provided by KPMG to the Subcommittee on 2/10/03, "describing all active tax products included in Tax Products Alerts, Tax Solutions Alerts and Tax Service Ideas," Bates KPMG 0000089–90.

tice's Innovative Strategies (IS) group.[190] This business plan indicates that, while the IS group's marketing efforts had decreased after IRS issuance of new tax shelter notices, it had done all the preparatory work needed to resume vigorous marketing of new, potentially abusive tax shelters in 2002. The IS business plan first recounts the group's past work on FLIP, OPIS, and BLIPS, noting that the millions of dollars in revenue produced from sales of these tax products had enabled IS to exceed its annual revenue goals in each year from 1998 until 2000. The business plan then states:

> "The fiscal [2001] IS revenue goal was $38 million and the practice has delivered $16 million through period 10. The shortfall from plan is primarily attributable to the August 2000 issuance [by the IRS] of Notice 2000–44. This Notice specifically described both the retired BLIPS strategy and the then current [replacement, the Short Option Strategy or] SOS strategy. Accordingly, we made the business decisions to stop the implementation of 'sold' SOS transactions and to stay out of the 'loss generator' business for an appropriate period of time."

The business plan then identified six tax products which had been approved for sale or were awaiting approval, and which were "expected to generate $27 million of revenue in fiscal '02." [191] Two of these strategies, called "Leveraged Private Split Dollar" and "Monetization Tax Advisory Services," were not explained, but were projected to generate $5 million in 2002 fees each.[192] Another tax product, under development and projected to generate $12 million in 2002 fees, is described as:

> "a gain mitigation solution, POPS. Judging from the Firm's historic success in generating revenue from this type of solution, a significant market opportunity obviously exists. We have completed the solution's technical review and have almost finalized the rationale for not registering POPS as a tax shelter." [193]

Still another tax product, under development and projected to generate $5 million in 2002 fees, is described as a "conversion transaction . . . that halves the taxpayer's effective tax rate by effectively converting ordinary income to long term capital gain. . . . The most significant open issue is tax shelter registration and the impact registration will have on the solution." The business plan estimates that, if the projected sales occur, "the planned revenue per [IS] partner would be $3 million and the planned contribution per partner would equal or exceed $1.5 million."

The business plan provides this analysis:

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[190] Document dated 5/18/01, "PFP Practice Reorganization Innovative Strategies Business Plan—DRAFT," Bates KPMG 0050620–23, at 1. This document was authored by Jeffrey Eischeid, according to Mr. Eischeid. Subcommittee interview of Jeffrey Eischeid (11/3/03).

[191] *Id.* at 3.

[192] *Id.* But see minutes dated 11/30/00, Monetization Solutions Task Force Teleconference, Bates KPMG 0050624–29, at 50627 (advocating KPMG design and implementation of "sophisticated entity structures that have elements of both financial product technology and tax technology," including "monetization solutions that have been traditionally offered by the investment banks" such as "prepaid forwards, puts and calls, short sales, synthetic OID conveyances, and other derivative structures.")

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

"[T]here has been a significant increase in the regulation of 'tax shelters.' Not only is this regulatory activity dampening market appetite, it is changing the structural nature of the underlying strategies. Specifically, taxpayers are having to put more money at risk for a longer period of time in order to improve the business purpose economic substance arguments. All things considered, it is more difficult today to close tax advantaged transactions. Nevertheless, we believe that the Innovative Strategies practice is a sustainable business opportunity with significant growth opportunity." [194]

This and other evidence obtained by the Subcommittee during the past year indicate an ongoing, internal effort within KPMG to continue the development and sale of generic tax products to multiple clients.

(3) Implementing Tax Products

(a) KPMG's Implementation Role

Finding: KPMG is actively involved in implementing the tax shelters which it sells to its clients, including by enlisting participation from banks, investment advisory firms, and tax exempt organizations; preparing transactional documents; arranging purported loans; issuing and arranging opinion letters; providing administrative services; and preparing tax returns.

In many cases, KPMG's involvement with a tax product sold to a client does not end with the sale itself. Many KPMG tax products, including the four examined by the Subcommittee, require the purchaser to carry out complex financial and investment activities in order to realize promised tax benefits. KPMG typically provided such clients with significant implementation assistance to ensure they realized the promised tax benefits on their tax returns. KPMG was also interested in successful implementation of its tax products, because the track record that built up over time for a particular product affected how KPMG could, in good faith, characterize that product to new clients. Implementation problems have also, at times, caused KPMG to adjust how a tax product is structured and even spurred development of a new product.

Executing FLIP, OPIS, and BLIPS. FLIP, OPIS, and BLIPS required the purchaser to establish a shell corporation, join a partnership, obtain a multi-million dollar loan, and engage in a series of complex financial and investment transactions that had to be carried out in a certain order and in a certain way to realize tax benefits. The evidence collected by the Subcommittee shows that KPMG was heavily involved in making sure the client transactions were completed properly.

As a first step, KPMG enlisted the participation of professional organizations to help design its products and carry them out. In the case of FLIP, which was the first of the four tax products to be developed, KPMG sought the assistance of investment experts

[194] *Id.* at 2.

at a small firm called Quellos to design the complex series of financial transactions called for by the product.[195] Quellos, using contacts it had established in other business dealings, helped KPMG convince a major bank, UBS AG, to provide financing and participate in the FLIP transactions. Quellos worked with UBS to fine-tune the financial transactions, helped KPMG make client presentations about FLIP and, for those who purchased the product, helped complete the paperwork and transactions, using Quellos securities brokers. KPMG also enlisted help from Wachovia Bank, convincing the bank to refer bank clients who might be interested in the FLIP tax product.[196] In some cases, the bank permitted KPMG and Quellos to make FLIP presentations to its clients in the bank's offices.[197] KPMG also enlisted Sidley Austin Brown & Wood to issue a favorable legal opinion letter on the FLIP tax product.[198]

In the case of OPIS and BLIPS, KPMG, again, enlisted the help of Sidley Austin Brown & Wood, but used a different investment advisory firm. Instead of Quellos, KPMG obtained investment advice from Presidio Advisory Services. Presidio was formed in 1997, by two former KPMG tax professionals, one of whom was a key participant in the development and marketing of FLIP.[199] These two tax professionals left the accounting firm, because they wanted to focus on the investment side of the generic tax products being developed by KPMG.[200] Unlike Quellos, which had substantial investment projects aside from FLIP, virtually all of Presidio's work over the following 5 years derived from KPMG tax products. Presidio's principals worked closely with KPMG tax professionals to design OPIS and BLIPS. Presidio's principals also helped KPMG obtain lending and securities services from three major banks, Deutsche Bank, HVB, and NatWest, to complete OPIS and BLIPS transactions.

In addition to enlisting the participation of legal, investment, and financial professionals, KPMG provided significant administrative support for the FLIP, OPIS, and BLIPS transactions, using KPMG personnel to help draft and prepare transactional documents, and assist the investment advisory firms and the banks with paperwork. For example, when a number of loans were due to be closed in certain BLIPS transactions, two KPMG staffers were stationed at HVB to assist the bank with closing and booking

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

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

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

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

[199] The two former KPMG tax professionals are John Larson and Robert Pfaff. They also formed numerous other companies, many of them shells, to participate in business dealings including, in some cases, OPIS and BLIPS transactions. These related companies include Presidio Advisors, Presidio Growth, Presidio Resources, Presidio Volatility Management, Presidio Financial Group, Hayes Street Management, Holland Park, Prevad, Inc., and Norwood Holdings (collectively referred to as "Presidio").

[200] Subcommittee interview of John Larson (10/21/03); email dated 7/29/97, from Larry DeLap to multiple KPMG tax professionals, "Revised Memorandum," Bates KPMG JAC 331160, forwarding memorandum dated 7/29/97, from Bob Pfaff to John Lanning, Jeff Stein and others, "My Thoughts Concerning KPMG's Tax Advantaged Transaction Practice, Presidio's Relationship with KPMG, Transition Issues."

issues.[201] Other KPMG employees were assigned to Presidio to assist in expediting BLIPS transactions and paperwork. KPMG also worked with Quellos, Presidio, and the relevant banks to ensure that the banks established large enough credit lines, with hundreds of millions of dollars, to allow a substantial number of individuals to carry out FLIP, OPIS, and BLIPS transactions.

When asked about KPMG's communications with the banks, the OPIS and BLIPS National Deployment Champion initially denied ever contacting bank personnel directly, claiming instead to have relied on Quellos and Presidio personnel to work directly with the bank personnel.[202] When confronted with documentary evidence of direct contacts, however, the Deployment Champion reluctantly admitted communicating on rare occasions with bank personnel. Evidence obtained by the Subcommittee, however, shows that KPMG communications with bank personnel were not rare. KPMG negotiated intensively with the banks over the factual representations that would be attributed to the banks in the KPMG opinion letters. On occasion, KPMG stationed its personnel at the banks to facilitate transactions and paperwork. The BLIPS National Deployment Champion met with NatWest personnel regarding the BLIPS transactions. In one instance in 2000, documents indicate that, when clients had exhausted the available credit at Deutsche Bank to conduct OPIS transactions, the Deployment Champion planned to meet with senior Deutsche Bank officials about increasing the credit lines so that more OPIS products could be sold.[203]

Executing SC2. In the case of SC2, the tax product could not be executed at all without a charitable organization willing to participate in the required transactions. KPMG took on the task of locating and convincing appropriate charities to participate in SC2 transactions. The difficulty of this task was evident in several KPMG documents. For example, one SC2 document warned KPMG personnel not to look for a specific charity to participate in a specific SC2 transaction until after an engagement letter was signed with a client because: "It is difficult to find qualifying tax exempts. . . . [O]f those that qualify only a few end up being interested and only a few of those will accept donations. . . . We need to be able to go to the tax-exempt with what we are going to give them to get them interested."[204] In another email, the SC2 National Deployment Champion wrote:

> "Currently we have five or six tax exempts that have reviewed the transaction, are comfortable they are not subject to UBIT [unrelated business income tax] and are eager to receive gifts of S Corp stock. These organizations are well established, solid organizations, but generally aren't

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

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

[203] See, e.g., memorandum dated 8/5/98, from Doug Ammerman to "PFP Partners," "OPIS and Other Innovative Strategies," Bates KPMG 0026141–43 at 2; email dated 5/13/99, sent by Barbara Mcconnachie but attributed to Doug Ammerman, to John Lanning and other KPMG tax professionals, "FW: BLIPS," Bates KPMG 0011903 ("Jeff Eischeid will be attending a meeting . . . to address the issue of expanding capacity at Deutsche Bank given our expectation regarding the substantial volume expected from this product.") It is unclear whether this meeting actually took place.

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

> organizations our clients and targets have made gifts to in the past. This point hit painfully home when, just before signing our engagement letter for an SC2 transaction with a $3 million fee, an Atlanta target got cold feet."[205]

KPMG refused to identify to the Subcommittee any of the charities it contacted about SC2 or any of the handful of charities that actually participated in SC2 stock donations, claiming this was "tax return information" that it could not disclose. The Subcommittee was nevertheless able to identify and interview two charitable organizations which, between them, participated in more than half of the 58 SC2 transactions KPMG arranged.[206]

Both charities interviewed by Subcommittee staff indicated that they first learned of SC2 when contacted by KPMG personnel. Both used the same phrase, that KPMG had contacted them "out of the blue."[207] Both charities indicated that KPMG personnel explained SC2 to them, convinced them to participate, introduced the potential SC2 donors to the charity, and supplied draft transactional documents. Both charities indicated that, with KPMG acting as a liaison, they then accepted S corporation stock donations from out-of-state residents whom they never met and with whom they had never had any prior contact.

KPMG also distributed to its personnel a document entitled, "SC2 Implementation Process," listing a host of implementation tasks they should complete in each transaction. These tasks included technical, administrative, and logistical chores. For example, KPMG personnel were told they should evaluate the S corporation's ownership structure and incorporation documentation; work with an outside valuation firm to determine the corporation's enterprise value and the value of the corporate stock and warrants; and physically deliver the appropriate stock certificates to the charity accepting the client's stock donation.[208]

Both charities said that KPMG often acted as a go-between for the charity and the corporate donor, shuttling documents back and forth and answering inquiries on both sides. KPMG apparently also drafted and supplied draft transactional documents to the S corporations and corporate owners.[209] One of the pension funds informed the Subcommittee staff that, when one corporate donor needed to re-take possession of the corporate stock due to an unrelated business opportunity that required use of the stock, KPMG assisted in the mechanics of selling the stock back to the donor.[210]

The documentation shows that KPMG tax professionals also expended significant effort developing a "back-end deal" for SC2 donors, meaning a tax transaction that could be used by the S corporation owner to further reduce or eliminate their tax liability when they retake control of the S corporation and distribute some

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[205] Email dated 2/22/01, from Councill Leak to multiple KPMG tax professionals, "SC2 Solution—New Development," Bates KPMG 0050822.

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

[207] *Id.*

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

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

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

or all of the income that built up within the company while the charity was a shareholder. The SC2 National Deployment Champion wrote to more than 20 of his colleagues working on SC2 the following:

> "Our estimate is that by 12/31/02, there will be approximately $1 billion of income generated by S-corps that have implemented this strategy, and our goal is to maintain the confidentiality of the strategy for as long as possible to protect these clients (and new clients). . . .
>
> "We have had our first redemption from the LAPD. Particular thanks to [a KPMG tax professional] and his outstanding relationship with the LAPD fund administrators, the redemption went smooth. [Three KPMG tax professionals] all worked together on structuring the back-end deal allowing for the shareholder to recognize a significant benefit, as well as getting KPMG a fee of approx. $1 million, double the original SC2 fee!!
>
> "[Another KPMG tax professional] is in the process of working on a back-end solution to be approved by WNT that will provide S-corp shareholders additional basis in their stock which will allow for the cash build-up inside of the S-corporation to be distributed tax-free to the shareholders. This should provide us with an additional revenue stream and a captive audience. Our estimate is that if 50% of the SC2 clients implement the back-end solution, potential fees will approximate $25 million." [211]

This email communication shows that the key KPMG tax professionals involved with SC2 viewed the strategy as a way to defer and reduce taxes on substantial corporate income that was always intended to be returned to the control of the stock donor. It also shows that KPMG's implementation efforts on SC2 continued long past the sale of the tax product to a client.

Preparing KPMG Opinion Letters. In addition to helping clients complete the transactions called for in FLIP, OPIS, BLIPS, and SC2, when it came time for clients to submit tax returns at the end of the year or in subsequent years, KPMG was available to help its clients prepare their returns. In addition, whether a client's tax return was prepared by KPMG or someone else, KPMG supplied the client with a tax opinion letter explaining the tax benefits that the product provided and could be reflected in the client's tax return. In three of the cases examined by the Subcommittee, KPMG also arranged for its clients to obtain a second favorable opinion letter from an outside law firm. In the fourth case, SC2, KPMG knew of law firms willing to issue a second opinion letter, but it is unclear whether any were actually issued.

A tax opinion letter, sometimes called a legal opinion letter when issued by a law firm, is intended to provide written advice to a client on whether a particular tax product is permissible under the law and, if challenged by the IRS, how likely it would be that the

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[211] Email dated 12/27/01, from Larry Manth to Andrew Atkin and other KPMG tax professionals, "SC2," Bates KPMG 0048773. See also email dated 8/18/01, from Larry Manth to multiple KPMG tax professionals, "RE: New Solutions—WNT," Bates KPMG 0026894.

challenged product would survive court scrutiny. The Subcommittee investigation uncovered disturbing evidence related to how opinion letters were being developed and used in connection with KPMG's tax products.

The first issue involves the accuracy and reliability of the factual representations that were included in the opinion letters supporting KPMG's tax products. In the four case histories, KPMG tax professionals expended extensive effort drafting a prototype tax opinion letter to serve as a template for the opinion letters actually sent by KPMG to its clients. One key step in the drafting process was the drafting of factual representations attributed to parties participating in the relevant transactions. Such factual representations play a critical role in the opinion letter by laying a factual foundation for its analysis and conclusions. Treasury regulations state:

> "The advice [in an opinion letter] must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner." [212]

KPMG stated in its opinion letters that its analysis relied on the factual representations provided by the client and other key parties. In the BLIPS prototype tax opinion, for example, KPMG stated that its "opinion and supporting analysis are based upon the following description of the facts and representations associated with the investment transactions undertaken by Investor." [213] The Subcommittee was told that Sidley Austin Brown & Wood relied on the same factual representations to compose the legal opinion letters that it drafted.

Virtually all of the FLIP, OPIS, and BLIPS opinion letters contained boilerplate repetitions of the factual representations attributed to the participating parties. For example, virtually all the KPMG FLIP clients made the same factual representations, worded in the same way. The same was true for KPMG's OPIS clients and for KPMG's BLIPS clients. Each of the banks that participated in BLIPS made factual representations that varied slightly from bank to bank, but did not vary at all for a particular bank. In other words, Deutsche Bank and HVB attested to slightly different versions of the factual representations attributed to the bank participating in the BLIPS transactions, but every BLIPS opinion letter that, for example, referred to Deutsche Bank, contained the exact same boilerplate language to which Deutsche Bank had agreed to attest.

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

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

The evidence is clear that KPMG took the lead in drafting the factual representations attributed to other parties, including the client or "investor" who purchased the tax product, the investment advisory firm that participated in the transactions, and the bank that provided the financing. In the case of the factual representations attributed to the investment advisory firm or bank, the evidence indicates that KPMG presented its draft language to the relevant party and then engaged in detailed negotiations over the final wording.[214] In the case of the factual representations attributed to a client, however, the evidence indicates KPMG did not consult with its client beforehand, even for representations purporting to describe, in a factual way, the client's intentions, motivations, or understanding of the tax product. KPMG alone, apparently without any client input, wrote the client's representations and then demanded that each client attest to them by returning a signed letter to the accounting firm.

The evidence indicates that KPMG not only failed to consult with its clients before attributing factual representations to them, it also refused to allow its clients to deviate from the KPMG-drafted representations, even when clients disagreed with the statements being attributed to them. For example, according to a court complaint filed by one KPMG client, Joseph Jacoboni, he initially refused to attest to the factual representations sent to him by KPMG about a FLIP transaction, because he had no first hand knowledge of the "facts" and did not understand the FLIP transaction.[215] According to Mr. Jacoboni, KPMG would not alter the client representations in any way and would not supply him with any opinion letter until he attested to the specific factual representations attributed to him by KPMG. After a standoff lasting nearly 2 months, with the deadline for his tax return fast approaching, Mr. Jacoboni finally signed the representation letter attesting to the statements KPMG had drafted.[216]

Equally disturbing is that some of the key factual representations KPMG attributed to its clients appear to contain false or misleading statements. For example, in the BLIPS prototype letter, KPMG wrote: "Investor has represented to KPMG . . . [that the] Investor independently reviewed the economics underlying the [BLIPS] Investment Fund before entering into the program and believed there was a reasonable opportunity to earn a reasonable pre-tax profit from the transactions."[217] The existence of a client profit motive and the existence of a reasonable opportunity to earn a reasonable pre-tax profit are central factors in determining whether a tax product like BLIPS has a business purpose and economic sub-

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

[215] *Jacoboni v. KPMG,* Case No. 6:02–CV–510 (M.D. Fla. 4/29/02) Complaint at ¶¶ 16–17 ("[I]t seemed ridiculous to ask Mr. Jacoboni to sign the Representation Letter, which neither he [Mr. Jacoboni's legal counsel] nor Mr. Jacoboni understood. Moreover, Mr. Jacoboni had no personal knowledge of the factual representations in the letter and could *not* verify the facts as KPMG requested." Emphasis in original.); Subcommittee interview of Mr. Jacoboni's legal counsel (4/4/03).

[216] *Id.* at ¶¶ 18–19. Mr. Jacaboni also alleges that, despite finally signing the letter, he never received the promised tax opinion letter from KPMG.

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

stance apart from its tax benefits. It is the Subcommittee's understanding that this client representation was repeated substantially verbatim in every BLIPS tax opinion letter KPMG issued.

The first stumbling block is the notion that every client who purchased BLIPS "independently" reviewed its "economics" beforehand, and "believed" there was a reasonable opportunity to make a reasonable profit. BLIPS was an enormously complicated transaction, with layers of structured finance, a complex loan, and intricate foreign currency trades. A technical analysis of its "economics" was likely beyond the capability of most of the BLIPS purchasers. In addition, KPMG knew there was only a remote possibility—not a reasonable possibility—of a client's earning a profit in BLIPS.[218] Nevertheless, since the existence of a reasonable opportunity to earn a reasonable profit was critical to BLIPS' having economic substance, KPMG included that questionable client representation in its BLIPS tax opinion letter.[219]

BLIPS was constructed so that the potential for client profit from the BLIPS transactions increased significantly if the client participated in all three phases of the BLIPS loan, which required a full 7 years to finish. The head of DPP-Tax observed that KPMG had drafted a factual representation for inclusion in the prototype BLIPS tax opinion letter stating that, "The original intent of the parties was to participate in all three investment stages of the Investment Program." He cautioned against including this factual representation in the opinion letter: "It seems to me that this [is] a critical element of the entire analysis and should not be blithely assumed as a 'fact.' . . . I would caution that if there were, say, 50 separate investors and all 50 bailed out at the completion of Stage I, such a representation would not seem credible."[220]

The proposed representation was not included in the final version of the BLIPS prototype opinion letter, and the actual BLIPS track record supported the cautionary words of the DPP head. In 2000, the KPMG tax partner in charge of WNT wrote:

> "Lastly, an issue that I am somewhat reluctant to raise but I believe is very important going forward concerns the representations that we are relying on in order to render our tax opinion in BLIPS I. In each of the 66 or more deals that were done at last year, our clients represented that they 'independently' reviewed the economics of the transaction and had a reasonable opportunity to earn a pretax profit. . . . As I understand the facts, all 66 closed out by year-end and triggered the tax loss. Thus, while I continue to believe that we can issue the tax opinions on the BLIPS

[218] See email dated 5/4/99, from Mark Watson, WNT, to Larry DeLap, DPP, Bates KPMG 0011916 (Quoting Presidio investment experts who set up the BLIPS transactions, KPMG tax expert states: "the probability of actually making a profit from this transaction is remote (possible, but remote).").

[219] KPMG required the investment advisory firm, Presidio, to make this same factual representation, even though Presidio had informed KPMG personnel that "the probability of actually making a profit from this transaction is remote (possible, but remote)." The evidence indicates that both KPMG and Presidio knew there was only a remote possibility—not a reasonable possibility—of a client's earning a profit in the BLIPS transaction, yet both continued to issue and stand behind an opinion letter attesting to what both knew was an inaccurate factual representation.

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

I deals, the issue going forward is can we continue to rely on the representations in any subsequent deals if we go down that road? . . . My recommendation is that we deliver the tax opinions in BLIPS I and close the book on BLIPS and spend our best efforts on alternative transactions."[221]

This email and other documentation indicate that KPMG was well aware that the BLIPS transactions were of limited duration and uniformly produced substantial tax losses that "investors" used to offset and shelter other income from taxation.[222] This growing factual record, showing that BLIPS investors invariably lost money, made it increasingly difficult for KPMG to rely on an alleged client representation about BLIPS' having a reasonable profit potential. KPMG nevertheless continued to sell the product and to issue tax opinion letters relying on a critical client representation that KPMG had drafted without client input and attributed to its clients, but which KPMG knew or had reason to know, was unsupported by the facts.

Discontinuing Sales. Still another KPMG implementation issue involves decisions by KPMG to stop selling particular tax products. In all four of the case studies examined by the Subcommittee, KPMG stopped marketing the tax product within 1 or 2 years of its first sale.[223] The decision was made in each case by the head of DPP-Tax, after consultation with the product's Deployment Champion and other senior tax professionals.

When asked to explain why sales were discontinued, the DPP head offered several reasons for pulling a tax product off the market.[224] The DPP head stated that he sometimes ended the marketing of a tax product out of concern that a judge would invalidate the tax product "as a step transaction," using evidence that a number of persons who purchased the product engaged in a series of similar transactions.[225] Limiting the number of tax products sold limited the evidence that each resulted in a similar set of transactions orchestrated by KPMG. Limiting the number of tax products sold also limited information about them to a small circle and made it more difficult for the IRS to detect the activity.[226]

Evidence in the four case studies shows that internal KPMG directives to stop sales of a particular tax product were, at times, ignored or circumvented by KPMG tax professionals marketing the products. For example, the DPP head announced an end to BLIPS sales in the fall of 1999, but allowed KPMG tax professionals to complete numerous BLIPS sales in 1999 and 2000, to persons who

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

[222] Email dated 5/4/99, from Mark Watson, WNT, to Larry DeLap, DPP, Bates KPMG 0011916. See also document dated 5/18/01, "PFP Practice Reorganization Innovative Strategies Business Plan—DRAFT," authored by Jeffrey Eischeid, Bates KPMG 0050620–23, at 1–2 (referring to BLIPS and its predecessors, FLIP and OPIS, as a "capital loss strategy," "loss generator" or "gain mitigation solution").

[223] See, e.g., email dated 12/29/01, from Larry DeLap to multiple KPMG tax professionals, "FW: SC2," Bates KPMG 0050562 (discontinuing SC2); email dated 10/1/99, from Larry DeLap to multiple KPMG tax professionals, "BLIPS," Bates KPMG 0011716 (discontinuing BLIPS); email dated 12/7/98, from Larry DeLap to multiple KPMG tax professionals, "OPIS," Bates KPMG 0025730 (discontinuing OPIS).

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

[225] *Id.*

[226] See Section VI(B)(4) of this Report on "Avoiding Detection."

had been approached before the marketing ban was announced.[227] These purchasers were referred to internally at KPMG as "grandfathered BLIPS" clients.[228] A handful of additional sales took place in 2000, over the objection of the DPP head, after his objection was overruled by head of the Tax Services Practice.[229] Also in 2000, some KPMG tax professionals attempted to restart BLIPS sales by developing a modified BLIPS product that would be sold to only extremely wealthy individuals.[230] This effort was ultimately unsuccessful in restarting BLIPS sales.

In the case of SC2, KPMG tax professionals simply did not comply with announced limits on the total number of SC2 products that could be sold or limits on the use of telemarketing calls to market the product.[231] In the case of FLIP and OPIS, additional sales, again, took place after the DPP head had announced an end to the marketing of the products.[232] The DPP head told Subcommittee staff that when he discontinued BLIPS sales in 1999, he was pressed by the BLIPS National Deployment Champion and others for an alternative product.[233] The DPP head indicated that, because of this pressure, he relented and allowed KPMG tax professionals to resume sales of OPIS, which he had halted a year earlier.

(b) Role of Third Parties in Implementing KPMG Tax Products

FLIP, OPIS, BLIPS, and SC2 could not have been executed without the active and willing participation of the banks, investment advisors, lawyers, and charitable organizations that made these products work. The roll call of respected professional firms with direct and extensive involvement in the four KPMG case studies includes Deutsche Bank, HVB, NatWest, UBS, Wachovia Bank, and Sidley Austin, Brown & Wood. Smaller professional firms such as Quellos, and charitable organizations such as the Los Angeles Department of Fire & Police Pensions and the Austin Fire Fighters Relief and Retirement Fund, while less well known nationally, are nevertheless respected institutions who played critical roles in the execution of at least one of the four tax products.

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[227] See, e.g., email dated 10/13/99, from Carl Hasting to Dale Baumann, "RE: Year 2000 Blips Transactions," Bates KPMG 0006485 ("I thought we were told to quit marketing 200[0] BLIPS transactions."); email dated 10/13/99, from Dale Baumann to Carl Hasting and others, "RE: Year 2000 Blips Transactions," Bates KPMG 0006485 ("No marketing to clients who were not on the BLIPS 2000 list. The BLIPS 2000 list were for those individuals who we approached before Larry told us to stop marketing the strategy. . . .").

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

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

[230] See, e.g., email dated 6/20/00, from William Boyle of Deutsche Bank to other Deutsche Bank personnel, "Updated Presidio/KPMG trades," Bates DB BLIPS 03280 ("Presidio and KPMG are developing an expanded version of BLIP's which it will execute on a limited basis for its wealthy clientele. They anticipate executing approximately 10–15 deals of significant size (i.e. in the $100–300m. Range).").

[231] See Section VI(B)(2) of this Report on "Mass Marketing Tax Products." See also, e.g., email dated 4/23/01, from John Schrier to Thomas Crawford, "RE: SC2 target list," Bates KPMG 0050029; email dated 12/20/01, from William Kelliher to David Brockway, "FW: SC2," Bates KPMG 0013311; and email response dated 12/29/01, from Larry DeLap to William Kelliher, David Brockway, and others, "FW: SC2," Bates KPMG 0013311.

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

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

Finding: Some major banks and investment advisory firms have provided critical lending or investment services or participated as essential counter parties in potentially abusive or illegal tax shelters sold by KPMG, in return for substantial fees or profits.

The Role of the Banks. Five major banks participated in BLIPS, FLIP, and OPIS. Deutsche Bank participated in more than 50 BLIPS transactions in 1999 and 2000, providing credit lines that totaled as much as $2.8 billion.[234] Deutsche Bank also participated in about 60 OPIS transactions in 1998 and 1999. HVB participated in more than 30 BLIPS transactions in 1999 and 2000, providing BLIPS credit lines that apparently totaled nearly $2.5 billion.[235] NatWest apparently also participated in a significant number of BLIPS transactions in 1999 and 2000, providing credit lines totaling more than $1 billion.[236] UBS AG participated in 100–150 FLIP and OPIS transactions in 1997 and 1998, providing credit lines which, in the aggregate, were in the range of several billion Swiss francs.[237]

Two investment advisory firms also participated in the development, marketing and implementation of BLIPS, FLIP, and OPIS. Quellos participated in the development, marketing, and execution of FLIP. It participated in over 80 FLIP transactions with KPMG, as well as similar number of these transactions with PricewaterhouseCoopers and Wachovia Bank. It also executed some OPIS transactions for KPMG. Presidio participated in the development, marketing, and implementation of OPIS and BLIPS transactions, including the 186 BLIPS transactions related to 186 KPMG clients.[238] The Presidio principals even conducted a BLIPS transaction on their own behalf.[239]

[234] See, e.g., email dated 6/20/00, from William Boyle of Deutsche Bank to other Deutsche Bank personnel, "Updated Presidio/KPMG trades," Bates DB BLIPS 03280; chart entitled, "Presidio Advisory Services. Deal List 1999," Bates HVB000875 (BLIPS transactions for 1999); chart entitled, "Presidio Advisory Services. Deal List 2000," Bates HVCD00018–19 (BLIPS transactions for 2000).

[235] See, e.g., memorandum dated 8/19/03 (this date is likely in error), from Ted Wolf and Sylvie DeMetrio to Christopher Thorpe and others, "Presidio," Bates HVCD 00001; chart entitled, "Presidio Advisory Services. Deal List 1999," Bates HVB000875 (BLIPS transactions for 1999); chart entitled, "Presidio Advisory Services. Deal List 2000," Bates HVCD00018–19 (BLIPS transactions for 2000). See also credit request dated 1/6/00, Bates HVB 003320–30 (seeking approval of $1.5 billion credit line for 2000, and noting that, in 1999, the bank "booked USD 950 million (out of USD 1.03 billion approved) . . . all cash collateralized.")

[236] See, e.g., email dated 6/20/00, from William Boyle of Deutsche Bank to other Deutsche Bank personnel, "Updated Presidio/KPMG trades," Bates DB BLIPS 03280.

[237] See, e.g., UBS memorandum dated 12/21/99, from Teri Kemmerer Sallwasser to Gail Fagan, "Boss Strategy Meetings . . .," Bates SEN–018253–57; Subcommittee interview of UBS representatives (4/4/03).

[238] See, e.g., email dated 3/14/98, from Jeff Stein to Robert Wells, John Lanning, Larry DeLap, Gregg Ritchie, and others, "Simon Says," Bates 638010, filed by the IRS on June 16, 2003, as an attachment to Respondent's Requests for Admission, *Schneider Interests v. Commissioner,* U.S. Tax Court, Docket No. 200–02, (describing the role of Presidio principal, Robert Pfaff, in the development of OPIS); Subcommittee interviews of John Larson (10/3/03 and 10/21/03).

[239] Subcommittee interviews of John Larson (10/3/03 and 10/21/03). Presidio discussed completing a BLIPS transaction on its own behalf with the assistance of HVB, but ultimately completed the transaction elsewhere. See, e.g., "Corporate Banking Division—Credit Request" dated 9/14/99, Bates HVB 000147–64; "Corporate Banking Division—Credit Request" dated 4/28/00, Bates HVB 004148–51; memorandum dated 9/14/99, from Robert Pfaff of Presidio to Dom DiGiorgio of HVB, "BLIPS loan test case," Bates HVB 000202; chart dated 9/14/99 entitled, "Presidio Ownership Structure," Bates HVB 000215; undated document entitled, "Structural Differences in the Transaction for Presidio Principals," Bates HVCD 00007; undated diagrams depicting BLIPS loans to Presidio principals, Bates HVB 004272–75.

The banks and investment advisory firms interviewed by the Subcommittee staff acknowledged obtaining lucrative fees for their participation in FLIP, OPIS, or BLIPS. Deutsche Bank internal documents state that the bank earned more than $33 million from OPIS and expected to earn more than $30 million for BLIPS.[240] HVB earned over $5.45 million for the BLIPS transactions it completed in less than 3 months in 1999, and won approval of increased BLIPS transactions throughout 2000, "based on successful execution of previous transactions, low credit risk and excellent profitability."[241]

The Subcommittee interviewed four of the five banks, most of which cooperated with the inquiry and were generally open and candid about their interactions with KPMG, their understanding of FLIP, OPIS, and BLIPS, and their respective roles in these tax products. Evidence obtained by the Subcommittee shows that the banks knew they were participating in transactions whose primary purpose was to provide tax benefits to persons who had purchased tax products from KPMG. Some of the documentation also make it plain that the bank was aware that the tax product was potentially abusive and carried a risk to the reputation of any bank choosing to participate in it.

For example, a number of Deutsche Bank documents make it clear that the bank knew BLIPS was a tax related transaction and posed a reputational risk to the bank if the bank chose to participate in it. One Deutsche Bank official working to obtain bank approval to participate in BLIPS wrote:

> "In this transaction, reputation risk is tax related and we have been asked by the Tax Department not to create an audit trail in respect of the Bank's tax affaires. The Tax department assumes prime responsibility for controlling tax related risks (including reputation risk) and will brief senior management accordingly. We are therefore not asking R&R [Reputation & Risk] Committee to approve reputation risk on BLIPS. This will be dealt with directly by the Tax Department and [Deutsche Bank Chief Executive Officer] John Ross."[242]

Another Deutsche Bank memorandum, prepared for the "New Product Committee" to use in reviewing BLIPS, included the following statements explaining the transaction:

> "BLIPS will be marketed to High Net Worth Individual Clients of KPMG. . . . Loan conditions will be such as to enable DB to, in effect, force (p)repayment after 60 days at its option. . . . For tax and accounting purposes, repaying

[240] See undated document entitled, "New Product Committee Overview Memo: BLIPS Transaction," Bates DB BLIPS 01959; email dated 4/28/99, from Francesco Piovanetti to Nancy Donohue, "presidio—w. revisions, I will call u in 1 min.," Bates DB BLIPS 6911.

[241] See HVB credit request dated 1/6/00, Bates HVB 003320–30 (HVB "earned USD 4.45 million" from BLIPS loan fees and "approximately USD 1 million" from related foreign exchange activities for BLIPS transactions completed from October to December 1999); HVB document dated 8/6/00, from Thorpe, marked "DRAFT," Bates HVB 001805.

[242] Email dated 7/30/99, from Ivor Dunbar of Deustche Bank, DMG UK, to multiple Deutsche Bank professionals, "Re: Risk & Resources Committee Paper—BLIPS," unreadable Bates number. See also email dated 7/29/99 from Mick Wood to Francesco Piovanetti and other Deutsche bank personnel, "Re: Risk & Resources Committee Paper—BLIPS," Bates DB BLIPS 6556 (paper prepared for the Risk & Resources Committee "skirts around the basic issue rather than addressing it head on (the tax reputational risk).").

> the [loan] premium amount will 'count'" like a loss for tax and accounting purposes. . . . At all times, the loan will maintain collateral of at least 101% to the loan + premium amount. . . . It is imperative that the transaction be wound up after 45–60 days and the loan repaid due to the fact that the HNW individual will not receive his/her capital loss (or tax benefit) until the transaction is wound up and the loan repaid. . . . At no time will DB Private Bank provide any tax advice to any individuals involved in the transactions. This will be further buttressed by signed disclaimers designed to protect and 'hold harmless' DB. . . . DB has received a legal opinion from Shearman & Sterling which validates our envisaged role in the transaction and sees little or no risk to DB in the trade. Furthermore opinions have been issued from KPMG Central Tax department and Brown & Wood attesting to the soundness of the transactions from a tax perspective." [243]

Still another Deutsche Bank document states: "For tax and accounting purposes, the [loan] premium amount will be treated as a loss for tax purposes." [244]

Bank documentation indicates that a number of internal bank departments, including the tax, accounting, and legal departments, were asked to and did approve the bank's participation in BLIPS. BLIPS was also brought to the attention of the bank's Chief Executive Officer John Ross who made the final decision on the bank's participation.[245] Minutes describing the meeting in which Mr. Ross approved the bank's participation in BLIPS state:

> "[A] meeting with John Ross was held on August 3, 1999 in order to discuss the BLIPS product. [A bank representative] represented [Private Banking] Management's views on reputational risk and client suitability. John Ross approved the product, however insisted that any customer found to be in litigation be excluded from the product, the product be limited to 25 customers and that a low profile be kept on these transactions. . . . John Ross also requested to be kept informed of future transactions of a similar nature." [246]

Given the extensive and high level attention provided by the Bank regarding its participation in BLIPS, it seems clear that the bank had evaluated BLIPS carefully and knew what it was getting into.

Other evidence shows that Deutsche Bank was aware that the BLIPS loans were not run-of-the-mill commercial loans, but had unusual features. Deutsche Bank refused, for example, to sign a letter representing that the BLIPS loan structure, which included an unusual multi-million dollar "loan premium" credited to a bor-

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

[244] Email dated 7/1/99 from Francesco Piovanetti to Ivor Dunbar, "'Hugo' BLIPS Paper," with attachment entitled, "Bond Linked Indexed Premium Strategy 'BLIPS,'" Bates DB BLIPS 6585–87 at 6587.

[245] See email dated 10/13/99, from Peter Sturzinger to Ken Tarr and other Deutsche Bank personnel, "Re: BLIPS," attaching minutes dated 8/4/99, from a "Deutsche Bank Private Banking, Management Committee Meeting" that discussed BLIPS, Bates DB BLIPS 6520–6521.

[246] *Id.* at 6520.

rower's account at the start of the loan,[247] was consistent with "industry standards." The BLIPS National Deployment Champion had asked the bank to make this representation to provide "comfort that the loan was being made in line with conventional lending practices." [248] When the bank declined to make the requested representation, the BLIPS National Deployment Champion tried a second time, only to report to his colleagues: "The bank has pushed back again and said they simply will not represent that the large premium loan is consistent with industry standards." [249] He tried a third time and reported: "I've pushed really hard for our original language. To say they are resisting is an understatement." [250] The final tax opinion letter issued by KPMG contained compromise language which said little more than the loan complied with the bank's own procedures: "The loan . . . was approved by the competent authorities within [the Bank] as consistent, in the light of all the circumstances such authorities consider relevant, with [the Bank's] credit and documentation standards." [251]

A year after Deutsche Bank began executing BLIPS transactions, a key bank official handling these transactions wrote an email which acknowledged the "tax benefits" associated with BLIPS and noted, again, the reputational risk these transactions posed to the bank:

> "During 1999, we executed $2.8b. of loan premium deals as part of the BLIP's approval process. At that time, NatWest and [HVB] had executed approximately $0.5 b. of loan premium deals. I understand that we based our limitations on concerns regarding reputational risk which were heightened, in part, on the proportion of deals we have executed relative to the other banks. Since that time, [HVB], and to a certain extent NatWest, have participated in approximately an additional $1.0–1.5 b. of grandfathered BLIP's deals. . . . [HVB] does not have the same sensitivity to and market exposure as DB does with respect to the reputational risk from making the high-coupon loan to the client. . . . As you are aware, the tax benefits from the transaction potentially arise from a contribution to the partnership subject to the high-coupon note and not from the execution of FX positions in the partnership, activities which we perform in the ordinary course of our business." [252]

This document shows that Deutsche Bank was fully aware of and had a sophisticated understanding of the tax aspects of BLIPS. To address the issue of reputational risk, the email went on to propose that, because HVB had a limited capacity to issue more BLIPS loans, and Deutsche Bank did not want to expose itself to increased

[247] See Appendix A.
[248] Email dated 3/20/00, from Jeffrey Eischeid to Mark Watson, "Bank representation," Bates KPMG 0025754.
[249] Email dated 3/27/00, from Jeffrey Eischeid to Richard Smith, "Bank representation," Bates KPMG 0025753.
[250] Email dated 3/28/00, from Jeffrey Eischeid to Mark Watson, "Bank representation," Bates KPMG 0025753.
[251] KPMG prototype tax opinion letter on BLIPS, dated 12/31/99, at 11.
[252] Email dated 6/20/00, from William Boyle to multiple Deutsche Bank professionals, "Updated Presidio/KPMG trades," Bates DB BLIPS 03280.

reputational risk by making additional direct loans to BLIPS clients, "we would like to lend an amount of money to [HVB] equal to the amount of money [HVB] lends to the client. . . . We would like tax department approval to participate in the aforementioned more complex trades by executing the underlying transactions and making loans to [HVB]." In other words, Deutsche Bank wanted to be the bank behind HVB, financing more BLIPS loans in exchange for fees and other profits.

Other Deutsche Bank documents suggest that the bank may have been helping KPMG find clients or otherwise marketing the BLIPS tax products. A November 1999 presentation by the bank's "Structured Finance Group," for example, listed BLIPS as one of several tax products the group was offering to U.S. and European clients seeking "gain mitigation." [253] The presentation listed as the bank's "strengths" its ability to lend funds in connection with BLIPS and its "relationships with [the] 'promoters'" [254] later named as Presidio and KPMG.[255] An internal bank email a few months earlier asked: "What is the status of the BLIPS. Are you still actively marketing this product[?]" [256]

The same document suggests that Deutsche Bank may have been a tax shelter promoter in its own right. For example, the document indicates that, in 1999, the Structured Transactions Group was offering over a dozen sophisticated tax products to U.S. and European clients seeking to "execute tax driven deals" or "gain mitigation" strategies.[257] The document indicates that Deutsche Bank was aggressively marketing these tax products to large U.S. corporations and individuals, and planning to close billions of dollars worth of transactions.[258] At least two of the tax products listed by Deutsche Bank, BLIPS and the Customized Adjustable Rate Debt Facility (CARDS), were later determined by the IRS to be potentially abusive tax shelters. During the late 1990's and early 2000, Deutsche Bank was also involved, either directly or through Bankers Trust (which Deutsche Bank acquired in June 1999), in a number of tax-driven transactions with Enron Corporation, including Project Steele, Project Cochise, Project Tomas, and Project Valhalla.[259]

Despite the bank's involvement in and sophisticated knowledge of generic tax products, when asked about BLIPS during a Subcommittee interview, the Deutsche Bank representative insisted that BLIPS was an investment strategy which, like all investment products, had tax implications. The bank representative also indicated that, despite handling BLIPS transactions for the bank, he

[253] Email dated 4/3/02, from Viktoria Antoniades to Brian McGuire and other Deutsche Bank personnel, "US GROUP 1 Pres," DB BLIPS 6329–52, attaching a presentation dated 11/15/99, entitled "Structured Transactions Group North America," at 6336, 6346.
[254] *Id.* at 6337.
[255] *Id.* at 6346.
[256] Email dated 7/19/99, involving multiple Deutsche Bank employees, "Update NY Issues," Bates DB BLIPS 6775.
[257] Email dated 4/3/02, from Viktoria Antoniades to Brian McGuire and other Deutsche Bank personnel, "US GROUP 1 Pres," DB BLIPS 6329–52, attaching a presentation dated 11/15/99, entitled "Structured Transactions Group North America," at 6336. See also undated document entitled, "Update on the Private Exchange Fund," Bates DB BLIPS 6433 (describing the packaging of another tax product offered by the Structured Transactions Group).
[258] *Id.* at 6345–46.
[259] See "Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations," Joint Committee on Taxation Staff (Report No. JCS–3–03, February 2003).

did not understand the details of the BLIPS transactions, and downplayed any reputational risk that BLIPS might have posed to the bank.[260]

In contrast to Deutsche Bank's stance, in which its representative's oral information repeatedly contradicted its internal documentation, HVB representatives provided oral information that was fully consistent with the bank's internal documentation. HVB's representative acknowledged, for example, that HVB knew BLIPS had been designed and was intended to provide tax benefits to KPMG clients. The bank indicated that, at the time it became involved, it felt it had no obligation to refrain from participating in BLIPS, since KPMG had provided the bank with an opinion stating that BLIPS complied with federal tax law. For example, in one document seeking approval to provide a significant line of credit to finance BLIPS loans, HVB wrote this about the tax risks associated with BLIPS: "Disallowance of tax attributes. A review by the IRS could potentially result in a ruling that would disallow the [BLIPS] structure. . . . We are confident that none of the foregoing would affect the bank or its position in any meaningful way for the following reasons. . . . KPMG has issued an opinion that the structure will most likely be upheld, even if challenged by the IRS."[261] A handwritten document prepared by HVB personnel is even more direct. It characterizes the 7% fee charged to KPMG clients for BLIPS as "paid by investor for tax sheltering."[262] This document also states that the bank "amortizes premium over the life of loan for tax purposes."

When it became clear that the IRS would list BLIPS as an abusive tax shelter, an internal HVB memorandum again acknowledged that BLIPS was a tax transaction and ordered a halt to financing the product, while disavowing any liability for the bank's role in carrying out the BLIPS transactions:

> "[I]t is clear that the tax benefits for individuals who have participated in the [BLIPS] transaction will not be grandfathered because Treasury believe that their actions were contrary to current law. . . . It is not likely that KPMG/Presidio will go forward with additional transactions. . . . As we have stated previously, we anticipate no adverse consequences for the HVB since we have not promoted the transaction. We have simply been a lender and nothing in the notice implies a threat to our position.
>
> "In view of the tone of the notice we will not book any new transactions and will cancel our existing unused [credit] lines prior to the end of this month."[263]

HVB's representative explained to the Subcommittee staff that the apparent bank risk in lending substantial sums to a shell corporation had been mitigated by the terms of the BLIPS loan which gave the bank virtually total control over the BLIPS loan proceeds

[260] Subcommittee interview of Deutsche Bank, (11/10/03).

[261] Credit request dated 9/26/99, Bates HVB 001166.

[262] Undated one-page, handwritten document outlining BLIPS structure entitled, "Presidio," which Alex Nouvakhov of HVB acknowledged during his Subcommittee interview had been written by him, Bates HVB 000204.

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

and enabled the bank to ensure the loan and loan premium would be repaid.[264] The bank explained, for example, that from the start of the loan, the borrower was required to maintain collateral equal to 101% of the loan proceeds and loan premium and could place these funds only in a narrow range of bank-approved investments.[265] That meant the bank treated not only all of the loan proceeds and loan premium as collateral, but also additional funds supplied by the KPMG client to meet the 101% collateral requirement. HVB wrote: "We are protected in our documentation through a minimum overcollateralization ratio of 1.0125 to 1 at all times. Violation of this ratio triggers immediate acceleration under the loan agreements without notice."[266] HVB also wrote: "The Permitted Investments . . . are either extremely conservative in nature . . . or have no collateral value for margin purposes."[267] KPMG put it this way: "Lender holds all cash as collateral in addition to being custodian and clearing agent for Partnership. . . . All Partnership trades can only be executed through Lender or an affiliate. . . . Lender must authorize trades before execution."[268]

Deutsche Bank and HVB were not the only banks involved in executing KPMG tax products. Another was Wachovia Bank, acting through First Union National Bank, which not only referred bank clients to KPMG to purchase FLIP, but also directly sold FLIP to many of its clients, and considered becoming involved with BLIPS and SC2 as well.[269] A 1999 Wachovia internal email demonstrates that the bank was fully aware that it was being asked to facilitate transactions designed to reduce or eliminate tax liability for KPMG clients:

> "[A] KPMG investment/tax strategy . . . was voted and approved by the due diligence subcommittee last week. This means that the Risk Oversight Committee will have this particular strategy on its agenda at its Wednesday meeting. . . . The strategy will service to offset either ordinary income or capital gains ($20 million minimum).
>
> "There are several critical points that should be noted with respect to this strategy if we get it approved. Many of

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

[265] See, e.g., email dated 10/29/99, from Richard Pankuch to Erwin Volt, "KWG I capital treatment for our Presidio Transaction," Bates HVB 000352 ("Our structure calls for all collateral to be placed in a collateral account pledged to the bank."); email dated 9/24/99, from Richard Pankuch to Christopher Thorpe and other HVB professionals, "Re: Presidio," Bates HVB 000682 ("all collateral is in our own hands and subject to the Permitted Investment requirement"). Compare undated Deutsche Bank document, likely prepared in 1999, "New Product Committee Overview Memo: BLIPS Transaction," Bates DB BLIPS 01959–63, at 1961 ("At all times, the loan will maintain collateral of at least 101% to the loan + loan premium amount. If the amount goes below this limit, the loan will be unwound and the principal + premium repaid."); email dated 7/1/99, from Francesco Piovanetti to Ivor Dunbar, "'Hugo' BLIPS Paper," with attachment entitled, "Bond Linked Indexed Premium Strategy 'BLIPS'," Bates HVB DB BLIPS 6885–87 ("The loan proceeds (par and premium) will be held in custody at DB in cash or money market deposits. . . . Loan conditions will be such as to enable DB to, in effect, force prepayment after sixty days at its option.").

[266] BLIPS credit request dated 9/14/99, Bates HVB 000155. See also Memorandum dated 7/29/99, from William Boyle to Mick Wood and other Deutsche Bank personnel, "GCI Risk and Resources Committee—BLIPS Transaction," Bates DB BLIPS 06566, at 3 (The BLIPS loan "will be overcollateralized and should the value of the collateral drop below a 1.0125:1.0 ratio, DB may liquidate the collateral immediately and apply the proceeds to repay amounts due under the Note and swap agreements.")

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

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

[269] See Section VI(2) of this Report for discussion of Wachovia's client referral activities.

these points related to Sandy Spitz' concern (and KPMG's concern) that First Union has a very high profile across our franchise for being associated with 'tax' strategies: namely, FLIP and BOSS. Sandy does not want this kind of high profile to be associated with this new strategy.

"In order to address some of Sandy's concerns and lower our profile . . .

"* The strategy has an KPMG acronym which will not be shared with the general First Union community. We will probably assign a generic name. . . .

"* No one-pager will be distributed to our referral sources describing the strategy. . . .

"* Fees to First Union will be 50 basis points if the investor is not a KPMG client, 25 bps if they are a KPMG client. . . .

"I have written up a technical summary of the tax opinion since Sandy will only allow us to read a draft copy of the opinion in his office without making a copy." [270]

Clearly, First Union was well aware that it was handling products intended to help clients reduce or eliminate their taxes and was worried about its own high profile from being "associated with 'tax' strategies" like FLIP.

In addition to its participation in KPMG-developed tax products, First Union helped develop and market the BOSS tax product sold by PricewaterhouseCoopers ("PWC"), which was later determined by the IRS to be a potentially abusive tax shelter. First Union had in its files the following document advocating the bank's involvement with BOSS:

"The proposed transaction takes advantage of an anomaly in current tax law which we expect will be closed down by legislation as soon as Congress finds out about it. We make this investment available only to select clients in order to limit the number of people who know about it. We hope that will delay the time Congress finds out about it, but at some point, it is likely that they will find out and enact legislation to shut it down. First Union acts as sales agent for PwC with respect to this transaction, since the bankers are in a very good position to know when a client has entered into a significant transaction which might have generated significant taxable income. PricewaterhouseCoopers would provide a Tax Opinion Letter which would say that if the entity were examined by the IRS, the transaction would 'more likely than not' be successfully upheld." [271]

This document provides additional, unmistakable evidence that First Union knew it was participating in transactions whose primary purpose was to reduce or eliminate clients' taxes.

[270] Email dated 8/30/99, from Tom Newman to multiple First Union professionals, "next strategy," Bates SEN–014622.

[271] Memorandum dated 12/21/99, from Teri Kemmerer Sallwasser to Gail Fagan, "Boss Strategy Meetings . . ." Bates SEN–018253–57.

Still another bank that handled KPMG tax products is UBS AG, now one of the largest banks in the world. UBS was convinced by Quellos and KPMG to participate in numerous FLIP and OPIS transactions in 1997 and 1998, referred to collectively by UBS as "redemption transactions."

UBS documentation clearly and repeatedly describes these transactions as tax-related. For example, one UBS document explaining the transactions is entitled: "U.S. Capital Loss Scheme—UBS 'redemption trades.'" It states:

> "The essence of the UBS redemption trade is the creation of a capital loss for U.S. tax purposes which may be used by a U.S. tax resident to off-set any capital gains tax liability to which it would otherwise be subject. The tax structure was originally devised by KPMG. . . . In October 1996, UBS was approached jointly by Quadra . . . and KPMG with a view to it seeking UBS' participation in a scheme that implemented the tax loss structure developed by KPMG. The role sought of UBS was one purely of execution counterparty. . . . It was clear from the outset—and has been continually emphasised since—that UBS made no endorsement of the scheme and that its connection with the structure should not imply any implicit confirmation by UBS that the desired tax consequences will be recognized by the U.S. tax authorities. . . . UBS undertook a thorough investigation into the propriety of its proposed involvement in these transactions. The following steps were undertaken: [redacted by UBS as 'privileged material']." [272]

At another point, the UBS document explains the "Economic Rationale" for redemption transactions to be: "Tax benefit for client," [273] while still another UBS document states: "The motivation for this structure is tax optimisation for U.S. tax residents who are enjoying capital gains that are subject to U.S. tax. The structure creates a capital loss from a U.S. tax point of view (but not from an economic point of view) which may be offset against existing capital gains." [274]

In February 1998, an unidentified UBS "insider" sent a letter to UBS management in London "to let you know that [UBS unit] Global Equity [D]erivatives is currently offering an illegal capital gains tax evasion scheme to US tax payers," meaning the redemption transactions. The letter continued:

> "This scheme is costing the US Internal Revenue [S]ervice several hundred million dollars a year. I am concerned that once IRS comes to know about this scheme they will levy huge financial/criminal penalties on UBS for offering tax evasion schemes. . . . In 1997 several billion dollars of this scheme was sold to high networth US tax payers, I am

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[272] UBS internal document dated 3/1/99, "Equities Large/Heavily Structured Transaction Approval," with attachment entitled, "U.S. Capital Loss Scheme—UBS 'redemption trades,'" Bates UBS 000009–15.

[273] *Id.* at UBS 000010.

[274] UBS internal document dated 11/13/97, "Description of the UBS 'Redemption' Structure," Bates UBS 000031.

> told that in 1998 the plan is continu[ing] to market this scheme and to offer several new US tax avoidance schemes involving swaps.
>
> "My sole objective is to let you know about this scheme, so that you can take some concrete steps to minimise the financial and reputational damage to UBS. . . .
>
> "P.S. I am sorry I cannot disclose my identity at this time because I don't know whether this action of mine will be rewarded or punished." [275]

In response to the letter, UBS halted all redemption trades for several months.[276] UBS apparently examined the nature of the transactions as well as whether they should be registered in the United States as tax shelters. UBS later resumed selling the products, stopping only after KPMG discontinued the sales.[277]

The UBS documents show that the bank was well aware that FLIP and OPIS were designed and sold to KPMG clients as ways to reduce or eliminate their U.S. tax liability. The bank apparently justified its participation in the transactions by reasoning that its participation did not signify its endorsement of the transactions and did not constitute aiding or abetting tax evasion. The bank then proceeded to provide the financing that made these tax products possible.

The Role of the Investment Advisors. Bank personnel were not the only financial professionals assisting KPMG with BLIPS, FLIP, and OPIS. Investment experts also played key roles in designing, marketing, and implementing the three tax products, working closely with KPMG tax professionals throughout the process. For example, the investment experts involved with BLIPS, FLIP, and OPIS helped KPMG with designing the specific financial transactions, making client presentations, obtaining financing from the banks, preparing the transactional documents, establishing the required shell corporations and partnerships, and facilitating the completion of individual client transactions. In the case of FLIP, investment experts at Quellos, then known as Quadra, provided these services. In the case of OPIS, both Quellos and Presidio provided these services. In the case of BLIPS, these services were generally provided by Presidio.

A memorandum sent by a Quellos investment expert to a banker at UBS explained the investment company's role in FLIP and the nature of the tax product itself as follows:

> "KPMG approached us as to whether we could affect the security trades necessary to achieve the desired tax results. I indicated that I felt we could and they are currently not looking elsewhere for assistance in executing the transaction.

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[275] Letter dated 2/12/98, addressed to SBC Warburg Dillon Read in London, Bates UBS 000038.

[276] See email dated 3/27/98, from Chris Donegan of UBS to Norm Bontje of Quadra and others, "Re: Redemption Trade," UBS 000039 ("Wolfgang and I are presently unable to execute any redemption transactions on UBS stock. The main reason for this seems to be a concern within UBS that this trade should be registered as a tax shelter with the IRS.").

[277] Subcommittee interview with UBS representative (10/28/03).

"The tax opportunity created is extremely complex, and is really based more on the structuring of the entities involved in the securities transactions rather than the securities transactions themselves. KPMG has assured me that prior to spending much time, beyond just conceptually seeing if we can do it, they would provide Quadra and any counterparty (UBS) with the necessary legal opinions and representatives letters as to why they are recommending this transaction to their clients. Assuming their tax analysis is complete, our challenge is to design a series of securities/derivatives trades that meet the required objectives.

"In summary, this tax motivated transaction is designed for U.S. companies requiring a tax loss. The way this loss is generated is through the U.S. company exercising a series of options to acquire majority ownership in a Foreign investment (Fund). The tax benefits are created for U.S. Co. based on the types of securities transactions done in the foreign investment Fund and shifting the cost basis to the parent U.S. Company. . . .

"If a U.S. company/individual has a $100 million dollar capital gain they owe taxes, depending on their tax position, ranging from $28 million to $35 million. As a result, they are more than willing to pay $2 to $4 million to generate a tax loss to offset the capital gain and corresponding taxes. . . .

"I have told KPMG that we should be able to execute the transaction once they have a commitment from a potential client. KPMG has already had a number of preliminary meetings with potential clients and one of their challenges was to identify a party that can manage the Fund level and facilitate the transactions with Foreign Co. Given your ability to act as Foreign Co., and facilitate the securities trades, I have told them to stop looking. Once they have a firm client, then we can map out the various details to execute the transaction." [278]

This document leaves no doubt that Quellos was fully aware that FLIP was a "tax motivated transaction" designed for companies or individuals "requiring a tax loss."

Quellos was successful in convincing UBS to participate in not only FLIP, but also OPIS transactions throughout 1997 and 1998, as described earlier. Quellos may also have been a tax shelter promoter in its own right. For example, in addition to its dealings with KPMG on FLIP and OPIS, Quellos teamed up with First Union National Bank and PWC to execute about 80 FLIP transactions for them. In addition, Quellos held discussions with KPMG regarding at least two tax products that Quellos itself had developed, but it is unclear whether sales of these products actually took place.[279] A

[278] Memorandum dated 8/12/96, from Jeff Greenstein of Quellos to Wolfgang Stolz of UBS, Bates UBS 000002.

[279] See, e.g., email dated 12/10/99, from Douglas Ammerman to multiple KPMG tax professionals, "Innovative Strategy Development," Bates KPMG 0036736 (discusses KPMG working with Quellos on two products that Quellos had developed, called FORTS, a "loss generating strategy," and WEST, a "conversion strategy.").

UBS document states that Quellos' "specialty is providing tax efficient investment schemes for high net worth U.S. individuals and their investment vehicles."[280]

Presidio played a similar role in the design, marketing, and implementation of OPIS and BLIPS. Two of Presidio's principals are former KPMG tax professionals who knew the KPMG tax professionals working on OPIS and BLIPS. These Presidio principals were repeatedly identified by KPMG as members of "the working group" developing OPIS and were described as having contributed to the design and implementation of OPIS.[281] Moreover, Presidio initially brought the idea for BLIPS to KPMG, and was thoroughly involved in the development, marketing, and implementation of the product. On May 1, 1999, prior to the final approval of BLIPS, Presidio representatives made a detailed presentation to KPMG tax professionals on how the company was planning to implement the BLIPS transactions.[282] During the presentation, among other points, Presidio representatives disclosed that there was only a "remote" possibility that any investor would actually profit from the contemplated foreign currency transactions, and that the banks providing the financing planned to retain, under the terms of the contemplated BLIPS "loans," an effective "veto" over how the "loan proceeds" could be invested. These statements, among others, caused KPMG's key technical reviewer in the Washington National Tax group to reconsider his approval of the BLIPS product, in part because he felt he had "not been given complete information about how the transaction would be structured."[283]

When BLIPS was eventually approved over the objections of the WNT technical reviewer, Presidio played a key role in making client presentations to sell the product and in executing the actual BLIPS transactions. One of the most important roles Presidio played in BLIPS was, in each BLIPS transaction, to direct two of the companies it controlled, Presidio Growth and Presidio Resources, to enter into a "Strategic Investment Fund" partnership with the relevant BLIPS client. This partnership was central to the entire BLIPS transaction, since it was this partnership that assumed and repaid the purported "loan" that gave rise to the BLIPS client's "tax loss." In each BLIPS transaction, a Presidio company

[280] Undated UBS internal document, "Memorandum on USB' involvement in U.S. Capital Loss Generation Scheme (the 'CLG Scheme')," Bates UBS 000006.

[281] See , e.g., memorandum dated 3/13/98, from Robert Simon to Jeff Stein and Sandy Smith, all of KPMG, "OPIS," Bates KPMG 0010262 ("The attached went to the entire working group (Pfaff, Ritchie, R.J. Ruble of Brown & Wood, Bickham, and Larson)."); email dated 3/14/98 from Jeff Stein to multiple KPMG tax professionals, "Simon Says," Bates 638010, filed by the IRS on June 16, 2003, as an attachment to Respondent's Requests for Admission, *Schneider Interests v. Commissioner,* U.S. Tax Court, Docket No. 200–02 ("By the way—anybody who does not have a copy of the Pfaff letter, let me know and I will fax it over to you. In addition in case you want a copy of the November 6, 1997 memo detailing the proposed LLC structure written by Simon to 'The Working Group' which included Ritchie, Pfaff, Larson, Bickahm [sic] and R.J. Ruble of the law firm of Brown & Wood let me know and I will fax it over to you as well."). Robert Pfaff and John Larson are the former KPMG tax professionals who left the firm to open Presidio.

[282] See, e.g., email dated 5/10/99, from Mark Watson to John Lanning and others, "FW: BLIPS," Bates MTW 0039; email dated 5/5/99, from Mark Watson to Larry DeLap, Bates KPMG 0011915–16. See also, e.g., memorandum dated 4/20/99, from Amir Makov of Presidio to John Rolfes of Deutsche Bank, "BLIPS friction costs," Bates DB BLIPS 01977 (showing Presidio's role in planning the BLIPS transactions; includes statement: "On day 60, Investor exits partnership and unwinds all trades in partnership.")

[283] See Section VI(B)(1) of this Report discussing the BLIPS development and approval process; email dated 5/10/99, from Mark Watson to John Lanning and others, "FW: BLIPS," Bates MTW 0039.

acted as the managing partner for the partnership and contributed a small portion of the funds used in the BLIPS transactions. Presidio also performed administrative tasks that, while more mundane, were critical to the success of the the tax product. For example, when BLIPS was just starting to get underway, Presidio took several steps to facilitate the transactions, including stationing personnel at one of the law firms preparing the transactional documents.[284]

When a problem arose indicating that currency conversions in two BLIPS transactions had been timed in such a way that they would create negative tax consequences for the BLIPS clients, Presidio apparently took the lead in correcting the "errors." An email sent by Presidio to HVB states:

> "I know that Steven has talked to you regarding the error for Roanoke Ventures. I have also noted an error for Mobil Ventures. None of the Euro's should have been converted to [U.S. dollars] in 1999. Due to the tax consequences that result from these sales, it is critical that these transactions be reversed and made to look as though they did not occur at all."[285]

Other documents suggest that, as Presidio requested, the referenced 1999 currency trades were somehow "reversed" and then executed the next month in early 2000.[286] HVB told Subcommittee staffers that they had been unaware of this matter and would have to research the transactions to determine whether, in fact, trades or paperwork had been altered.[287]

Presidio has worked with KPMG on a number of tax products in addition to the four examined in this Report. A Presidio representative told the Subcommittee staff that 95% of the company's revenue came from its work with KPMG.[288]

Finding: Some law firms have provided legal services that facilitated KPMG's development and sale of potentially abusive or illegal tax shelters, including by providing design assistance or collaborating on allegedly "independent" opinion letters representing to clients that a tax product would withstand an IRS challenge, in return for substantial fees.

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[284] Email dated 5/13/99, from Barbara Mcconnachie to multiple KPMG tax professionals, "FW: BLIPS," Bates MTW 0045 ("Presidio has 2 individuals permanently housed at Sherman & Sterling to assist in the necessary documentation."). Sherman & Sterling prepared many of the key transactional documents for BLIPS transactions involving Deutsche Bank.

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

[286] See, e.g., memorandum dated 12/23/99, from Kerry Bratton of Presidio to Amy McCarthy of HVB, "Transfer Instructions," Bates HVB 001699; memorandum dated 1/19/00, from Steven Buss at Presidio to Alex Nouvakhov at HVB, "FX Instructions—Mobile Ventures LLC," Bates HVB 001603; email dated 1/19/00, from Alex Nouvakhov at HVB to Matt Dunn at HVB, "Presidio," Bates HVB 001601 ("We need to sell Euros for another Presidio account and credit their [U.S. dollar] DDA account. It is the same deal as the one for Roanoke you did earlier today."); email dated 1/19/00, from Alex Nouvakhov at HVB to Steven Buss at Presidio, "Re: mobile," Bates HVB 001602; memorandum dated 1/19/00, from Steven Buss at Presidio to Timothy Schifter at KPMG, "Sale Confirmation," Bates HVB 001600.

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

[288] Subcommittee interview of John Larson (6/20/03).

The Role of the Law Firms. The evidence obtained by the Subcommittee during the course of the investigation determined that one law firm, Sidley Austin Brown & Wood, played a significant and ongoing role in the development, marketing, and implementation of the four KPMG tax products featured in this Report.

Sidley Austin Brown & Wood is currently being audited by the IRS to evaluate the firm's "role . . . in the organization and sale of tax shelters" and compliance with federal tax shelter requirements.[289] In court pleadings, the IRS has alleged the following:

> "[I]t appears that [Sidley Austin Brown & Wood] was involved in the organization and sale of transactions which were or later became 'listed transactions,' or that may be other 'potentially abusive tax shelters.' The organization and sale of these transactions appears to have been coordinated by [primarily] . . . Raymond J. Ruble. . . . During the investigation, I learned that [Sidley Austin Brown & Wood] issued approximately 600 opinions with respect to certain listed transactions promoted (or co-promoted) by, among others, KPMG, Arthur Andersen, BDO Seidman, Diversified Group, Inc., and Ernst & Young. . . . The IRS has identified transactions for which [Sidley Austin Brown & Wood] provided opinions, . . . FLIPS, OPIS, COBRA, BLIPS and CARDS, as 'listed transactions.'"[290]

The IRS also alleges that, in response to a December 2001 disclosure initiative in which taxpayers obtained penalty waivers in exchange for identifying their tax shelter promoters, 80 disclosure statements named Sidley Austin Brown & Wood as "promoting, soliciting, or recommending their participation in certain tax shelters."[291] The IRS also alleges that the law firm provided approximately 600 opinions for at least 13 tax products, including FLIP, OPIS, and BLIPS.[292]

Information obtained by the Subcommittee indicates that Sidley Austin Brown & Wood, through the efforts of Mr. Ruble, did more than simply draft opinion letters supporting KPMG tax products; the law firm formed an alliance with KPMG to develop and market these tax products. IRS court pleadings, for example, quote a December 1997 email in which Mr. Ruble states: "This morning my managing partner, Tom Smith, approved Brown & Wood LLP working with the newly conformed tax products group at KPMG on a joint basis in which we would jointly develop and market tax products and jointly share in the fees."[293] An internal KPMG memorandum around the same time states: "[W]e need to consummate a formal strategic allicance with Brown & Wood."[294]

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[289] "Declaration of Richard E. Bosch," IRS Revenue Agent, *In re John Doe Summons to Sidley Austin Brown & Wood* (N.D. Ill. 10/16/03) at ¶ 5.

[290] *Id.* ¶¶ 9, 10, 12.

[291] *Id.* at ¶ 14.

[292] *Id.* at ¶ 27(a).

[293] *Id.* at ¶ 15, citing an email dated 12/15/97, from R.J. Ruble. This email also references a meeting to be set up between KPMG and two partners at Sidley Austin Brown & Wood, Paul Pringle and Eric Haueter. See also email dated 12/24/97, from R.J. Ruble to Randall Brickham at KPMG, "Confidential Matters," Bates KPMG 0047356 ("Thanks again . . . for spending time with Paul and Eric. Their meeting you all helps me immensely with the politics here.").

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

Three months later, an internal KPMG memorandum discussing an upcoming meeting between KPMG and Brown & Wood states that KPMG tax professionals intended to discuss "how to institutionalize the KPMG/B&W relationship."[295] Among other items, KPMG planned to discuss "the key profit-drivers for our joint practice," citing in particular KPMG's "Customer list" and "Financial commitment" and Brown & Wood's "Institutional relationships within the investment banking community." The memorandum states that KPMG also planned to discuss "[w]hat should be the profit-split between KPMG, B&W and the tax products group/implementor for jointly-developed products," and suggesting that in "a 7% deal" KPMG, B&W and the "Implementor" should split the net profits evenly, after awarding a "finder's allocation" to the party who found the tax product purchaser. Still other documents indicate that Sidley Austin Brown & Wood, through Mr. Ruble, became a member of a working group that jointly developed OPIS.[296] Evidence obtained by the Subcommittee also indicates that Sidley Austin Brown & Wood, through Mr. Ruble, was an active participant in the development of BLIPS, expending significant time working with KPMG tax professionals to author their respective opinion letters.

In the case histories examined by the Subcommittee, once the design of a KPMG tax product was complete and KPMG began selling the product to clients, Sidley Austin Brown & Wood's primary implementation role became one of issuing legal opinion letters to the persons who had purchased the products. Sidley Austin Brown & Wood, through Mr. Ruble, wrote literally hundreds of legal opinions supporting FLIP, OPIS, and BLIPS.[297] In the case of SC2, KPMG had apparently made arrangements for clients to obtain a second opinion from either Sidley Austin Brown & Wood[298] or Bryan Cave, another major law firm,[299] but it is unclear how many SC2 buyers, if any, took advantage of these arrangements and bought a second opinion.

Traditionally, second opinion letters are supplied by a disinterested tax expert with no financial stake in the transaction being evaluated, and this expert sends an individualized letter to a single client. Certain IRS penalties, in fact, can be waived if a taxpayer relies "in good faith" on expert tax advice.[300] The mass marketing of tax products to multiple clients, however, has been followed by the mass production of opinion letters that, for each letter sent to

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[295] Memorandum dated 3/2/98, from Randall Bickham to Gregg Ritchie, "B&W Meeting," Bates KPMG 0047225–27.

[296] See , e.g., memorandum dated 3/13/98, from Robert Simon to Jeff Stein and Sandy Smith, all of KPMG, "OPIS," Bates KPMG 0010262 ("The attached went to the entire working group (Pfaff, Ritchie, R.J. Ruble of Brown & Wood, Bickham, and Larson)."); email dated 3/14/98 from Jeff Stein to multiple KPMG tax professionals, "Simon Says," Bates 638010, filed by the IRS on June 16, 2003, as an attachment to Respondent's Requests for Admission, *Schneider Interests v. Commissioner*, U.S. Tax Court, Docket No. 200–02 ("By the way—anybody who does not have a copy of the Pfaff letter, let me know and I will fax it over to you. In addition in case you want a copy of the November 6, 1997 memo detailing the proposed LLC structure written by Simon to "The Working Group" which included Ritchie, Pfaff, Larson, Bickahm [sic] and R.J. Ruble of the law firm of Brown & Wood let me know and I will fax it over to you as well.").

[297] See "Declaration of Richard E. Bosch," IRS Revenue Agent, *In re John Doe Summons to Sidley Austin Brown & Wood* (N.D. Ill. 10/16/03) at ¶ 18, citing an email by KPMG tax professional Gregg Ritchie.

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

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

[300] See 26 U.S.C. § 6662(d)(2)(C)(i); Treas.Reg. §§ 1.6662–4(g)(4)(ii) and 1.6664–4(c)(1).

a client, earns its author a handsome fee. Since there are few costs associated with producing new opinion letters, once a prototype opinion letter has been completed for the generic tax product, the mass production of largely boilerplate opinion letters has become a lucrative business for firms like Sidley Austin Brown & Wood. The attractive profits available from these letters have also created new incentives for law firms to team up with tax product promoters to become the preferred source for a second opinion letter. This profit motive undermines an arms-length relationship between the two opinion writers.

Actions taken by Sidley Austin Brown & Wood and KPMG to collaborate on their respective opinion letters raises additional questions about the law firm's independent status. The evidence indicates that the law firm collaborated extensively with KPMG in the drafting of the BLIPS, FLIP, and OPIS opinion letters. This collaboration included joint identification, research, and analysis of key legal and tax issues; discussions about the best way to organize and present the reasoning used in their respective letters; and joint efforts to identify necessary factual representations by the participating parties in the transactions being analyzed. In the case of FLIP, Mr. Ruble faxed a copy of his draft opinion letter to KPMG before issuing it.[301] In the case of BLIPS, Sidley Austin Brown & Wood and KPMG actually exchanged copies of their respective draft opinion letters and conducted a detailed "side-by-side" review "to make sure we each cover everything the other has."[302] The result was two, allegedly independent opinion letters containing numerous, virtually identical paragraphs.

KPMG used the availability of a second opinion letter from Sidley Austin Brown & Wood as a marketing tool to increase sales of its tax products, telling clients that having this second letter would help protect them from accuracy-related penalties if the IRS were to later invalidate a tax product.[303] Many clients were apparently swayed by this advice and sought an opinion letter from the law firm. Evidence obtained by the Subcommittee indicates that the opinion letters provided by the law firm were, like KPMG's opinion letters, virtually identical in content and reflected little, if any, individualized client interaction or legal advice. In some cases, KPMG arranged to obtain a client's opinion letter directly from the law firm and delivered it to the client, apparently without the client's ever speaking to any Sidley Austin Brown & Wood lawyer. One individual told the Subcommittee staff that after KPMG sold him FLIP, KPMG arranged for him to obtain a favorable opinion letter from Sidley Austin Brown & Wood without his ever contacting the law firm or directly speaking with a lawyer.[304] An indi-

[301] Facsimile cover sheet dated 2/26/97, from R.J. Ruble to David Lippman and John Larson at KPMG, Bates XX 001440.

[302] Email dated 9/24/99, from R.J. Ruble of Brown & Wood, to Jeffrey Eischeid and Rick Bickham of KPMG, Bates KPMG 0033497; followed by other emails exchanged between Brown & Wood and KPMG personnel, from 9/25/99 to 10/29/99, Bates KPMG 0033496–97.

[303] See, e.g., KPMG document dated 6/19/00, entitled "SC2—Meeting Agenda," Bates KPMG 0013375–96, at 13393; see also Section VI(B)(2) of this Report on using tax opinion letters as a marketing tool.

[304] *Jacoboni v. KPMG,* Case No. 02–CV–510 (D.M.D. Fla. 4/29/02), at ¶ 19 ("Mr. Jacoboni later received a copy of a 'concurring opinion' dated August 31, 1998, from the law firm Brown & Wood, LLP, which was requested by Dale Baumann of KPMG. The Brown & Wood concurring

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vidual testifying at a recent Senate Finance Committee hearing testified that he had received a Sidley Austin Brown & Wood opinion letter for COBRA, a tax product he had purchased from Ernst & Young, by picking up the letter from the accounting firm's office. He testified that he never communicated with anyone at the law firm.[305] This type of evidence suggests that the law firm's focus was not on providing individualized legal advice to clients, but on churning out boilerplate opinion letters for a fee.

By routinely directing clients to Sidley Austin Brown & Wood to obtain a second opinion letter, KPMG produced a steady stream of income for the law firm. In the case of BLIPS, FLIP, and OPIS, Sidley Austin Brown & Wood was apparently paid at least $50,000 per opinion. One document indicates that Sidley Austin Brown & Wood was paid this fee in every case where its name was mentioned during a sales pitch for BLIPS, whether or not the client actually purchased the law firm's opinion letter. Other evidence indicates that in some BLIPS transactions expected to produce a very large "tax loss" for the client, Sidley Austin Brown & Wood was paid more than $50,000 for its opinion letter.

Sidley Austin Brown & Wood provided opinion letters not only to KPMG, but also to other firms selling similar tax products. For example, the law firm also issued favorable opinion letters for COBRA, a tax product similar to OPIS, but sold by Ernst & Young. An email seems to suggest that when a client sought a tax opinion letter for a product from Ernst & Young and was turned down, Sidley Austin Brown & Wood may have advised the client to try KPMG instead. The internal Ernst & Young email states:

> "[Redacted name] told me that during the January meeting, Richard Shapiro gave him the name of R.J. Rubell [sic] at Brown and Wood and said that they could contact him directly regarding the tax opinion and other issues. He did that. Rubell said that Brown and Wood stands by the deal and is willing to issue the same opinion letter as before. They and others do not see the risk that E&Y sees. Apparently, B&W is also working with Diversified and KPMG and Rubell steered them in that direction." [306]

It is unclear exactly what problem is being addressed, but this email raises concerns about opinion letter shopping and about the propriety of the law firm's steering clients away from Ernst & Young, apparently because that firm refused to issue a requested letter, and toward KPMG.

In short, in exchange for substantial fees, Sidley Austin Brown & Wood provided legal services that facilitated KPMG's development and sale of potentially abusive or illegal tax shelters such as FLIP, OPIS, and BLIPS, including by providing design assistance and collaborating on allegedly "independent" opinion letters rep-

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opinion was mailed from New York to Mr. Jacoboni in Florida."); Subcommittee interview of legal counsel to Joseph Jacoboni (4/4/03).

[305] See testimony of Henry Camferdam regarding his purchase of COBRA, Senate Finance Committee hearing, "Tax Shelters: Who's Buying, Who's Selling, and What's the Government Doing About It?" (10/21/03) (Camferdam: "I never talked to anyone at Brown & Wood. In fact, all of their documents were sent to us via [Ernst & Young]—not directly to us.").

[306] Email dated 2/11/00, from Alexander Eckman to David G. Johnson and others, subject line redacted, Bates 2003EY011640.

resenting to clients that the KPMG tax products would withstand an IRS challenge.

Finding: Some charitable organizations have participated as essential counter parties in a highly questionable tax shelter developed and sold by KPMG, in return for donations or the promise of future donations.

The Role of the Charitable Organizations. SC2 transactions could not have taken place at all without the willing participation of a charitable organization. To participate in SC2 transactions, a charity had to undertake a number of non-routine and potentially expensive, time-consuming tasks. For example, the charity had to agree to accept an S corporation stock donation, which for many charities is, in itself, unusual; make sure it is exempt from the unrelated business income tax (hereinafter "UBIT") and would not be taxed for any corporate income earned during the time when the charity was a shareholder; sign a redemption agreement; determine how to treat the stock donation on its financial statements; and then hold the stock for several years before receiving any cash donation for its efforts. Moreover, relatively few charities are exempt from the UBIT, and those that are—like pension funds—do not normally receive large contributions from private donors.

KPMG approved SC2 for sale to clients in March 2000, and discontinued all sales 18 months later, around September 2001, after selling the tax product to about 58 S corporations. The SC2 sales produced fees exceeding $26 million for KPMG, making SC2 one of KPMG's top ten revenue producers in 2000 and 2001. Although KPMG refused to identify the charities that participated in the SC2 transactions, the Subcommittee was able to identify and interview two which, between them, participated in more than half of the SC2 transactions KPMG arranged.

The two charities interviewed by the Subcommittee staff indicated that they would not have participated in the SC2 transactions absent being approached, convinced, and assisted by KPMG. The Los Angeles Department of Fire & Police Pensions System is a $10 billion pension fund that serves the police and fire departments in the city of Los Angeles in California. The Austin Fire Fighters Relief and Retirement Fund is a much smaller pension fund serving the fire departments in Austin, Texas.

Based upon information provided to the Subcommittee, it appears that, out of the about 58 SC2 tax products sold by KPMG in 2000 and 2001, the Los Angeles pension fund participated in 29 of the SC2 transactions, while the Austin pension fund participated in five. The Los Angeles pension fund indicated that, as a result of the SC2 transactions, it is currently holding stock valued at about $7.3 million from 16 S corporations, and has sold back donated stock to 13 corporations in exchange for cash payments totaling about $5.5 million. Both pension funds told the Subcommittee that the SC2 stock donors and their corporations had generally been from out-of-state. The Los Angeles pension fund indicated that it had received stock from S corporations in Arizona, Georgia, Hawaii, Missouri, and North Carolina. The Austin pension fund indicated that it had received stock from S corporations in California, Mississippi, New Jersey, and New York. Both pension funds indicated that they had not met any of the SC2 donors until KPMG introduced them to the charities.

Both charities indicated to the Subcommittee staff that, in determining whether to participate in the SC2 transactions, they relied on KPMG's representation that the transactions complied with federal tax law. The Los Angeles pension fund also obtained from an outside law firm a legal opinion letter on the narrow issue of whether the charity had the legal authority to accept a donation of S corporation stock. In analyzing this issue, the law firm notes first in the legal opinion letter that all of the facts recited about the transaction had been provided to the law firm by a KPMG tax professional.[307] The letter concludes that the pension fund may accept an S corporation stock donation from an unrelated third party: "Although this is a very unusual transaction, and there is almost no statutory, regulatory or other authority addressing the issue, we believe the Plan is permitted to accept a contribution." The letter also states, however, that the law firm had not been asked to provide any legal advice about the substance of the SC2 transaction itself, that it had not been given any documentation to review, and that it was not offering any opinion on "the impact of the transaction on the 'donor' from a tax or other standpoint."[308]

Apparently, neither charity obtained a legal or tax opinion letter or other written legal advice, from KPMG or any other firm, on whether the SC2 tax product and related transactions complied with federal tax law or whether the charity's participation in SC2 transactions could be viewed as aiding or abetting tax evasion. The two pension funds told the Subcommittee that they simply relied on KPMG's reputation as a reputable firm in assuming the donation strategy was within the law.

Both pension funds told the Subcommittee that, in every SC2 transaction, it was their expectation that they would not retain ownership of the donated stock, but would sell it back to the stock donor after the expiration of the period of time indicated in the redemption agreement. They also indicated that they did not expect to obtain significant amounts of money from the S corporation during the period in which the charity was a stockholder but expected, instead, to obtain a large cash payment at the time the charity sold the stock back to the donor. Moreover, the charities told the Subcommittee staff that their expectations have, in fact, been met, and the SC2 transactions have been carried out as planned by KPMG, the donors, and the charities. These facts and expectations raise serious questions about whether the SC2 transactions ever truly passed ownership of the stock to the charity or acted merely as an

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[307] Letter dated 12/30/99, from Seyfarth, Shaw, Fairweather & Geraldson to the Los Angeles pension fund, at 3.

[308] *Id.* The letter states: "You have asked us to advise you concerning the ability of the L.A. Fire & Police Pension System (the 'Plan') to accept a contribution from an unrelated third party in the form of nonvoting stock of a closely held California S corporation. . . . It should be noted that, from a procedural and due-diligence standpoint, (1) we have not been asked to conduct, and we have not conducted, any investigation into the company and/or the individual involved, (2) we have not yet reviewed any of the underlying documentation in connection with the donation or the possible future redemption of the stock, and offer no opinion on such agreements or their impact on any of the views expressed in this letter, (3) we have not examined, or opined in any way about, the impact of the transaction on the 'donor' from a tax or other standpoint, and (4) we have not checked the investment against any investment policy guidelines that may have been adopted by the Board."

assignment of income for a specified period time to the charitable organization.

In the case of BLIPS, FLIP, OPIS, and SC2, major banks, investment advisory firms, law firms, and charitable organizations provided critical services or acted as essential counterparties in the transactions called for by the tax products. Each obtained lucrative fees, often totaling in the millions of dollars, for their participation. Despite the complexity, frequency, and size of the transactions and their clear connection to tax avoidance schemes, none of the participating organizations presented to the Subcommittee a reasoned, contemporaneous analysis of the tax shelter, reputational risk, ethical, or professional issues justifying the organization's role in facilitating these highly questionable and abusive tax transactions.

(4) Avoiding Detection

Finding: KPMG has taken steps to conceal its tax shelter activities from tax authorities and the public, including by refusing to register potentially abusive tax shelters with the IRS, restricting file documentation, and using improper tax return reporting techniques.

Evidence obtained by the Subcommittee in the four KPMG case studies shows that KPMG has taken a number of steps to conceal its tax shelter activities from IRS, law enforcement, and the public. In the first instance, it has simply denied being a tax shelter promoter and claimed that tax shelter information requests do not apply to its products. Second, evidence in the FLIP, OPIS, BLIPS, and SC2 case histories indicate that KPMG took a number of precautions in the way it designed, marketed, and implemented these tax products to avoid or minimize detection of its activities.

No Tax Shelter Disclosure. KPMG's public position is that it does not develop, sell or promote tax shelters, as explained earlier in this Report. As a consequence, KPMG has not voluntarily registered, and thereby disclosed to the IRS, a single one of its tax products. A memorandum quoted at length earlier in this Report [309] establishes that, in 1998, a KPMG tax professional advised the firm not to register the OPIS tax product with the IRS, even if OPIS qualified as a tax shelter under the law, citing competitive pressures and a perceived lack of enforcement or effective penalties for noncompliance with the registration requirement. Another document discussing registration of OPIS had this to say: "*Must* register the product. B&W concerns—risk is too high. Confirm w/Presidio that they will register." [310] The head of DPP-Tax told the Subcommittee staff that he had recommended registering not only OPIS, but also BLIPS, but was overruled in each instance by the top official in charge of the Tax Services Practice.[311]

Other documents show that consideration of tax shelter registration issues was a required step in the tax product approval process,

[309] See Section VI(B) of this Report.

[310] Handwritten notes dated 3/4/98, author not indicated, regarding "Brown & Wood" and "OPIS," Bates KPMG 0047317. Emphasis in original. "B&W" refers to Brown & Wood, the law firm that worked with KPMG on OPIS. Presidio is an investment firm that worked with KPMG on OPIS.

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

but rather than resulting in IRS registrations, KPMG appears to have devoted resources to devising rationales for not registering a product with the IRS. KPMG's Tax Services Manual states that every new tax product must be analyzed by the WNT Tax Controversy Services group "to address tax shelter regulations issues." [312] For example, one internal document analyzing tax shelter registration issues discusses the "policy argument" that KPMG's tax "advice . . . does not meet the paradigm of 6111(c) registration" and identifies other flaws with the legal definition of "tax shelter" that may excuse registration. The email also suggests possibly creating a separate entity to act as the registrant for KPMG tax products:

> "If we decide we will be registering in the future, thought should be given to establishing a separate entity that meets the definition of an organizer for all of our products with registration potential. This entity, rather than KPMG, would then be available through agreement to act as the registering organizer. . . . If such an entity is established, KPMG can avoid submitting its name as the organizer of a tax shelter on Form(s) 8264 to be filed in the future." [313]

Another KPMG document, a fiscal year 2002 draft business plan for the Personal Financial Planning Practice, describes two tax products under development, but not yet approved, due in part to pending tax shelter registration issues.[314] The first, referred to as POPS, is described as "a gain mitigation solution." The business plan states: "We have completed the solution's technical review and have almost finalized the rationale for not registering POPS as a tax shelter." The second product is described as a "conversion transaction . . . that halves the taxpayer's effective tax rate by effectively converting ordinary income to long term capital gain." The business plan notes: "The most significant open issue is tax shelter registration and the impact registration will have on the solution."

The IRS has issued "listed transactions" that explicitly identify FLIP, OPIS, and BLIPS as potentially abusive tax shelters. Due to these tax products and others, the IRS is investigating KPMG to determine whether it is a tax shelter promoter and is complying with the tax shelter requirements in Federal law.[315] KPMG continues flatly to deny that it is a tax shelter promoter and has continued to resist registering any of its tax products with the IRS.

A second consequence of KPMG's public denial that it is a tax shelter promoter has been its refusal fully to comply with the document requests made by the IRS for lists of clients who purchased tax shelters from the firm. In a recent hearing before the Senate

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

[313] Email dated 5/11/98, from Jeffrey Zysik to multiple KPMG tax professionals, "Registration," Bates KPMG 0034805–06. See also email dated 5/12/98, from Jeffrey Zysik to multiple KPMG tax professionals, "Registration requirements.," Bates KPMG 0034807–11 (reasonable cause exception, tax shelter definitions, number of registrations required); email dated 5/20/98, from Jeffrey Zysik to multiple KPMG tax professionals, "Misc. Tax Reg. issues," Bates KPMG 0034832–33 ("reasonable cause exception for not registering"; application of regulatory "tax shelter ratio" to identify tax shelters; "establishing a separate entity to act as the entity registering ALL tax products. . . . Otherwise we must submit our name as the tax shelter organizer.").

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

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

Finance Committee, the U.S. Department of Justice stated that, although the client-list maintenance requirement enacted by Congress "clearly precludes any claim of identity privilege for tax shelter customers regardless of whether the promoters happen to be accountants or lawyers, the issue continues to be the subject of vigorous litigation." [316] The Department pointed out that one circuit court of appeals and four district courts had already ruled that accounting firms, law firms, and a bank must divulge client information requested by the IRS under the tax shelter laws, but certain accounting firms were continuing to contest IRS document requests. At the same hearing, the former IRS chief counsel characterized the refusal to disclose client names by invoking either attorney-client privilege or Section 7525 of the tax code as "frivolous," while also noting that one effect of the ensuing litigation battles "was to delay [promoter] audits to the point of losing one or more tax years to the statute of limitations." [317]

IRS Commissioner, Mark Everson, testified at the same hearing that the IRS had filed suit against KPMG in July 2002, "to compel the public accounting firm to disclose information to the IRS about all tax shelters it has marketed since 1998." [318] He stated, "Although KPMG has produced many documents to the IRS, it has also withheld a substantial number."

Some of the documents obtained by the Subcommittee during its investigation illustrate the debate within KPMG over responding to the IRS requests for client names and other information. In April 2002, one KPMG tax professional wrote:

> "I have two clients who are about to file [tax returns] for 2001. We have discussed with each of them what is happening between KPMG and IRS and both do not plan to disclose at this time. Since Larry's message indicated the information requested was to respond to an IRS summons, I am concerned we are about to turn over a new list of names for transactions I believe IRS has no prior knowledge of. I need to know immediately if that is what is happening. It will obviously have a material effect on their evaluation of whether they wish to disclose and what positions they wish to take on their 2001 returns. Since April 15th is Monday, I need a response. . . . [I]f we are responding to what appears to be an IRS fishing expedition, it is going to reflect very badly on KPMG. Several clients have seriously questioned whether we are doing everything we can to protect their interests." [319]

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[316] Testimony of Eileen J. O'Connor, Assistant Attorney General for the Tax Division, U.S. Department of Justice, before the Senate Committee on Finance, "Tax Shelters: Who's Buying, Who's Selling and What's the Government Doing About It?" (10/21/03), at 3.

[317] Testimony of B. John Williams, Jr. former IRS chief counsel, before the Senate Committee on Finance, "Tax Shelters: Who's Buying, Who's Selling and What's the Government Doing About It?" (10/21/03), at 4–5.

[318] Testimony of Mark W. Everson, IRS Commissioner, before the Senate Committee on Finance, "Tax Shelters: Who's Buying, Who's Selling and What's the Government Doing About It?" (10/21/03), at 11.

[319] Email dated 4/9/02, from Deke Carbo to Jeffrey Eischeid, "Larry's Message," Bates KPMG 0024467. See also email dated 4/19/02, from Ken JOnes to multiple KPMG tax professionals, "TCS Weekly Update," Bates KPMG 0050430–31 ("We have just hand-carried the lists of investors over to the IRS, for the following deals: . . . SC2. . . . Note that not all cilents names were

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Tax Return Reporting. KPMG also took a number of questionable steps to minimize the amount of information reported in tax returns about the transactions involved in its tax products in order to limit IRS detection.

Perhaps the most disturbing of these actions was first taken in tax returns reporting transactions related to OPIS. To minimize information on the relevant tax returns and avoid alerting the IRS to the OPIS tax product, some KPMG tax professionals advised their OPIS clients to participate in the transactions through "grantor trusts." These KPMG tax professionals also advised their clients to file tax returns in which all of the losses from the OPIS transactions were "netted" with the capital gains realized by the taxpayer at the grantor trust level, instead of reporting each individual gain or loss, so that only a single, small net capital gain or loss would appear on the client's personal income tax return. This netting approach, advocated in an internally-distributed KPMG memorandum,[320] elicited intense debate within the firm. KPMG's top WNT technical tax expert on the issue of grantor trusts wrote the following in two emails over the span of 4 months:

> "I don't think netting at the grantor trust level is a proper reporting position. Further, we have never prepared grantor trust returns in this manner. What will our explanation be when the Service and/or courts ask why we suddenly changed the way we prepared grantor trust returns/statements only for certain clients? When you put the OPIS transaction together with this 'stealth' reporting approach, the whole thing stinks."[321]

> "You should all know that I do not agree with the conclusion reached in the attached memo that capital gains can be netted at the trust level. I believe we are filing misleading, and perhaps false, returns by taking this reporting position."[322]

One of the tax professionals selling OPIS wrote:

> "This 'debate' . . . [over grantor trust netting] affects me in a significant way in that a number of my deals were sold giving the client the option of netting. . . . Therefore, if they ask me to net, I feel obligated to do so. These sales were before Watson went on record with his position and after the memo had been outstanding for some time.

> "What is our position as a group? Watson told me he believes it is a hazardous professional practice issue. Given

turned over for each of these Solutions . . . so if you need to find out if a company or individual was on the list . . . call or email me.").

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

[321] Email dated 9/2/98, from Mark Watson to John Gardner, Jeffrey Eischeid, and others; "RE:FW: Grantor trust memo," Bates KPMG 0035807. See also email dated 9/3/98, from Mark Watson to Jeffrey Eischeid and John Gardner, "RE:FW: Grantor trust memo," Bates KPMG 0023331–32 (explaining objections to netting at the grantor trust level).

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

that none of us wants to face such an issue, I need some guidance."[323]

The OPIS National Deployment Champion responded: "[W]e concluded that each partner must review the WNT memo and decide for themselves what position to take on their returns—after discussing the various pros and cons with their clients."[324]

The technical reviewer who opposed grantor trust netting told the Subcommittee staff that it was his understanding that, as the top WNT technical expert, his technical judgment on the matter should have stopped KPMG tax professionals from using or advocating the use of this technique and thought he had done so, before leaving for a KPMG post outside the United States. He told the Subcommittee staff he learned later, however, that the OPIS National Deployment Champion had convened a conference call without informing him and told the participating KPMG tax professionals that they could use the netting technique if they wished. He indicated that he also learned that some KPMG tax professionals were apparently advising BLIPS clients to use grantor trust netting to avoid alerting the IRS to their BLIPS transactions.[325]

In September 2000, the IRS issued Notice 2000–44, invalidating the BLIPS tax product. This Notice included a strong warning against grantor trust netting:

> "[T]he Service and the Treasury have learned that certain persons who have promoted participation in transactions described in this notice have encouraged individual taxpayers to participate in such transactions in a manner designed to avoid the reporting of large capital gains from unrelated transactions on their individual income tax returns (Form 1040). Certain promoters have recommended that taxpayers participate in these transactions through grantor trusts and . . . advised that the capital gains and losses from these transactions may be netted, so that only a small net capital gain or loss is reported on the taxpayer's individual income tax return. In addition to other penalties, any person who willfully conceals the amount of capital gains and losses in this manner, or who willfully counsels or advises such concealment, may be guilty of a criminal offense. . . ."[326]

The technical reviewer who had opposed using grantor trust netting told the Subcommittee that, soon after this Notice was published, he had received a telephone call from his WNT replacement informing him of the development and seeking his advice. He indi-

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

[324] Email dated 1/22/99, from Jeffrey Eischeid to Carl Hasting, "FW: Grantor trust reporting," Bates KPMG 0010066. Other OPIS tax return reporting issues are discussed in other KPMG documentation including, for example, memorandum dated 12/21/98, from Bob Simon/Margaret Lukes to Robin Paule, "Certain U.S. International Tax Reporting Requirements re: OPIS," Bates KPMG 0050630–40.

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

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

cated that it was his understanding that a number of client calls were later made by KPMG tax professionals.[327]

Other tax return reporting concerns also arose in connection with BLIPS. In an email with the subject line, "Tax reporting for BLIPS," a KPMG tax professional sent the following message to the BLIPS National Deployment Champion: "I don't know if I missed this on a conference call or if there's a memo floating around somewhere, but could we get specific guidance on the reporting of the BLIPS transaction. . . . I have 'IRS matching' concerns." The email later continues:

> "One concern I have is the IRS trying to match the Deutsche dividend income which contains the Borrower LLC's FEIN [Federal Employer Identification Number][.] (I understand they're not too efficient on matching K–1's but the dividends come through on a 1099 which they do attempt to match). I wouldn't like to draw any scrutiny from the Service whatsoever. If we don't file anything for Borrower LLC we could get a notice which would force us to explain where the dividends ultimately were reported. Not fatal but it is scrutiny nonetheless." [328]

About a month later, another KPMG tax professional wrote to the BLIPS National Deployment Champion:

> "We spoke to Steven Buss about the possibility of reissuing the Presidio K–1s in the EIN of the member of the single member [limited liability corporations used in BLIPS]. He said that you guys hashed it out on Friday 3/24 and in a nutshell, Presidio is not going to re-issue K–1s.
>
> "David was wondering what the rationale was since the instructions and PPC say that single member LLCs are disregarded entities so 1099s, K–1s should use the EIN of the single member." [329]

She received the following response:

> "It was discussed on the national conference call today. Tracey Stone has been working with Mark Ely on the issue. Ely has indicated that while the IRS may have the capability to match ID numbers for partnerships, they probably lack the resources to do so. While technically the K–1's should have the social security number of the owner on them, it is my understanding that Mark has suggested that we not file a partnership for the single member LLC and that Presidio not file amended K–1s. . . . Tracey indicated that Mark did not like the idea of having us prepare

[327] Subcommittee interview of Mark Watson (11/4/03). See also Memorandum of Telephone Call, dated 5/24/00, from Kevin Pace regarding a telephone conversation with Carl Hastings, Bates KPMG 0036353 ("[T]here is quite a bit of activity in the trust area . . . because they have figured out that trusts are a common element in some of these shelter deals. So our best intelligence is that you are increasing your odds of being audited, not decreasing your odds by filing that Grantor Trust return. So we have discontinued doing that.")

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

[329] Email dated 3/28/00, from Jean Monahan to Jeffrey Eischeid and other KPMG tax professionals, "presidio K–1s," Bates KPMG 0024451. See also email dated 3/22/00, unidentified sender and recipients, "Nondisclosure," Bates KPMG 0025704.

partnership returns this year because then the IRS would be looking for them in future years."[330]

Additional emails sent among various KPMG tax professionals discuss whether BLIPS participants should extend or amend their tax returns, or file certain other tax forms, again with repeated references to minimizing IRS scrutiny of client return information.[331]

In the case of FLIP, KPMG tax professionals devised a different approach to avoiding IRS detection.[332] Again, the focus was on tax return reporting. The idea was to arrange for the offshore corporation involved in FLIP transactions to designate a fiscal year that ended in some month other than December in order to extend the year in which the corporation would have to report FLIP gains or losses on its tax return. For example, if the offshore corporation were to use a fiscal year ending in June, FLIP transactions which took place in August 1997, would not have to be reported on the corporation's tax return until after June 1998. Meanwhile, the individual taxpayer involved with the same FLIP transactions would have reported the gains or losses in his or her tax return for 1997. The point of arranging matters so that the FLIP transactions would be reported by the corporation and individual in tax returns for different years was simply to make it more difficult for the IRS to detect a link between the two participants in the FLIP transactions.

In the case of SC2, KPMG advised its tax professionals to tell potential buyers worried about being audited:

> "[T]his transaction is very stealth. We are not generating losses or other highly visible items on the S-corp return. All income of the S-corp is allocated to the shareholders, it just so happens that one shareholder [the charity] will not pay tax."[333]

No Roadmaps. A Subcommittee hearing held in December 2002, on an abusive tax shelter sold by J.P. Morgan Chase & Co. to Enron presented evidence that the bank and the company explicitly designed that tax shelter to avoid providing a "roadmap" to tax authorities.[334] KPMG appears to have taken similar precautions in FLIP, OPIS, BLIPS, and SC2.

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

[331] See, e.g., emails dated 4/1/00–4/3/00 among Mark Ely, David Rivkin and other KPMG tax professionals, "RE: Blips and tax filing issues," Bates KPMG 0006481–82; emails dated 3/23/00, between Mark Watson, Jeffrey Eischeid, David Rivkin and other KPMG tax professionals, "RE: Blips and tax filing issues," Bates KPMG 0006480. See also email dated 7/27/99, from Deke Carbo to Randall Bickham, Jeffrey Eischeid, and Shannon Liston, "Grouping BLIPS Investors," KPMG Bates 0023350 (suggests "grouping" multiple, unrelated BLIPS investors in a single Deutsche Bank account, possibly styled as a joint venture account, which might not qualify as a partnership required to file a K–1 tax return); email response dated 7/27/99, unidentified sender and recipients, "Grouping BLIPS Investors," KPMG Bates 0023350 (promises followup on suggestion which may "[solve] our grouping problem").

[332] See email dated 3/11/98 from Gregg Ritchie to multiple KPMG tax professionals, "Potential FLIP Reporting Strategy," Bates KPMG 0034372–75. See also internal KPMG memorandum dated 3/31/98, by Robin Paule, Los Angeles/Warner Center, "Form 5471 Filing Issues," Bates KPMG 0011952–53; and internal KPMG memorandum dated 3/6/98, by Bob Simon and Margaret Lukes, "Potential FLIP Reporting Strategy," Bates KPMG 0050644–45.

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

[334] "Fishtail, Bacchus, Sundance, and Slapshot: Four Enron Transactions Funded and Facilitated by U.S. Financial Institutions," Report prepared by the U.S. Senate Permanent Sub-

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In the case of SC2, in an exchange of emails among senior KPMG tax professionals discussing whether to send clients a letter explicitly identifying SC2 as a high-risk strategy and outlining certain specific risks, the SC2 National Deployment Champion wrote:

> "[D]o we need to disclose the risk in the engagement letter? . . . Could we have an addendum that discloses the risks? If so, could the Service have access to that? Obviously the last thing we want to do is provide the Service with a road map." [335]

The DPP head responded:

> ". . . If the risk has been disclosed and the IRS is successful in a challenge, the client can't maintain he was bushwhacked because he wasn't informed of the risk. . . . We could have a statement in the engagement letter that the client acknowledges receipt of a memorandum concerning risks associated with the strategy, then cover the double taxation risk and penalty risks (and other relevant risks) in that separate memorandum. Depending on how one interprets section 7525(b), such a memorandum arguably qualifies for the federal confidential communications privilege under section 7525(a)." [336]

This was not the only KPMG document that discussed using attorney-client or other legal privileges to limit disclosure of KPMG documents and activities related to its tax products. For example, a 1998 document containing handwritten notes from a KPMG tax professional about a number of issues related to OPIS states, under the heading "Brown & Wood": "Privilege[:] B&W can play a big role at providing protection in this area." [337]

Other parties who participated in the KPMG tax products also discussed using attorney-client privilege to conceal their activities. One was Deutsche Bank, which participated in both OPIS and BLIPS. In an internal email, one Deutsche Bank employee wrote to another regarding BLIPS: "I would have thought you could still ensure that . . . the papers are prepared, and all discussion held, in a way which makes them legally privileged. (. . . you may remember that was one of my original suggestions)." [338] Earlier, when considering whether to participate in BLIPS initially, the bank decided to limit its discussion of BLIPS on paper and not to obtain the approval of the bank committee that normally evaluates the risk that a transaction poses to the reputation of the bank, in order not to leave "an audit trail":

> "1. STRUCTURE: A diagramatic representation of the deal may help the Committee's understanding—we can prepare this.

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committee on Investigations of the Committee on Governmental Affairs, S. Prt. 107–82 (1/2/03), at 32.

[335] Email dated 3/25/00, from Larry Manth to Larry DeLap, Phillip Galbreath, Mark Springer, and Richard Smith, "RE: S-corp Product," Bates KPMG 0016986–87.

[336] Email dated 3/27/00, from Larry DeLap to Larry Manth, Phillip Galbreath, Mark Springer and Richard Smith, "RE: S-Corp Product," Bates KPMG 0016986.

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

[338] Email dated 7/29/99, from Mick Wood to Francesco Piovanetti and other Deutsche Bank professionals, "Re: Risk & Resources Committee Paper—BLIPS," Bates DB BLIPS 6556.

"2. PRIVILEDGE [sic]: This is not easy to achieve and therefore a more detailed description of the tax issues is not advisable.

"3. REPUTATION RISK: In this transaction, reputation risk is tax related and we have been asked by the Tax Department not to create an audit trail in respect of the Bank's tax affaires. The Tax department assumes prime responsibility for controlling tax related risks (including reputation risk) and will brief senior management accordingly. We are therefore not asking R&R Committee to approve reputation risk on BLIPS. This will be dealt with directly by the Tax Department and John Ross." [339]

Another bank that took precautions against placing tax product information on paper was Wachovia Bank's First Union National Bank. A First Union employee sent the following instructions to a number of his colleagues apparently in connection with the bank's approving sales of a new KPMG tax product:

"In order to . . . lower our profile on this particular strategy, the following points should be noted: The strategy has an KPMG acronym which will not be shared with the general First Union community. . . . Our traditional sources of client referrals inside First Union should not be informed of which Big 5 accounting firm we will choose to bring in on a strategy meeting with a client. . . . No one-pager will be distributed to our referral sources describing the strategy." [340]

Other documents obtained by the Subcommittee include instructions by senior KPMG tax professionals to their staff not to keep certain revealing documentation in their files or to clean out their files, again to avoid or limit detection of firm activity. For example, in the case of BLIPS, a KPMG tax professional sent an email to multiple colleagues stating: "You may want to remind everyone on Monday NOT to put a copy of Angie's email on the 988 elections in their BLIPS file. It is a road map for the taxing authorities to all the other listed transactions. I continue to find faxes from Quadra in the files . . . in the two 1996 deals here which are under CA audit which reference multiple transactions—not good if we would have to turn them over to California." [341] In the case of OPIS, a KPMG tax professional wrote: "I have quite a few documents/papers/notes related to the OPIS transaction. . . . Purging unnecessary information now pursuant to an established standard is probably ok. If the Service asks for information down the road (and we have it) we'll have to give it to them I suspect. Input from (gulp) DPP may be appropriate." [342]

[339] Email dated 7/30/99, from Ivor Dunbar to multiple Deutsche Bank professionals, "Re: Risk & Resources Committee Paper—BLIPS," unreadable Bates DB BLIPS number.

[340] Email dated 8/30/99, from Tom Newman to multiple First Union professionals, "next strategy," Bates SEN–014622.

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

[342] Email dated 9/16/98, from Bob to unknown recipients, "Documentation," Bates KPMG 0025729. Documents related to other KPMG tax products, such as TEMPEST and OTHELLO, contain similar information. See, e.g., message from Bob McCahill and Ken Jones, attached to

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Marketing Restrictions. KPMG also took precautions against detection of its activities during the marketing of the four products studied by the Subcommittee. FLIP and OPIS were explained only after potential clients signed a confidentiality agreement promising not to disclose the information to anyone else.[343] In the case of BLIPS, KMPG tax professionals were instructed to obtain "[s]igned nondisclosure agreements . . . before any meetings can be scheduled."[344] KPMG also limited the paperwork used to explain the products to clients. Client presentations were done on chalkboards or erasable whiteboards, and written materials were retrieved from clients before leaving a meeting.[345] KPMG determined as well that "[p]roviding a copy of a draft opinion letter will no longer be done to assist clients in their due diligence."[346] In SC2, the DPP head instructed KPMG tax professionals not to provide any "sample documents" directly to a client.[347]

KPMG also attempted to place marketing restrictions on the number of products sold so that word of them would be restricted to a small circle. In the case of BLIPS, the DPP initially authorized only 50 to be sold.[348] In the case of SC2, a senior tax professional warned against mass marketing the product to prevent the IRS from getting "wind of it":

> "I was copied on the message below, which appears to indicate that the firm is intent on marketing the SC2 strategy to virtually every S corp with a pulse (if S corps had pulses). Going way back to Feb. 2000, when SC2 first reared its head, my recollection is that SC2 was intended to be limited to a relatively small number of large S corps. That plan made sense because, in my opinion, there was (and is) a strong risk of a successful IRS attack on SC2 if the IRS gets wind of it. . . . [T]he intimate group of S corps potentially targeted for SC2 marketing has now expanded to 3,184 corporations. Call me paranoid, but I

an email dated 3/1/02, from Walter Duer to multiple KPMG tax professionals, "RE: TCS Review of TEMPEST and OTHELLO," Bates KPMG 0032378–80 ("There is current IRS audit activity with respect to two early TEMPEST engagements. One situation is under fairly intense scrutiny by IRS Financial Institutions and Products specialists. . . . Although KPMG has yet to receive a subpoena or any other request for documents, client lists, etc. we believe it is likely that such a request(s) is inevitable. Since TEMPEST is a National Stratecon solution for which Bob McCahill and Bill Reilly were the Co-Champions . . . it is most efficient to have all file reviews and "clean-ups" (electronic or hard copy) performed in one location, namely the FS NYC office. This effort will be performed by selected NE Stratecon professionals . . . with ultimate review and final decision making by Ken Jones. . . . [W]e want the same approach to be followed for OTHELLO as outlined above for TEMPEST. Senior tax leadership, Jeff Stein and Rick Rosenthal concur with this approach.")

343 See, e.g., memorandum dated 8/5/98, from Doug Ammerman to PFP Partners, "OPIS and Other Innovative Strategies," Bates KPMG 0026141–43, at 2–3 ("subject to their signing a confidentiality agreement"); *Jacoboni v. KPMG,* Case No. 6:02–CV–510 (District Court for the Middle District of Florida) Complaint (filed 4/29/02), at ¶ 9 ("KPMG executives told [Mr. Jacoboni] he could *not* involve any other professionals because the investment 'strategy' [FLIP] was 'confidential.'" Emphasis in original.); Subcommittee interview of legal counsel of Mr. Jacoboni (4/4/03).

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

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

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

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

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

> think that such a widespread marketing campaign is likely to bring KPMG and SC2 unwelcome attention from the IRS. . . . I realize the fees are attractive, but does the firm's tax leadership really think that his is an appropriate strategy to mass market?"[349]

The DPP head responded: "We had a verbal agreement following a conference call with Rick Rosenthal earlier this year that SC2 would not be mass marketed. In any case, the time has come to formally cease all marketing of SC2. Please so notify your deployment team and the marketing directors."[350]

(5) Disregarding Professional Ethics

In addition to all the other problems identified in the Subcommittee investigation, troubling evidence emerged regarding how KPMG handled certain professional ethics issues, including issues related to fees, auditor independence, and conflicts of interest in legal representation.

Contingent, Excessive, and Joint Fees. The fees charged by KPMG in connection with its tax products raise several concerns. It is clear that the lucrative nature of the fees drove the marketing efforts and helped convince other parties to participate.[351] KPMG made more than $124 million from just the four tax products featured in this Report. Sidley Austin Brown & Wood made millions from issuing concurring legal opinions on the validity of the four tax products. Deutsche Bank made more than $30 million in fees and other profits from BLIPS.

Traditionally, accounting firms charged flat fees or hourly fees for tax services. In the 1990's, however, accounting firms began charging "value added" fees based on "the value of the services provided, as opposed to the time required to perform the services."[352] In addition, some firms began charging "contingent fees" that were paid only if a client obtained specified results from the services offered, such as achieving specified tax savings.[353] Many states prohibit accounting firms from charging contingent fees due to the improper incentives they create, and a number of SEC, IRS, state, and AICPA rules allow their use in only limited circumstances.[354]

Within KPMG, the head of DPP-Tax took the position that fees based on projected client tax savings were contingent fees prohib-

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

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

[351] See, e.g., email dated 3/14/98, from Jeff Stein to multiple KPMG tax professionals, "Simon Says," Bates 638010, filed by the IRS on June 16, 2003, as an attachment to Respondent's Requests for Admission, *Schneider Interests v. Commissioner,* U.S. Tax Court, Docket No. 200–02 (addressing a dispute over which of two tax groups, Personal Financial Planning and International, should get credit for revenues generated by OPIS).

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

[353] See AICPA Code of Professional Conduct, Rule 302 ("[A] contingent fee is a fee established for the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such service.")

[354] See, e.g., AICPA Rule 302; 17 C.F.R. § 210.2–01(c)(5) (SEC contingent fee prohibition: "An accountant is not independent if, any point during the audit and professional engagement period, the accountant provides any service or product to an audit client for a contingent fee."); KPMG Tax Services Manual, § 32.4 on contingent fees in general and § 31.10.3 at 31–5 (DPP head determines whether specific KPMG fees comply with various rules on contingent fees.)

ited by AICPA Rule 302.[355] Other KPMG tax professionals disagreed, complained about the DPP interpretation, and pushed hard for fees based on projected tax savings. For example, one memorandum objecting to the DPP interpretation of Rule 302 warned that it "threatens the value to KPMG of a number of product development efforts," "hampers our ability to price the solution on a value added basis," and will cost the firm millions of dollars.[356] The memorandum also objected strongly to applying the contingent fee prohibition to, not only the firm's audit clients, but also to any individual who "exerts significant influence over" an audit client, such as a company director or officer, as required by the DPP. The memorandum stated this expansive reading of the prohibition was problematic, because "many, if not most, of our CaTS targets are officers/directors/shareholders of our assurance clients."[357] The memorandum states: "At the present time, we do not know if DPP's interpretation of Rule 302 has been adopted with the full awareness of the firm's leadership. . . . However, it is our impression that no one other than DPP has fully considered the issue and its impact on the tax practice."

In the four case studies examined by the Subcommittee, the fees charged by KPMG for BLIPS, OPIS, and FLIP were clearly based upon the client's projected tax savings.[358] In the case of BLIPS, for example, the BLIPS National Deployment Champion wrote the following description of the tax product and recommended that fees be set at 7% of the generated "tax loss" that clients would achieve on paper from the BLIPS transactions and could use to offset and shelter other income from taxation:

> "BLIPS . . . [A] key objective is for the tax loss associated with the investment structure to offset/shelter the taxpayer's other, unrelated, economic profits. . . . The all-in cost of the program, assuming a complete loss of investment principal, is 7% of the targeted tax loss (pre-tax). The tax benefit of the investment program, which ranges from 20% to 45% of the targeted tax loss, will depend on the taxpayer's effective tax rates.
>
> "*FEE:* BLIPS is priced on a fixed fee basis which should approximate 1.25% of the tax loss. Note that this fee is included in the 7% described above."[359]

Another document, an email sent from Presidio to KPMG, provides additional detail on the 7% fee charged to BLIPS clients, ascribing "basis points" or portions of the 7% fee to be paid to various

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[355] Subcommittee interview of Lawrence DeLap (10/30/03); memorandum dated 7/14/98, from Gregg Ritchie to multiple KPMG tax professionals, "Rule 302 and Contingency Fees—CONFIDENTIAL," Bates KPMG 0026557–58.

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

[357] "CaTS" stands for KPMG's Capital Transaction Services Group which was then in existence and charged with selling tax products to high net worth individuals.

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

[359] Document dated 7/21/99, entitled "Action Required," authored by Jeffrey Eischeid, Bates KPMG 0040502. See also, e.g., memorandum dated 8/5/98, from Doug Ammerman to "PFP Partners," "OPIS and Other Innovative Strategies," Bates KPMG 0026141–43 at 2 ("In the past KPMG's fee related to OPIS has been paid by Presidio. According to DPP-Assurance, this fee structure may constitute a contingent fee and, as a result, may be a prohibited arrangement. . . . KPMG's fee must be a *fixed* amount and be paid directly by the client/target." Emphasis in original.)

participants for various expenses. All of these basis points, in turn, depended upon the size of the client's expected tax loss to determine their amount. The email states:

"The breakout for a typical deal is as follows:

Bank Fees	125
Mgmt Fees	275
Gu[aran]teed Pymt.	8
Net Int. Exp.	6
Trading Loss	70
KPMG	125
Net return to Class A	91" [360]

Virtually all BLIPS clients were charged this 7% fee.

In the case of SC2, which was constructed to shelter certain S corporation income otherwise attributable and taxable to the corporate owner, KPMG described SC2 fees as "fixed" at the beginning of the engagement at an amount that "generally . . . approximated 10 percent of the expected average taxable income of the S Corporation for the 2 years following implementation." [361] SC2 fees were set at a minimum of $500,000, and went as high as $2 million per client.[362]

The documents suggest that, at least in some cases, KPMG deliberately manipulated the way it handled certain tax products to circumvent state prohibitions on contingent fees. For example, a document related to OPIS identifies the states that prohibit contingent fees. Then, rather than prohibit OPIS transactions in those states or require an alternative fee structure, the memorandum directs KPMG tax professionals to make sure the OPIS engagement letter is signed, the engagement is managed, and the bulk of services is performed "in a jurisdiction that does not prohibit contingency fees." [363]

Another set of fee issues related to the fees paid to the key law firm that issued concurring legal opinions supporting the four KPMG tax products, Sidley Austin Brown & Wood. This law firm was paid $50,000 for each legal opinion it provided in connection with BLIPS, FLIP, and OPIS. Documents and interview evidence obtained by the Subcommittee indicate that the law firm was paid even more in transactions intended to provide clients with large tax losses, and that the amount paid to the law firm may have been linked directly to the size of the client's expected tax loss. For example, one email describing the fee amounts to be paid to Sidley Austin Brown & Wood in BLIPS and OPIS deals appears to assign to the law firm "basis points" or percentages of the client's expected tax loss:

"Brown & Wood fees:

Quadra OPIS98—30 bpts

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

[361] Tax Solution Alert for S-Corporation Charitable Contribution Strategy, FY00–28, revised as of 12/7/01, at 2. See also email dated 12/27/01, from Larry Manth to Andrew Atkin and other KPMG tax professionals, "SC2," Bates KPMG 0048773 (describing SC2 fees as dependent upon client tax savings).

[362] *Id.*

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

Quadra OPIS99—30 bpts
Presidio OPIS98—25 bpts
Presidio OPIS99—25 bpts
BLIPS—30 bpts"[364]

American Bar Association (ABA) Model Rule 1.5 states that "[a] lawyer shall not make an agreement for, charge, or collect an unreasonable fee," and cites as the factors to consider when setting a fee amount "the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly." Sidley Austin Brown & Wood charged substantially the same fee for each legal opinion it issued to a FLIPS, OPIS, or BLIPS client, even when opinions drafted after the initial prototype opinion contained no new facts or legal analysis, were virtually identical to the prototype except for client names, and in many cases required no client consultation. As mentioned earlier, in BLIPS, Sidley Austin Brown & Wood was also paid a fee in any sale where a prospective buyer was told that the law firm would provide a favorable tax opinion letter if asked, regardless of whether the opinion was later requested or provided.[365] These fees, with few costs after the prototype opinion was drafted, raise questions about the firm's compliance with ABA Model Rule 1.5.

Still another issue involves joint fees. In the case of BLIPS, clients were charged a single fee equal to 7% of the tax losses to be generated by the BLIPS transactions. The client typically paid this fee to Presidio, an investment advisory firm, which then apportioned the fee amount among various firms according to certain factors. The fee recipients typically included KPMG, Presidio, participating banks, and Sidley Austin Brown & Wood, and one of the factors determining the fee apportionment was who had brought the client to the table. This fee splitting arrangement may violate restrictions on contingency and client referral fees, as well as an American Bar Association prohibition against law firms sharing legal fees with non-lawyers.[366]

Auditor Independence. Another professional ethics issue involves auditor independence. Deutsche Bank, HVB, and Wachovia Bank are all audit clients of KPMG, and at various times all three have played roles in marketing or implementing KPMG tax products. Deutsche Bank and HVB provided literally billions of dollars in financing to make OPIS and BLIPS transactions possible. Wachovia, through First Union National Bank, referred clients to KPMG and was paid or promised a fee for each client who actually purchased a tax product. For example, one internal First Union email on fees stated: "Fees to First Union will be 50 basis points

[364] Email dated 5/15/00, from Angie Napier to Jeffrey Eischied and others, "B&W fees and generic FLIP rep letter," Bates KPMG 0036342.
[365] See "Declaration of Richard E. Bosch," IRS Revenue Agent, *In re John Doe Summons to Sidley Austin Brown & Wood* (N.D. Ill. 10/16/03) at ¶ 18, citing an email dated 10/1/97, from Gregg Ritchie to Randall Hamilton, "Flip Tax Opinion."
[366] See ABA Model Rule 5.4, "A lawyer or law firm shall not share legal fees with a non-lawyer." Reasons provided for this rule include "protect[ing] the lawyer's professional independence of judgment."

if the investor is not a KPMG client, and 25 bps if they are a KPMG client."[367]

KPMG Tax Services Manual states: "Due to independence considerations, the firm does not enter into alliances with SEC audit clients."[368] KPMG defines an "alliance" as "a business relationship between KPMG and an outside firm in which the parties intend to work together for more than a single transaction."[369] KPMG policy is that "[a]n oral business relationship that has the effect of creating an alliance should be treated as an alliance."[370] Another provision in KPMG's Tax Services Manual states: "The SEC considers independence to be impaired when the firm has a direct or material indirect business relationship with an SEC audit client."[371]

Despite the SEC prohibition and the prohibitions and warnings in its own Tax Services Manual, KPMG worked with audit clients, Deutsche Bank, HVB, and Wachovia, on multiple BLIPS, FLIP, and OPIS transactions. In fact, at Deutsche Bank, the KPMG partner in charge of Deutsche Bank audits in the United States expressly approved the bank's accounting of the loans for the BLIPS transactions.[372] KPMG tax professionals were aware that doing business with an audit client raised auditor independence concerns.[373] KPMG apparently attempted to resolve the auditor independence issue by giving clients a choice of banks to use in the OPIS and BLIPS transactions, including at least one bank that was not a KPMG audit client.[374] It is unclear, however, whether individuals actually could choose what bank to use. It is also unclear how providing clients with a choice of banks alleviated KPMG's conflict of interest, since it still had a direct or material, indirect business relationship with banks whose financial statements were certified by KPMG auditors.

In 2003, the SEC opened an informal inquiry into whether the client referral arrangements between KPMG and Wachovia violated the SEC's auditor independence rules. In its second quarter

[367] Email dated 8/30/99, from Tom Newman to multiple First Union employees, "next strategy," Bates SEN–014622.

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

[369] *Id.*, § 52.1.1 at 52–1.

[370] Minutes dated 9/28/98, of KPMG "Assurance/Tax Professional Practice Meeting" in New York, "Summary of Conclusions and Action Steps," Bates XX 001369–74, at 1373.

[371] KPMG Tax Services Manual, § 52.5.2 at 52–6 (Emphasis in original.). The SEC "Business Relationships" regulation states: "An accountant is not independent if, at any point during the audit and professional engagement period, the accounting firm or any covered person in the firm has any direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity, such as an audit client's officers, directors, or substantial stockholders." 17 C.F.R. § 210.2–01(c)(3).

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

[373] See, e.g., memorandum dated 8/5/98, from Doug Ammerman to "PFP Partners," "OPIS and Other Innovative Strategies," Bates KPMG 0026141–43 ("Currently, the only institution participating in the transaction is a KPMG audit client. . . . As a result, DPP-Assurance feels there may be an independence problem associated with our participation in OPIS . . ."); email dated 2/11/99, from Larry DeLap to multiple KPMG tax professionals, "RE: BLIPS," Bates KPMG 0037992 ("The opinion letter refers to transactions with Deutsche Bank. If the transactions will always involve Deutsche Bank, we could have an independence issue."); email dated 4/20/99, from Larry DeLap to multiple KPMG tax professionals, "BLIPS," Bates KPMG 0011737–38 (Deutsche Bank, a KPMG audit client, is conducting BLIPS transactions); email dated 11/30/01, from Councill Leak to Larry Manth, "FW: First Union Customer Services," Bates KPMG 0050842 (lengthy discussion of auditor independence concerns and First Union).

[374] See, e.g., email dated 4/20/99, from Larry DeLap to multiple KPMG tax professionals, "BLIPS," Bates KPMG 0011737–38 (discussing using Deutsche Bank, a KPMG audit client, in BLIPS transactions).

filing with the SEC in August 2003, Wachovia provides the following description of the ongoing SEC inquiry:

> "On June 19, 2003, the Securities and Exchange Commission informally requested Wachovia to produce certain documents concerning any agreements or understandings by which Wachovia referred clients to KPMG LLP during the period January 1, 1997 to the present. Wachovia is cooperating with the SEC in its inquiry. Wachovia believes the SEC's inquiry relates to certain tax services offered to Wachovia customers by KPMG LLP during the period from 1997 to early 2002, and whether these activities might have caused KPMG LLP not to be 'independent' from Wachovia, as defined by applicable accounting and SEC regulations requiring auditors of an SEC-reporting company to be independent of the company. Wachovia and/or KPMG LLP received fees in connection with a small number of personal financial consulting transactions related to these services. During all periods covered by the SEC's inquiry, including the present, KPMG LLP has confirmed to Wachovia that KPMG LLP was and is 'independent' from Wachovia under applicable accounting and SEC regulations."

In its third quarter filing with the SEC, Wachovia stated that, on October 21, 2003, the SEC issued a "formal order of investigation" into this matter, and the bank is continuing to cooperate with the inquiry.

A second set of auditor independence issues involves KPMG's decision to market tax products to its own audit clients. Evidence appears throughout this Report of KPMG's efforts to sell tax products to its audit clients or the officers, directors, or shareholders of its audit clients. This evidence includes instances in which KPMG mined its audit client data to develop a list of potential clients for a particular tax product;[375] tax products that were designed and explicitly called for "fostering cross-selling among assurance and tax professionals";[376] and marketing initiatives that explicitly called upon KPMG tax professionals to contact their audit partner counterparts and work with them to identify appropriate clients and pitch KPMG tax products to those audit clients.[377] A KPMG memorandum cited earlier in this Report observed that "many, if not most, of our CaTS targets are officers/directors/shareholders of our assurance clients."[378]

By using its audit partners to identify potential clients and targeting its audit clients for tax product sales pitches, KPMG not only took advantage of its auditor-client relationship, but also cre-

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[375] See, e.g., Presentation dated 7/17/00, "Targeting Parameters: Intellectual Property—Assurance and Tax," with attachment dated September 2000, entitled "Intellectual Property Services," at page 1 of the attachment, Bates XX 001567–93.

[376] Presentation dated 3/6/00, "Post-Transaction Integration Service (PTIS)—Tax," by Stan Wiseberg and Michele Zinn of Washington, D.C., Bates XX 001597–1611.

[377] Email dated 8/14/01, from Jeff Stein and Walter Duer to "KPMG LLP Partners, Managers and Staff," "Stratecon Middle Market Initiative," Bates KPMG 0050369.

[378] Memorandum dated 7/14/98, from Gregg Ritchie to multiple KPMG tax professionals, "Rule 302 and Contingency Fees—CONFIDENTIAL," Bates KPMG 0026555–59. CaTS stands for the Capital Transaction Services Group which was then in existence and charged with selling tax products to high net worth individuals.

ated a conflict of interest in those cases where it successfully sold a tax product to an audit client. This conflict of interest arises when the KPMG auditor reviewing the client's financial statements is required, as part of that review, to examine the client's tax return and its use of the tax product to reduce its tax liability and increase its income. In such situations, KPMG is, in effect, auditing its own work.

The inherent conflict of interest is apparent in the minutes of a 1998 meeting held in New York between KPMG top tax and assurance professionals to address topics of concern to both divisions of KPMG.[379] A written summary of this meeting includes as its first topic: "Accounting Considerations of New Tax Products." The section makes a single point: "Some tax products have pre-tax accounting implications. DPP-Assurance's role should be to *review* the accounting treatment, not to *determine* it."[380] This characterization of the issue implies not only a tension between KPMG's top auditing and tax professionals, but also an effort to diminish the authority of the top assurance professionals and make it clear that they may not "determine" the accounting treatment for new tax products.

The next topic in the meeting summary is: "Financial Statement Treatment of Aggressive Tax Positions."[381] Again, the section discloses an ongoing tension between KPMG's top auditing and tax professionals on how to account for aggressive tax products in an audit client's financial statements. The section notes that discussions had taken place and further discussions were planned "to determine whether modifications may be made" to KPMG's policies on how "aggressive tax positions" should be treated in an audit client's financial statements. An accompanying issue list implies that the focus of the discussions will be on weakening rather than strengthening the existing policies. For example, among the policies to be re-examined were KPMG's policies that, "*[n]o* financial statement tax benefit should be provided unless it is probable the position will be allowed,"[382] and that the "probable of allowance" test had to be based solely on technical merits and could not consider the "probability" that a client might win a negotiated settlement with the IRS. The list also asked, in effect, whether the standard for including a financial statement tax benefit in a financial statement could be lowered to include, not only tax products that "should" survive an IRS challenge, which KPMG interprets as having a 70% or higher probability, but also tax products that are "more-likely-than-not" to withstand an IRS challenge, meaning a better than 50% probability.

Conflicts of Interest in Legal Representation. A third set of professional ethics issues involves legal representation of clients who, after purchasing a tax product from KPMG, have come under the scrutiny of the IRS for buying an illegal tax shelter and understating their tax liability on their tax returns. The mass marketing

[379] Minutes dated 9/28/98, of KPMG "Assurance/Tax Professional Practice Meeting" in New York, "Summary of Conclusions and Action Steps," Bates XX 001369–74. (Capitalization in original omitted.)

[380] *Id.* at Bates XX 001369. (Emphasis in original.)

[381] Minutes dated 9/28/98, of KPMG "Assurance/Tax Professional Practice Meeting" in New York, "Summary of Conclusions and Action Steps," Bates XX 001369–74.

[382] *Id.* at Bates XX 001370. (Emphasis in original.)

of tax products has led to mass enforcement efforts by the IRS after a tax product has been found to be abusive and the IRS obtains the lists of clients who purchased the product. In response, certain law firms have begun representing multiple clients undergoing IRS audit for purchasing similar tax shelters.

One key issue involves KPMG's role in referring its tax shelter clients to specific law firms. In 2002, KPMG assembled a list of "friendly" attorneys and began steering its clients to them for legal representation. For example, an internal KPMG email providing guidance on "FLIPS/OPIS/BLIPS Attorney Referrals" states: "This is a list that our group put together. All of the attorneys are part of the coalition and friendly to the firm. Feel free to forward to a client if they would like a referral." [383] The "coalition" referred to in the email is a group of attorneys who had begun working together to address IRS enforcement actions taken against taxpayers who had used the FLIP, OPIS, or BLIPS tax products.

One concern with the KPMG referral list is that at least some of the clients being steered to "friendly" law firms might want to sue KPMG itself for selling them an illegal tax shelter. In one instance examined by the Subcommittee, for example, a KPMG client under audit by the IRS for using BLIPS was referred by KPMG to a law firm, Sutherland, Asbill & Brennan, with which KPMG had a longstanding relationship but with which the client had no prior contact. In this particular instance, the law firm did not even have offices in the client's state. The client was also one of more than two dozen clients that KPMG had steered to this law firm. While KPMG did not obtain a fee for making those client referrals, the firm likely gained favorable attention from the law firm for sending it multiple clients with similar cases. These facts suggest that Sutherland Asbill would owe a duty of loyalty to KPMG, not only as a longstanding and important client, but also as a welcome source of client referrals.

The engagement letter signed by the KPMG client, in which he agreed to pay Sutherland Asbill to represent him before the IRS in connection with BLIPS, contained this disclosure:

> "In the event you desire to pursue claims against the parties who advised you to enter into the transaction, we would not be able to represent you in any such claims because of the broad malpractice defense practice of our litigation team (representing all of the Big Five accounting firms, for example)." [384]

The KPMG client told the Subcommittee that he had not understood at the time that this disclosure meant that Sutherland Asbill was already representing KPMG in other "malpractice defense" matters and therefore could not represent him if he decided to sue

[383] Email dated 4/9/02, from Erin Collins to multiple KPMG tax professionals, "FLIPS/OPIS/BLIPS Attorney Referrals," Bates KPMG 0050113. See also email dated 11/4/02, from Ken Jones to multiple KPMG tax professionals, "RE: Script," Bates KPMG 0050130 ("Attached is a list of law firms that are handling FLIP/OPIS cases. Note that there are easily another 15 or so law firms . . . but these are firms that we have dealt with in the past. Note that we are not making a recommendation, although if someone wants to talk about the various strengths/weaknesses of one firm vs. another . . . we can do that.").

[384] Engagement letter between Sutherland Asbill & Brennan LLP and the client, dated 7/23/02, at 1, Bates SA 001964.

KPMG for selling him an illegal shelter. The client signed the engagement letter on July 24, 2002.

On September 8, 2002, Sutherland Asbill "engaged KPMG" itself to assist the law firm in its representation of KPMG's former client, including with respect to "investigation of facts, review of tax issues, and other such matters as Counsel may direct." This engagement meant that KPMG, as Sutherland Asbill's agent, would have access to confidential information related to its client's legal representation, and that KPMG itself would be providing key information and analysis in the case. It also meant that the KPMG client would be paying for the services provided by the same accounting firm that had sold him the tax shelter. When a short while later, the client asked Sutherland Asbill about the merits of suing KPMG, he was told that the firm could not represent him in such a legal action, and he switched to new legal counsel.

The conflict of interest issues here involve, not only whether KPMG should be referring its clients to a "friendly" law firm, but also whether the law firm itself should be accepting these clients, in light of the firm's longstanding and close relationship with KPMG. While both KPMG and the client have an immediate joint interest in defending the validity of the tax product that KPMG sold and the client purchased, their interests could quickly diverge if the suspect tax product is found to be in violation of federal tax law. This divergence in interests has been demonstrated repeatedly since 2002, as growing numbers of KPMG clients have filed suit against KPMG seeking a refund of past fees paid to the firm and additional damages for KPMG's selling them an illegal tax shelter.

The preamble to the American Bar Association (ABA) Model Rules states that "a lawyer, as a member of the legal profession, is a representative of clients, an officer of the legal system and a public citizen having special responsibility for the quality of justice. . . . As (an) advocate, a lawyer zealously asserts the client's position under the rules of the adversary system." The problem here is the conflict of interest that arises when a law firm attempts to represent an accounting firm's client at the same time it is representing the accounting firm itself, and the issue in controversy is a tax product that the accounting firm sold and the client purchased. In such a case, the attorney cannot zealously represent the interests of both clients due to conflicting loyalties. A related issue is whether the law firm can ethically use the accounting firm as the tax expert in the client's case, given the accounting firm's self interest in the case outcome.

At the request of the Subcommittee, the Congressional Research Service's American Law Division analyzed the possible conflict of interest issues.[385] The CRS analysis concluded that, under American Bar Association Model Rule 1.7, a law firm should decline to represent an accounting firm client in a tax shelter case if the law firm already represents the accounting firm itself on other matters. The CRS analysis identified "two possible, and interconnected, conflicts of interest" that should lead the law firm to decline the engagement. The first is a "current conflict of interest" at the time

[385] Memorandum dated 11/14/03, by Jack Maskell, Legislative Attorney, American Law Division, Congressional Research Service, "Attorneys and Potential Conflicts of Interest Between New Clients and Existing Clients."

of engagement, which arises from "a 'substantial risk' that the attorney . . . would be 'materially limited' by his responsibilities to another client" in "pursuing certain relevant and proper courses of action on behalf of the new client" such as filing suit against the firm's existing client, the accounting firm. The second is a "potential conflict of interest whereby the attorney may not represent the new client in litigation . . . against an existing, current client. That particular, potential conflict of interest could not be waived."

The CRS analysis also recommends that the law firm fully inform a potential client about the two conflicts of interest prior to any engagement, so that the client can make a meaningful decision on whether he or she is willing to be represented by a law firm that already represents the accounting firm that sold the client the tax product at issue. According to ABA Model Rule 1.7, informed consent must be in writing, but "[t]he requirement of a writing does not supplant the need in most cases for the lawyer to talk with the client, to explain the risks and advantages, if any, of representation burdened with a conflict of interest, as well as reasonably available alternatives, and to afford the client a reasonable opportunity to consider the risks and alternatives and to raise questions and concerns." The CRS analysis opines that a "blanket disclosure" provided by a law firm in an engagement letter is insufficient, without additional information, to ensure the client fully understands and consents to the conflicts of interest inherent in the law firm's dual representation of the client and the accounting firm.

APPENDICES

APPENDIX A

CASE STUDY OF BOND LINKED ISSUE PREMIUM STRUCTURE (BLIPS)

KPMG approved the Bond Linked Issue Premium Structure (BLIPS) for sale to multiple clients in 1999. KPMG marketed BLIPS for about 1 year, from about October 1999 to about October 2000. KPMG sold BLIPS to 186 individuals, in 186 transactions, and obtained more than $53 million in revenues, making BLIPS one of KPMG's top revenue producers in the years it was sold and the highest revenue-producer of the four case studies examined by the Subcommittee.

BLIPS was developed by KPMG primarily as a replacement for earlier KPMG tax products, FLIP and OPIS, each of which KPMG has characterized as a "loss generator" or "gain mitigation strategy."[386] In 2000, the IRS issued a notice declaring transactions like BLIPS to be potentially abusive tax shelters.[387]

BLIPS is so complex that a full explanation of it would take more space that this Report allows, but it can be summarized as follows. Charts depicting a typical BLIPS transaction are also provided.[388]

1) The Gain. Individual has ordinary or capital gains income (e.g., $20 million).

2) The Sales Pitch. Individual is approached with a "tax advantaged investment strategy" by KPMG and Presidio, an investment advisory firm, to generate an artificial "loss" sufficient to offset the income and shelter it from taxation. Individual is told that, for a fee, Presidio will arrange the required investments and bank financing, and KPMG and a law firm will provide separate opinion letters stating it is "more likely than not" the tax loss generated by the investments will withstand an IRS challenge.

3) The Shell Corporation. Pursuant to the strategy, Individual forms a single-member limited liability corporation ("LLC") and contributes cash equal to 7% ($1.4 million) of the tax loss ($20 million) to be generated by the strategy.

4) The "Loan." LLC obtains from a bank, for a fee, a non-recourse "loan" (e.g., $50 million) with an ostensible 7-year term at an above-market interest rate, such as 16%. Because of the above-

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[386] See, e.g., document dated 5/18/01, "PFP Practice Reorganization Innovative Strategies Business Plan—DRAFT," authored by Jeffrey Eischeid, Bates KPMG 0050620–23, at 1.

[387] BLIPS is covered by IRS Notice 2000–44 (2000–36 IRB 255) (9/5/00).

[388] A detailed explanation of these charts is included in the opening statement of Senator Carl Levin at the hearing before the Senate Permanent Subcommittee on Investigations, "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals" (11/18/03).

market interest rate, LLC also obtains from the bank a large cash amount up-front (e.g., $20 million) referred to as a "loan premium." The "premium" equals the net present value of the portion of the "loan" interest payments that exceed the market rate and that LLC is required to pay during the full 7-year "loan." The "loan premium" also equals the tax loss to be generated by the strategy. LLC thus receives two cash amounts from the bank ($50 million plus $20 million totaling $70 million).

5) The "Loan" Restrictions. LLC agrees to severe restrictions on the "loan" to make it a very low credit risk. Most importantly, LLC agrees to maintain "collateral" in cash or liquid securities equal to 101% of the "loan" amount, including the "loan premium" (e.g., $70.8 million). LLC also agrees to severe limits on how the "loan proceeds" may be invested and gives the bank unilateral authority to terminate the "loan" if the "collateral" amount drops below 101% of the "loan" amount.

6) The Partnership. LLC and two Presidio affiliates form a partnership called a Strategic Investment Fund ("Fund") in which LLC has a 90% partnership interest, one Presidio affiliate holds a 9% interest, and the second Presidio affiliate has a 1% interest. The 1% Presidio affiliate is the managing partner.

7) The Assets. The Fund is capitalized with the following assets. The LLC contributes all of its assets, consisting of the "loan" ($50 million), "loan premium" ($20 million), and the Individual's cash contribution ($1.4 million). Presidio's two affiliates contribute cash equal to 10% of the LLC's total assets ($155,000). The Fund's capital is a total of these contributions ($71.6 million).

8) The Loan Transfer. LLC assigns the "loan" to the Fund which assumes LLC's obligation to repay it. This obligation includes repayment of the "loan" and "loan premium," since the "premium" consists of a portion of the interest payments owed on the "loan" principal.

9) The Swap. At the same time, the Fund enters into a swap transaction with the bank on the "loan" interest rate. In effect, the Fund agrees to pay a floating market rate on an amount equal to the "loan" and "loan premium" (about 8% on $70 million), while the bank agrees to pay the 16% fixed rate on the face amount of the "loan" (16% on $50 million). The effect of this swap is to reduce the "loan" interest rate to a market-based rate.

10) The Foreign Currency Investment "Program." The Fund converts most of its U.S. dollars into euros with a contract to convert the funds back into U.S. dollars in 30–60 days. This amount includes most or all of the loan and loan premium amount. Any funds not converted into euros remain in the Fund account. The euros are placed in an account at the bank. The Fund engages in limited transactions which involve the "shorting" of certain low-risk foreign currencies and which are monitored by the bank to ensure that only a limited amount of funds are ever placed at risk and that the funds deemed as 101% "collateral" for the bank "loan" are protected.

11) The Unwind. After 60 to 180 days, LLC withdraws from the partnership. The partnership unwinds, converts all cash into U.S. dollars, and uses that cash to repay the "loan" plus a "prepayment penalty" equal to the unamortized amount of the "loan premium," so that the "loan" and "loan premium" are paid in full. Any remaining partnership assets are apportioned and distributed to the LLC and Presidio partners, either in cash or securities. LLC sells any securities at fair market value.

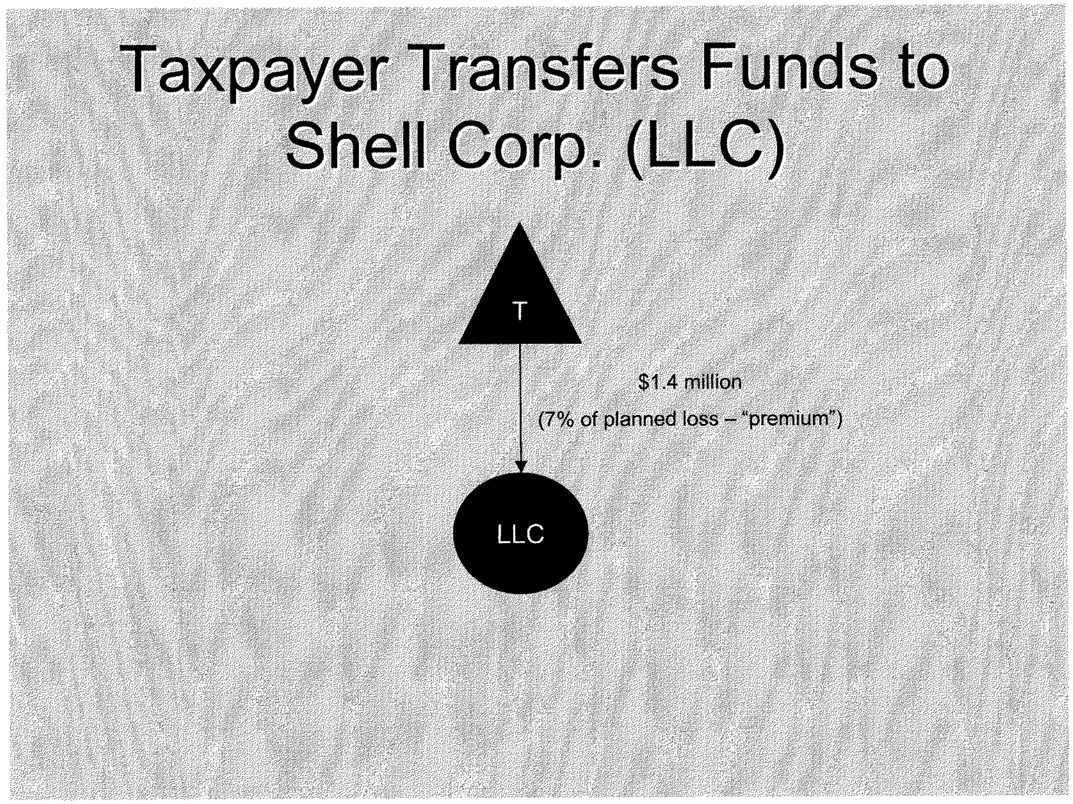
12) Tax Claim for Cost Basis. For tax purposes, the LLC's income or loss passes to its owner, the Individual. According to the opinion letters, the Individual can attempt to claim, for tax purposes, that he or she retained a cost basis in the partnership equal to the LLC's contributions of cash ($1.4 million) and the "loan premium" ($20 million), even though the partnership later assumed the LLC's "loan" obligation and repaid the "loan" in full, including the "premium amount." According to the opinion letters, the individual can attempt to claim a tax loss equal to the cost basis ($21.4 million), adjusted for any gain or loss from the currency trades, and use that tax loss to offset ordinary or capital gains income.

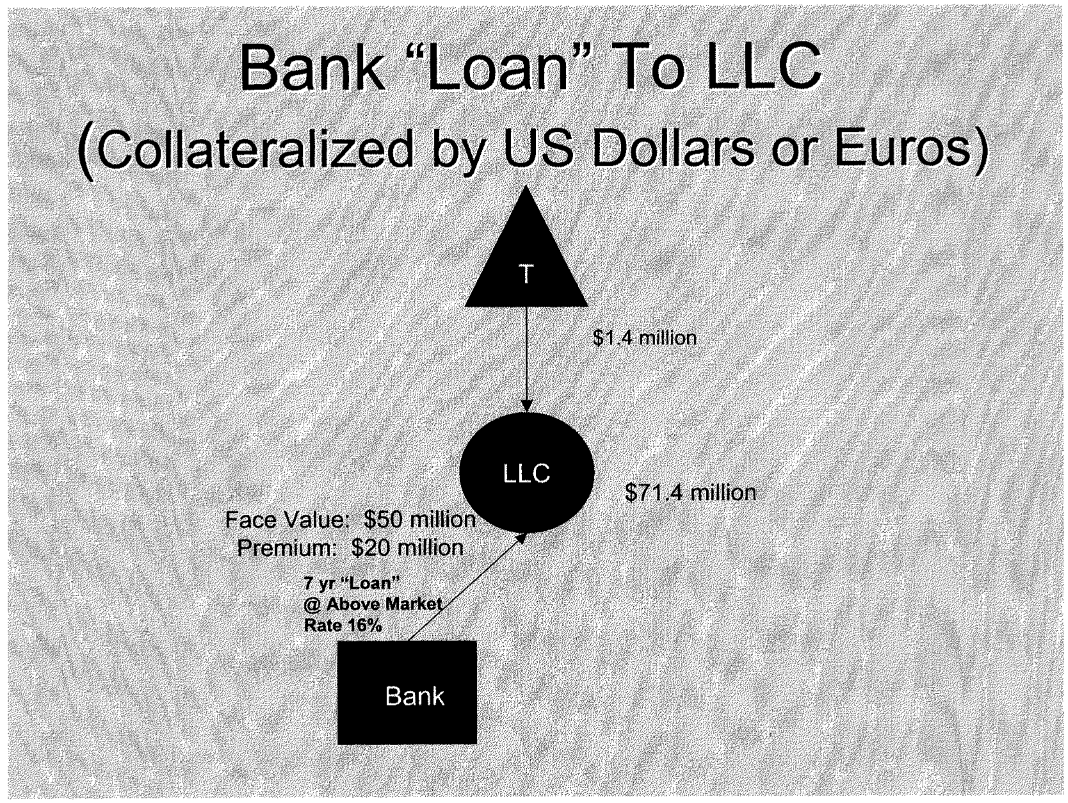
13) IRS Action. In 2000, the IRS issued a notice declaring that the "purported losses" arising from these types of transactions, which use an "artificially high basis," "do not represent bona fide losses reflecting actual economic consequences" and "are not allowable as deductions for federal income tax purposes." IRS Notice 2000–44 listed this transaction as a potentially abusive tax shelter.

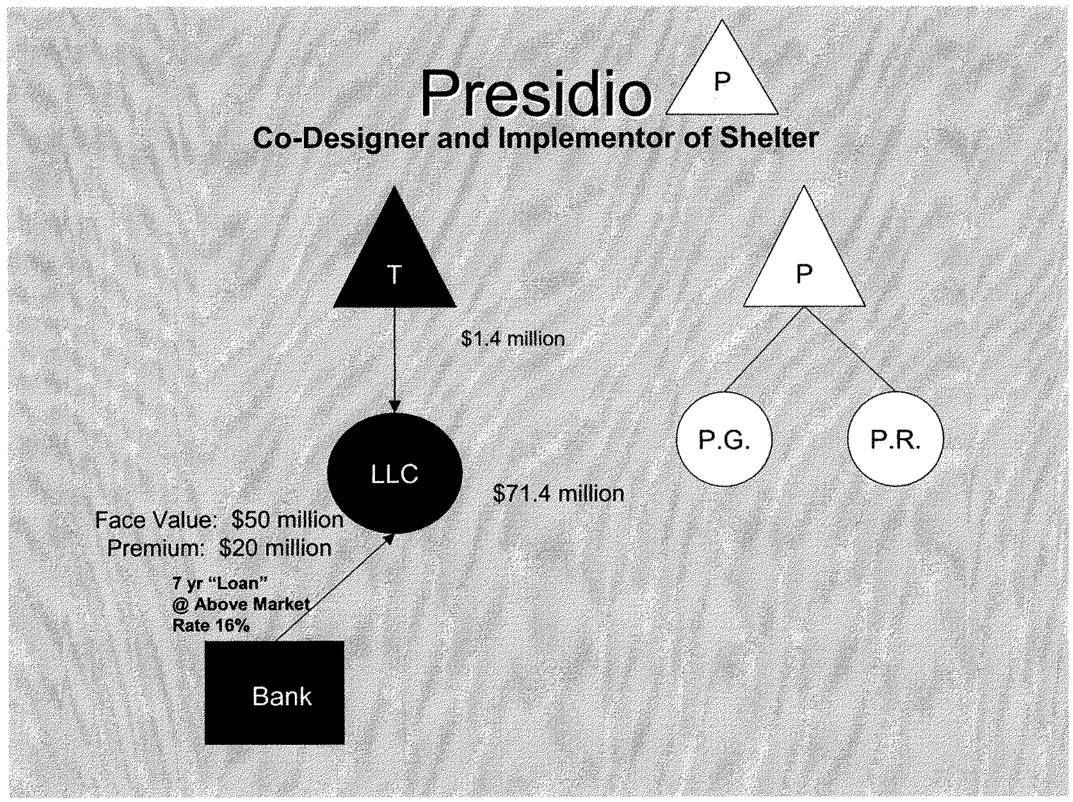
BLIPS

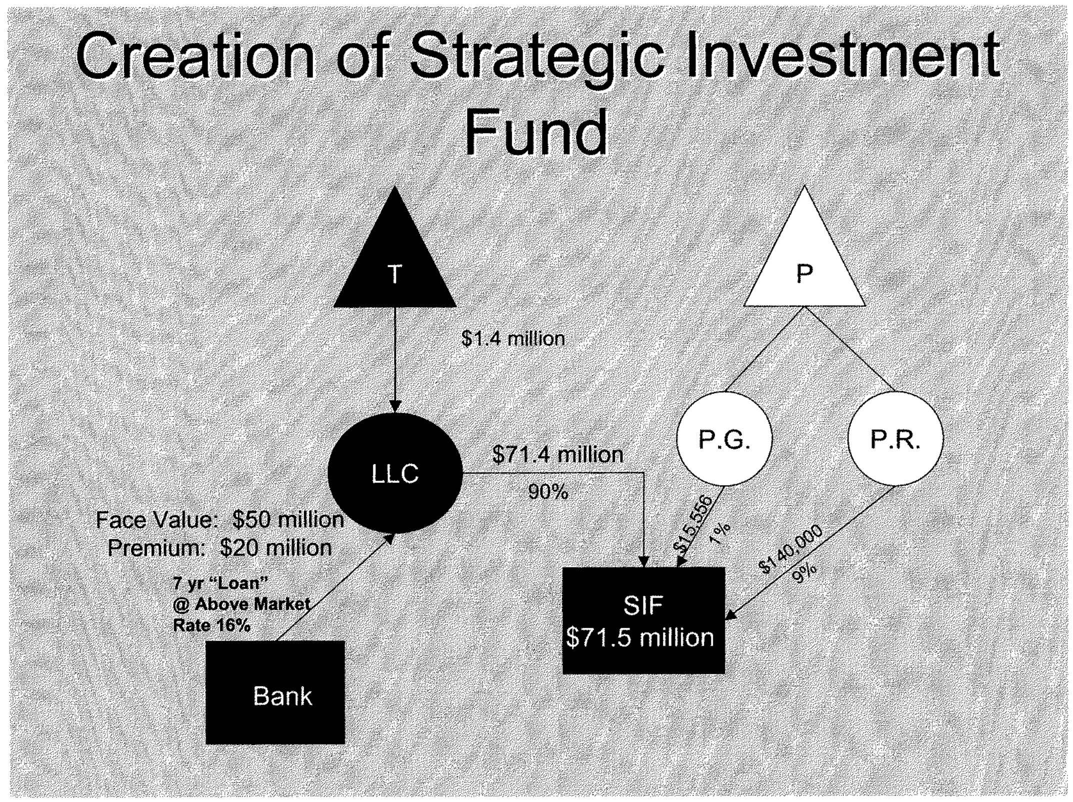
Bond Linked Issue Premium Structure

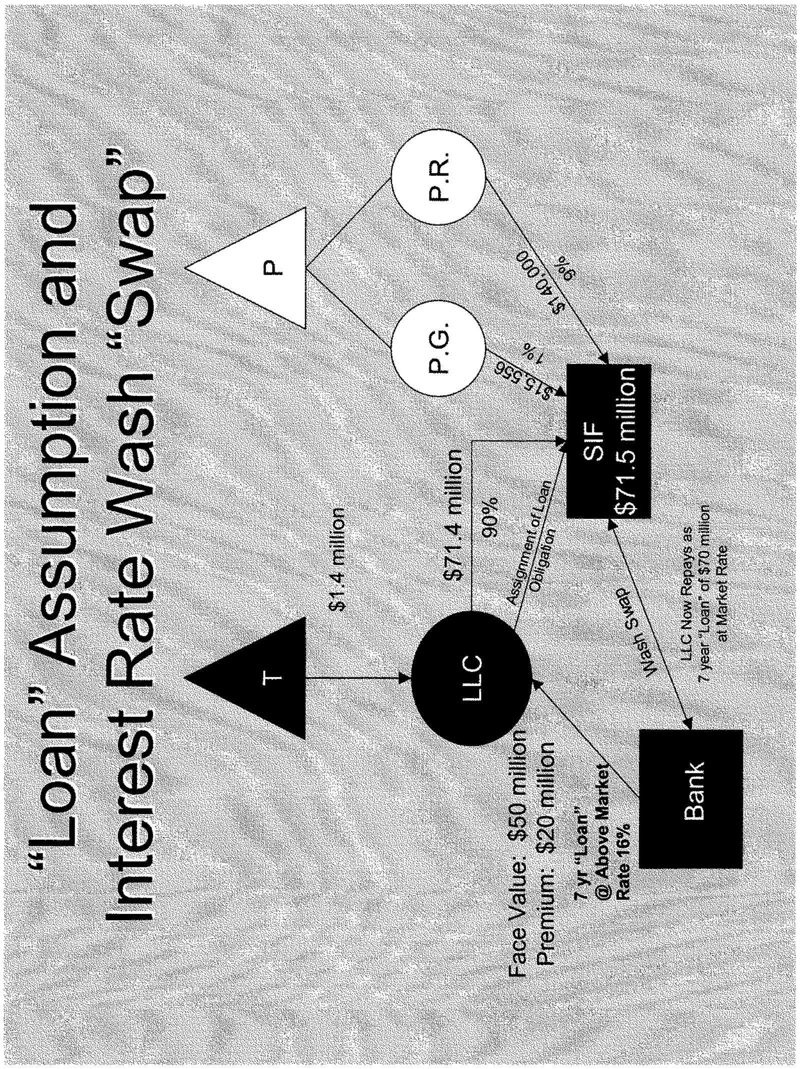
Prepared by U.S. Senate Permanent Subcommittee on Investigations, Subcommittee Staff of Senator Carl Levin, November 2003

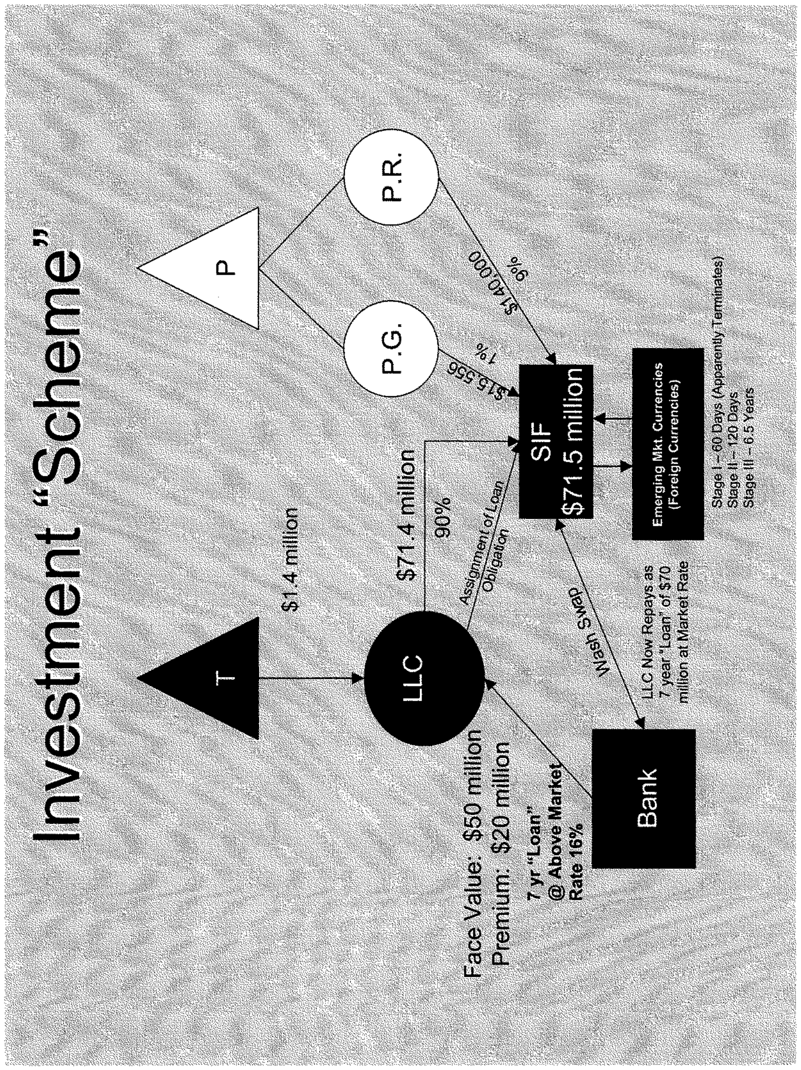

Taxpayer Transfers Funds to Shell Corp. (LLC)
T
$1.4 million
(7% of planned loss – "premium")
LLC

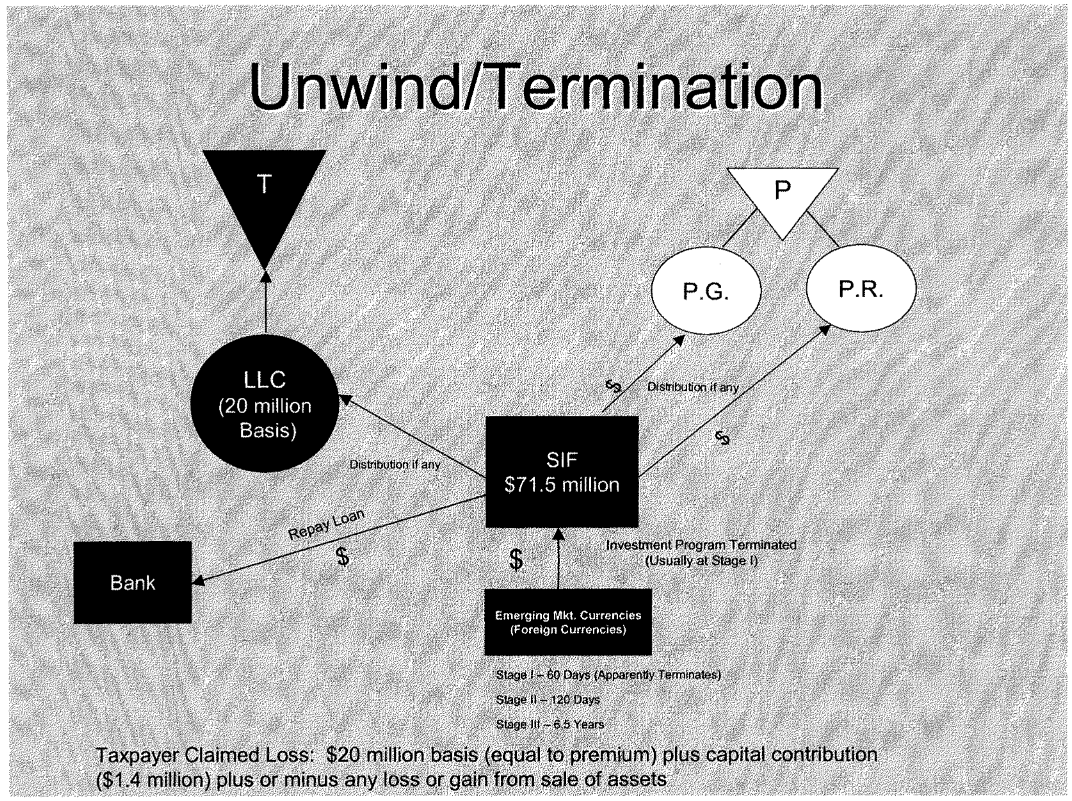

Bank “Loan” To LLC
(Collateralized by US Dollars or Euros)
T
$1.4 million
LLC
$71.4 million
Face Value: $50 million
Premium: $20 million
7 yr “Loan”
@ Above Market
Rate 16%
Bank


Presidio
P
Co-Designer and Implementor of Shelter
T
$1.4 million
P
P.G.
P.R.
LLC
$71.4 million
Face Value: $50 million
Premium: $20 million
7 yr "Loan"
@ Above Market
Rate 16%
Bank


Creation of Strategic Investment Fund
T
$1.4 million
P
P.G.
P.R.
LLC
$71.4 million
90%
Face Value: $50 million
Premium: $20 million
7 yr "Loan"
@ Above Market
Rate 16%
Bank
$15,556
1%
$140,000
9%
SIF
$71.5 million


"Loan" Assumption and
Interest Rate Wash "Swap"
T
P
$1.4 million
P.G.
P.R.
LLC
$71.4 million
90%
Assignment of Loan Obligation
$15,556
1%
$140,000
9%
Face Value: $50 million
Premium: $20 million
7 yr "Loan"
@ Above Market
Rate 16%
SIF
$71.5 million
Wash Swap
Bank
LLC Now Repays as
7 year "Loan" of $70 million
at Market Rate


Investment "Scheme"
T
P
P.G.
P.R.
$1.4 million
LLC
$71.4 million
90%
Assignment of Loan Obligation
1%
$15,556
9%
$140,000
SIF
$71.5 million
Emerging Mkt. Currencies (Foreign Currencies)
Stage I – 60 Days (Apparently Terminates)
Stage II – 120 Days
Stage III – 6.5 Years
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



Unwind/Termination
T
P
P.G.
P.R.
LLC
(20 million
Basis)
$
Distribution if any
$
Distribution if any
SIF
$71.5 million
Repay Loan
$
Bank
$
Investment Program Terminated
(Usually at Stage I)
Emerging Mkt. Currencies
(Foreign Currencies)
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

APPENDIX B

CASE STUDY OF S-CORPORATION CHARITABLE CONTRIBUTION STRATEGY (SC2)

KPMG approved the S-Corporation Charitable Contribution Strategy (SC2) for sale to multiple clients in 2000. KPMG marketed SC2 for about 18 months, from about March 2000 to about September 2001. KPMG sold SC2 to 58 S-corporations, in 58 transactions, and obtained more than $26 million in revenues, making SC2 one of KPMG's top ten revenue producers in 2000 and 2001. SC2 is not covered by a "listed transaction" issued by the IRS, but is currently under IRS review.

SC2 can be summarized as follows. A chart depicting a typical SC2 transaction is also provided.[389]

1) The Income. Individual owns 100% of S-corporation which earns net income (e.g., $3 million annually).

2) The Sales Pitch. Individual is approached by KPMG with a "charitable donation strategy" to shelter a significant portion (often 90%) of the S-corporation's income from taxation by "allocating," with little or no distribution, the income to a charitable organization. Individual is told that, for a fee, KPMG will arrange a temporary "donation" of corporate non-voting stock to the charity and will provide an opinion letter stating it is "more likely than not" that nonpayment of tax on the income "allocated" to the charity while it "owns" the stock will withstand an IRS challenge, even if the allocated income is not actually distributed to the charity and the individual regains control of the income. The individual is told he can also take a personal tax deduction for the "donation."

3) Setting Up The Transaction. The S-corporation issues nonvoting shares of stock that, typically, equal 9 times the total number of outstanding shares (e.g., corporation with 100 voting shares issues 900 non-voting shares). Corporation gives the non-voting shares to the existing individual-shareholder. Corporation also issues to the individual-shareholder warrants to purchase a substantial number of company shares (e.g., 7,000 warrants). Corporation issues a resolution limiting or suspending income distributions to all shareholders for a specified period of time (e.g., generally the period of time in which the charity is intended to be a shareholder, typically 2 or 3 years). Prior to issuing this resolution, corporation may distribute cash to the existing individual-shareholder.

4) The Charity. A "qualifying" charity (one which is exempt from federal tax on unrelated business income) agrees to accept S-corporation stock donation. KPMG actively seeks out qualified charities and identifies them for the individual.

5) The "Donation." S-corporation employs an independent valuation firm to analyze and provide a valuation of its non-voting shares. Due to the non-voting character of the shares and the existence of a large number of warrants, the non-voting shares have a

[389] A detailed explanation of this chart is included in the opening statement of Senator Carl Levin at the hearing before the Senate Permanent Subcommittee on Investigations, "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals" (11/18/03).

very low fair market value (e.g., $100,000). Individual "donates" non-voting shares to the selected charity, making the charity the temporary owner of 90% of the corporation's shares. Individual claims a charitable deduction for this "donation." At the same time, the corporation and charity enter into a redemption agreement allowing the charity, after a specified period of time (generally 2 or 3 years), to require the corporation to buy back the shares at fair market value. The individual also pledges to donate an additional amount to the charity to ensure it obtains the shares' original fair market value in the event that the shares' value decreases. The charity does not receive any cash payment at this time.

6) The "Allocation." During the period in which the charity owns the non-voting shares, the S-corporation "allocates" its annual net income to the charity and original individual-shareholder in proportion to the percentage of overall shares each holds (e.g., 90:10 ratio). However, pursuant to the corporate resolution adopted before the non-voting shares were issued and donated to the charity, little or no income "allocated" to the charity is actually distributed. The corporation retains or reinvests the non-distributed income.

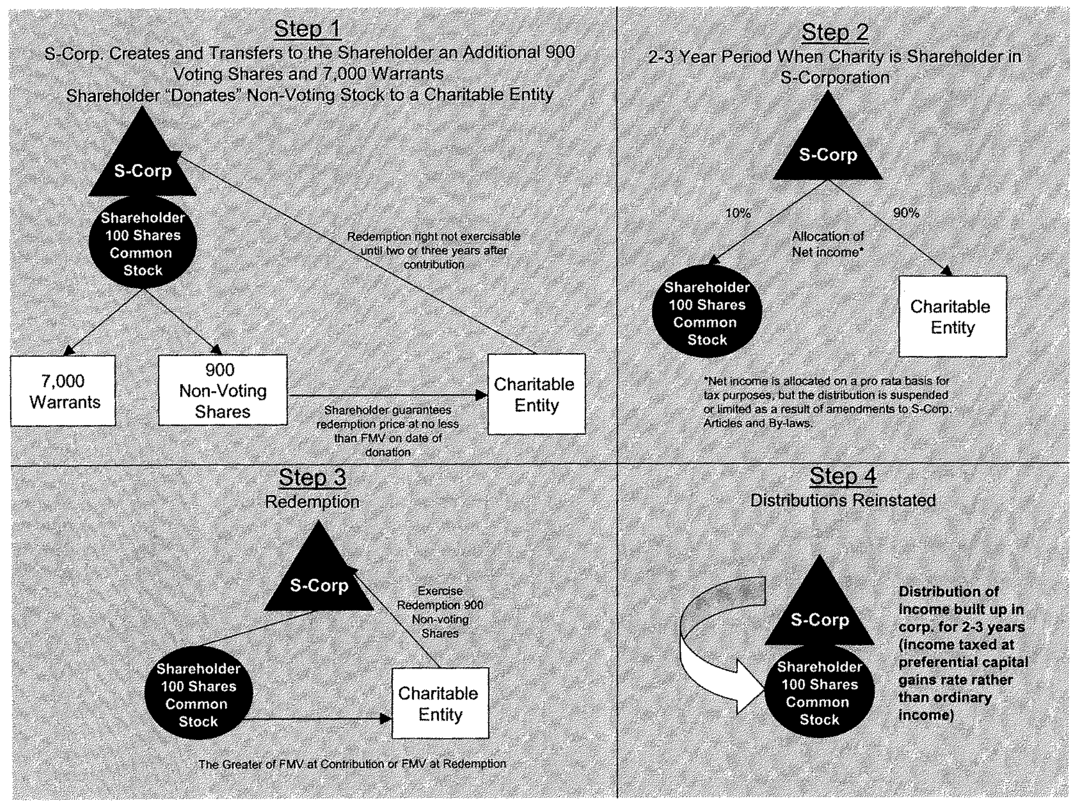
7) The Redemption. After the specified period in the redemption agreement, the charity sells back the non-voting shares to the S-corporation for fair market value (e.g., $100,000). The charity obtains a cash payment from the corporation for the shares at this time. Should the charity not resell the stock, the individual-shareholder can exercise the warrants, obtain additional corporate shares, and substantially dilute the value of the charity's shares. Once the non-voting shares are repurchased by the corporation, the corporation distributes to the individual-shareholder, who now owns 100% of the corporation's outstanding shares, all of the undistributed cash from previously earned income.

8) Taxpayer's Claim. Due to its tax exempt status, the charity pays no tax on the corporate income "allocated" or distributed to it. According to the KPMG opinion letter, for tax purposes, the individual can claim a charitable deduction for the "donated" shares in the year in which the "donation" took place. During the years in which the charity "owned" most of the corporate shares, individual will pay taxes on only that portion of the corporate income that was "allocated" to him or her. KPMG also advised that all income "allocated" to the charity is then treated as previously taxed, even after the corporation buys back the non-voting stock and the individual regains control of the corporation. KPMG also advised the individual that, when the previously "allocated" income was later distributed to the individual, the individual could treat some or all as long-term capital gains rather than ordinary income, taxable at the lower capital gains rate. The end result is that the individual owner of the S-corporation was told by KPMG that he or she could defer and reduce the rate of the taxes paid on income earned by the S-corporation.

9) IRS Action. This transaction is under review by the IRS.

SC^2

Prepared by U.S. Senate Permanent Subcommittee on Investigations, Subcommittee Staff of Senator Carl Levin, November 2003


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
Redemption right not exercisable until two or three years after contribution
7,000 Warrants
900 Non-Voting Shares
Shareholder guarantees redemption price at no less than FMV on date of donation
Charitable Entity
Step 2
2-3 Year Period When Charity is Shareholder in S-Corporation
S-Corp
10%
90%
Allocation of Net income*
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 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)

APPENDIX C

OTHER KPMG INVESTIGATIONS OR ENFORCEMENT ACTIONS

In recent years, KPMG has become the subject of IRS, SEC, and state investigations and enforcement actions in the areas of tax, accounting fraud, and auditor independence. These enforcement actions include ongoing litigation by the IRS to enforce tax shelter related document requests and a tax promoter audit of the firm, which are described in the text of the Report. They also include SEC, California, and New York investigations examining a potentially abusive tax shelter involving at least ten banks that are allegedly using sham mutual funds established on KPMG's advice; SEC and Missouri enforcement actions related to alleged KPMG involvement in accounting fraud at Xerox and General American Mutual Holding Co.; an SEC censure of KPMG for violating auditor independence restrictions by investing in AIM mutual funds while AIM was a KPMG audit client; and a bankruptcy examiner report on misleading accounting at Polaroid while KPMG was Polaroid's auditor.

SHAM MUTUAL FUND INVESTIGATION

KPMG is currently under investigation by the SEC and tax authorities in California and New York for advising at least ten banks to shift as much as $17 billion of bank assets into shell regulated investment companies, allegedly to shelter more than $750 million in income from taxation.

A regulated investment company (RIC), popularly known as a mutual fund, is designed to pool funds from at least 100 investors to purchase securities. RIC investors, also known as mutual fund shareholders, are normally taxed on the income they receive as dividends from their shares, while the RIC itself is tax exempt. In this instance, KPMG allegedly advised each bank to set up one or more RICs as a bank subsidiary, to transfer some portfolio of bank assets to the RIC, and then to declare any income as dividends payable to the bank. Citing KPMG tax advice, the banks allegedly claimed that they did not have to pay taxes on the dividend income due to state laws exempting from taxation money transferred between a subsidiary and its corporate parent. Zions Bancorp., for example, has stated to the press: "These registered investment companies were established upon our receiving tax and accounting guidance from KPMG and the securities law counsel from the Washington, D.C. firm of Ropes & Grey." [390]

The RICs established by the banks are allegedly sham mutual funds whose primary purpose was not to establish an investment pool, but to shelter bank income from taxation. The evidence allegedly suggests that the funds really had one investor—the parent bank—rather than 100 investors as required by the SEC. Press reports state, for example, that some of the RICs had apparently sold all 100 shares to the employees of the parent bank. Also according to press reports, the existence of this tax avoidance scheme was discovered after a bank was approached by KPMG, declined to par-

[390] "Zions Among Banks Accused of Scheme," *Desert News* (8/8/03).

ticipate, and asked its legal counsel to alert California officials to what the bank saw as an improper tax shelter. When asked about this matter, California Controller Steve Westly has been quoted as saying, "We do not believe this is appropriate."[391] RICs established by the ten banks participating in this tax shelter have since been voluntarily de-registered, according to press reports, with the last removed from SEC records in 2002.

KPMG ACCOUNTING FRAUD AT XEROX

On January 29, 2003, the SEC filed suit in federal district court charging KPMG and four KPMG partners with accounting fraud for knowingly allowing Xerox to file 4 years of false financial statements which distorted Xerox's filings by billions of dollars.[392] The prior year, in 2002, without admitting or denying guilt, Xerox paid the SEC a $10 million civil penalty, then the highest penalty ever paid to the SEC for accounting fraud, and agreed to restate its financial results for the years 1997 through 2000. In July 2003, six former Xerox senior executives paid the SEC civil penalties totaling over $22 million in connection with the false financial statements.

KPMG is contesting the SEC civil suit and denies any liability for the accounting fraud. Two of the named KPMG partners remain employed by the firm. The SEC complaint includes the following statements:

> "KPMG and certain KPMG partners permitted Xerox to manipulate its accounting practices and fill a $3-billion 'gap' between actual operating results and results reported to the investing public from 1997 through 2000. The fraudulent scheme allowed Xerox to claim it met performance expectations of Wall Street analysts, to mislead investors and, consequently, to boost the company's stock price. The KPMG defendants were not the watch dogs on behalf of shareholders and the public that the securities laws and the rules of the auditing profession required them to be. Instead of putting a stop to Xerox's fraudulent conduct, the KPMG defendants themselves engaged in fraud by falsely representing to the public that they had applied professional auditing standards to their review of Xerox's accounting, that Xerox's financial reporting was consistent with Generally Accepted Accounting Principles and that Xerox's reported results fairly represented the financial condition of the company. . . .
>
> "In the course of auditing Xerox for the years 1997 through 2000, defendants KPMG [and the four KPMG partners] knew, or were reckless in not knowing, for each year in which they were responsible for the Xerox audit, that Xerox was preparing and filing quarterly and annual financial statements and other reports which likely contained material misrepresentations and omissions in violation of the antifraud provisions of the federal securities laws. . . .

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[391] "Banks Shifted Billions Into Funds Sheltering Income From Taxes," *Wall Street Journal* (8/7/03).
[392] *SEC v. KPMG,* Case No. 03–CV–0671 (D.S.D.N.Y. 1/29/03).

"In the summer or early fall of 1999, Xerox complained to KPMG's chairman, Stephen Butler, about the performance of [one of the defendant KPMG audit partners], who questioned Xerox management about several of the topside accounting devices that formed the fraudulent scheme. Although KPMG policy was to review assignments of an engagement partner after five years, and [the KPMG partner] had been assigned to Xerox less than two years, Butler responded to Xerox's complaints by offering [the KPMG partner] a new assignment in Finland. After [the KPMG partner] declined the new assignment, KPMG replaced [him] as the worldwide lead engagement partner with [another of the defendant KPMG partners] for the 2000 audit. This was the second time in six years in which KPMG removed the senior engagement partner early in his tenure at Xerox's request."

KPMG was Xerox's auditor for approximately 40 years, through the 2000 audit. KPMG was paid $26 million for auditing Xerox's financial results for fiscal years 1997 through 2000. It was paid $56 million for non-audit services during that period. When Xerox finally restated its financial results for 1997–2000, it restated $6.1 billion in equipment revenues and $1.9 billion in pre-tax earnings—the largest restatement in U.S. history to that time.

MISSOURI DEPARTMENT OF INSURANCE V. KPMG

On December 10, 2002, the Director of the Missouri Department of Insurance, acting as the liquidator for an insurance firm, General American Mutual Holding Company ("General American"), sued KPMG alleging that: (1) KPMG, acting in conflicting roles as consultant and auditor, misrepresented the financial statements of its client, General American, and (2) KPMG failed to disclose substantial risks associated with an investment product called Stable Value which, with KPMG's knowledge and assistance, was sold by General American during the 1990's.[393]

Stable Value was an investment product that, in essence, allowed General American to borrow money from investors and reinvest it in high-risk securities to obtain a greater return. In the event General American was downgraded by a ratings agency, however, the terms of the Stable Value product allowed investors to withdraw their funds. In 1999, General American, in fact, suffered a ratings downgrade, and hundreds of Stable Value holders redeemed their shares, forcing General American to go into receivership and subjecting its investors to huge losses. KPMG is alleged to have never disclosed the risks of the Stable Value product to General American and, according to the Missouri Department of Insurance, actively attempted to conceal this risk.

The following excerpts are taken from a complaint filed by the Director of the Missouri Department of Insurance against KPMG in the Jackson County Circuit Court:

"In the 1990's, with KPMG knowledge, and assistance, General American management developed and grew to ob-

[393] *Lakin v. KPMG,* (MO Cir. 12/10/02).

scene proportions a high-risk product known as Stable Value. In essence, certain General American management, with KPMG's help, bet the very existence of General American on its Stable Value business segment and lost. . . . With KPMG's knowledge, General American management forced an otherwise conservative company to engage in an ever-increasing extremely volatile product. When this scheme failed, it was General American's innocent members who were harmed. . . .

"KPMG consciously chose to: (a) misrepresent General American's financial position; (b) not require the mandated disclosures regarding the magnitude and risks associated with the Stable Value product; and (c) conceal from and misrepresent to the Missouri Department of Insurance and General American's members and outside Board of Directors, the true nature of the Stable Value product. And during this same time, when KPMG was setting up General American's innocent members for huge financial losses, KPMG kept scooping up as much money in fees as possible. . . . KPMG abandoned and breached its professional obligations owed to General American, General American's members and the Missouri Department of Insurance. KPMG's failures include a lack of independence, conflicts of interest, breaches of ethical standards, and other gross departures from the most basic of auditing and other professional obligations. . . .

"To further the cover-up of its wrongful acts, KPMG engaged in a continued pattern of deceit during the Missouri Department of Insurance's investigation into General American's liquidity crisis. The record is replete with KPMG witnesses giving false testimony, evasive answers and just 'playing dumb' in an apparent hope to avoid State of Missouri regulatory scrutiny and the filing of this Petition. What KPMG wanted to hide from the regulators was its misrepresentations, gross breaches of its professional obligations and numerous failures regarding full and fair financial reporting for General American."

SEC CENSURES KPMG

On January 14, 2002, the SEC censured KPMG for engaging in improper professional conduct in violation of the SEC's rules on auditor independence and in violation of Generally Accepted Auditing Standards. KPMG consented to the SEC's order but did not admit or deny the SEC's findings.

The following is taken from the SEC's press release announcing the censure of KPMG: [394]

"The SEC found that, from May through December 2000, KPMG held a substantial investment in the Short-Term Investments Trust (STIT), a money market fund within the AIM family of funds. According to the SEC's order,

[394] Press Release by the SEC, "SEC Censures KPMG for Auditor Independence Violation," (No. 2002–4 1/14/02), available at www.sec.gov/news/press/2002–4.txt.

> KPMG opened the money market account with an initial deposit of $25 million on May 5, 2000, and at one point the account balance constituted approximately 15% of the fund's net assets. In the order, the SEC found that KPMG audited the financial statements of STIT at a time when the firm's independence was impaired, and that STIT included KPMG's audit report in 16 separate filings it made with the SEC on November 9, 2000. The SEC further found that KPMG repeatedly confirmed its putative independence from the AIM funds it audited, including STIT, during the period in which KPMG was invested in STIT.
>
> "'This case illustrates the dangers that flow from a failure to implement adequate polices and procedures designed to detect and prevent auditor independence violations,' said Paul R. Berger, Associate Director of Enforcement."

In addition to censuring the firm, the SEC ordered KPMG to undertake certain remedies designed to prevent and detect future independence violations caused by financial relationships with, and investments in, the firm's audit clients.

POLAROID AND KPMG

Polaroid Corporation filed for bankruptcy protection in October 2001. In February 2003, a federal bankruptcy court named Perry Mandarino, a tax expert, as an independent examiner for Polaroid. In August 2003, the bankruptcy examiner issued a report stating that Polaroid and its accounting firm, KPMG, had engaged in improper accounting procedures and failed to warn investors of Polaroid's impending bankruptcy. KPMG attempted to keep the report sealed, but the court made the report available to the public. Since the issuance of the examiner's report, shareholders have filed a class action lawsuit against Polaroid and KPMG alleging violations of the Securities and Exchange Act for filing false financial statements.

Both the report and the lawsuit allege that KPMG and Polaroid engaged in a series of fraudulent accounting transactions, including overstating the value of assets and issuing financial statements that made the company appear healthier than it was. The examiner determined that KPMG should have provided a qualified opinion on the corporation's financial statements and included a warning about its status as a "going concern." The examiner found that KPMG had been considering such a warning, but decided against issuing it after a telephone call was made by Polaroid's chief executive to KPMG's chairman.[395] KPMG has charged that the report is "unfounded" and "incorrect."[396]

[395] See, e.g., "KPMG Defends Audit Work for Polaroid," *Wall Street Journal* (8/25/03).
[396] "Polaroid Hit with Lawsuit After Report," *Boston Globe* (8/27/03).

PREPARED STATEMENT OF DEBRA S. PETERSEN
TAX COUNSEL IV, CALIFORNIA FRANCHISE TAX BOARD,
RANCHO CORDOVA, CALIFORNIA

Mr. Chairman and members of the Subcommittee,

I am Debra Petersen and I am testifying on behalf of Controller Steve Westly and the California Franchise Tax Board (FTB). On their behalf, I would like to thank you for this opportunity to give testimony on some of the most egregious tax scams we have ever seen.

In recent years, the FTB has seen a gross proliferation of abusive tax schemes and tax shelters that have been aggressively marketed to taxpayers. These transactions and schemes run afoul of the basic intent of the tax laws. We have been appalled at the positions taken to justify these transactions and schemes. These are designed and sold as tax savings strategies and are veiled with a limited technical reading of the tax law and a flimsy excuse for a valid business purpose. The transactions are designed to create artificial losses and to make use of losses and deductions a second time.

Tax Shelters in General

Generally, an abusive tax scheme is a transaction that is promoted with the promise of tax benefits, has predictable tax losses or tax consequences and/or has no true or correlating economic loss experienced with respect to the taxpayer's income or assets. Typically, an abusive tax scheme follow the literal reading of the tax statute, but applies the meaning in a manner that is inconsistent with the purpose or intent of the tax statute.

Some of the characteristics of abusive tax schemes are:

- the separation of income and expenses (one taxpayer reports the income and a different taxpayer reports the expenses related to the same transaction);
- the use of pass-through entities that have no other purposes than to accommodate the desired tax results (they may not conduct an operating business);
- the use of third-party accommodators;
- the use of offshore foreign account or accommodator;
- a double benefit for the same tax loss or deduction; and/or
- conducted over a short period of time (transitory in nature).

These schemes lack economic substance meaning that there are no economic advantages other than tax savings, that the tax benefits outweigh the economic risks and profit potential or that there is no business purpose separate from the tax consequences. Usually there is no justifiable business purpose for the transaction other than to reduce taxes and the transaction lacks the potential to generate a profit.

We have seen the major accounting firms and other professional firms actively engage in the sale and promotion of these tax shelters and schemes in return for hefty fees. These shelters are marketed and purchased by reputable firms, not by fly-by-night or underground companies, which makes it all the more shocking that these tax avoidance transactions exist. These types of transactions are not isolated, but pervasive and are used by large and small taxpayers alike. A tax advisor told a taxpayer that "everyone is doing this," pressuring the taxpayer to think that one would be foolish not to engage in tax shelter transactions.

The professional firm that promotes the abusive tax shelter will issue tax opinions. Often, these tax opinions are not properly prepared and lull the taxpayer/investor into a false sense of security. These opinions are written to only address potential problem areas based upon specifically cited published tax law but they fail to address the overall ramifications of the transactions. The opinions generally fail to discuss all the risks of the transaction including application of tax doctrines such as step transaction, lack of economic substance and assignment of income. The opinions often assume facts that are critical to making a proper assessment of the risks of the transactions and often are not complete in addressing all relevant tax code provisions.

Frequently, the fees obtained by the promoters are directly related to the amount of tax benefits to be delivered and are enormous. The fees do not represent the actual costs to put together the deal and are very often contingent in nature.

For the most part, these transactions and schemes are not disclosed on the tax returns and very often the tax preparers and promoters, who may be one and the same, will go to great lengths to hide the transactions from taxing authorities. They will set up elaborate multi-tiered entity structures using pass-through entities or tax-exempt entities to hide the transactions. It is very resource intensive to identify the entire transaction as one part will appear on one taxpayer's return and the rest on other returns, including exempt organization returns which may not be examined by tax agencies.

We are aware that professional firms sold abusive tax products from 1999 through 2001. We have not examined tax returns for the 2002 taxable year yet and do not have a feel for the extent to which such activity is continuing or has taken place after 2001. We did find some abusive tax transactions before 1999, but in some cases we were not aware of the entire transaction so that we were unable to identify them as abusive tax shelters.

When we conduct our audits, we usually deal with a representative who typically is also the tax shelter promoter. In some cases, however, we did speak directly to taxpayers who invested in abusive tax shelters. These individuals typically had substantial gains from a one-time event or large, constant streams of income amounts.

When speaking with their tax advisor about their gain or income for the year, their tax advisor made them aware of the availability of certain tax shelters; they did not seek out the tax shelter investment on their own.

The transactions we have seen are so complicated and convoluted, that an investor would not have put together such a transaction on their own. The investors rely upon and are at the mercy of their "trusted business advisor" who clearly can no longer be trusted with giving valid tax advice. Our auditors and legal staff have difficulties understanding the transaction because of the insertion of steps that have no business purpose except to complicate the nature of the transaction. Often, we are not aware of all the facts and cannot always reach the right conclusion the first time we see the transaction or a piece of the transaction.

We have observed the direct marketing of shelters to clients of the promoter, to smaller tax preparation firms and to the public through direct mailing. We estimate that roughly eighty percent of the tax shelter cases are marketed by firms to their own client, about ten to fifteen percent are the result of literature mailed to potential investors and five to ten percent based upon referrals.

These tax shelters and tax avoidance schemes are a horrific threat to the tax compliance system and to state revenues. State tax revenues in California have declined over the past few years and we think that a good portion of that decline is attributable to tax shelter activities.

Specific Shelter Transactions

We have identified several hundred cases involving California taxpayers for the 1999 through 2001 tax years that may involve tax shelters. These cases include tax shelter transactions involving contingent liabilities,[1] loan premiums, basis shifting, short sales, loss shifting, notional principal contracts, loan assumptions, abusive use of registered investment companies and real estate investment trusts, and digital or binary options. Some of these were marketed by professional firms under names such as FLIP, OPIS, BLIPS, COBRA, BOSS, Son of BOSS, TRACT, SC^2, PICO, CARDS and COINS. In our opinion, none of these transactions comply with federal and state income tax laws.[2]

The transactions used in FLIP (Foreign Leveraged Investment Program) and OPIS (Offshore Portfolio Investment Strategy) are extremely complex and 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. Generally,

[1] In response to the abuses involving contingent liabilities, Congress enacted, on December 21, 2002, Internal Revenue Code section 358(h) which applies retroactively to October 18, 1999 and the Internal Revenue Serviced issued, on June 23, 2003, temporary and proposed regulations which are also retroactive to October 18, 1999.

[2] The Internal Revenue Service has listed many of these as potentially abusive tax shelters. The Franchise Tax Board will likewise be listing these transactions.

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. The Internal Revenue Service issued Notice 2001-45, 2001-C.B. 129 to alert taxpayers and their representatives that the purported tax benefits from these transactions are not properly allowable for federal income tax purposes. It also alerted taxpayers, their representatives and promoters of these transactions that they may be subject to penalties and reporting requirements. The notice concludes that "the Service intends to disallow losses claimed (or to increase taxable income or gains) in the transaction described in this Notice to the extent a taxpayer derives a tax benefit that is attributable to stock basis purportedly shifted from the redeemed shares." The reasons for the disallowance, depending upon the specific facts of a given case, may include that the redemption does not result in a dividend and therefore there is no basis shift, the basis shift is not a proper adjustment as contemplated by Treasury Regulations section 1.302-2(c), and there is no attribution of stock ownership or basis shift because the steps taken to achieve those results are transitory and serve no purpose other than tax avoidance. The Franchise Tax Board agrees with and will follow the Internal Revenue's position on these transactions.

I have examined materials collected by the Permanent Subcommittee on Investigations pertaining to the promotion of BLIPS and SC^2. With respect to BLIPS, the transaction lacks economic substance. It is designed to create a non-economic paper loss through the use of basis inflation. When we look through the surface of the transaction to the true substance, there is no economic tax loss. The loss to be generated is determined up front and the transaction is structured to produce the desired amount of tax loss. Use of foreign currency transactions is a clever attempt to make the transaction appear to have some element of risk, but in reality, the foreign currency actually selected is not subject to large market fluctuations in the short term. The cases we have seen during our audits are completed in a short period of time, within sixty to ninety days, thus minimizing the potential for market fluctuations. There is no valid business purpose for the formation of the pass-through entity. The sole purpose of this entity is to create tax basis that will give rise to an alleged tax loss. This transaction requires the orchestration of each step by a sophisticated tax advisor and a cooperative investment firm such as Presidio. It also requires the accommodation by a bank such as Deutsche Bank AG.

The Internal Revenue Service issued Notice 2000-44, 2000-2 C.B. 255, to address transactions that purport to generate tax losses for taxpayers. One of the transactions described in that notice is similar to BLIPS. The notice discusses a taxpayer that borrows funds at a premium that is subsequently assumed by a partnership. The taxpayer claims a basis in the partnership equal to cash contributed and reduced by only the stated principal amount of the loan (ignoring the premium). When the partnership interest is disposed of, the taxpayer claims a loss for the basis even though the taxpayer has incurred no corresponding economic loss. The notice states that the "purported losses resulting from the transactions described above do not represent bona fide losses reflecting actual economic consequences as required for purposes of section 165. The purported losses from these transactions (and from any similar arrangements designed to produce noneconomic tax losses by artificially overstating basis in partnership interests) are not allowable as deductions for federal income tax purposes." The notice states that the purported tax benefits claimed from these transactions may be disallowed under Internal Revenue Code section 752, Treasury Regulations section 1.701-2 or other anti-abuse rules. With respect to individuals, the transactions may be subject to challenge under Internal Revenue Code section 165(c)(2) as transactions not entered into for profit. The notice alerts taxpayers, their representatives and promoters of these transactions that they may be subject to penalties and reporting requirements. The Franchise Tax Board agrees with and will follow the Internal Revenue's position on these transactions.

With respect to the SC^2 transactions, I see several problems with the way this transaction is structured. The tax opinion rendered by Seyfarth, Shaw, Fairweather & Geraldson, dated December 30, 1999, states that the "plan will be required to execute a redemption agreement which will provide, in effect, that the Plan will have the right to 'put' the stock back to the corporation (or one of its shareholders) at some point in the future (which we are advised will be in approximately two years)." These facts, combined with the issuance of warrants to the S corporation shareholder leads me to conclude that there was not a completed gift in the year that the preferred stock was transferred to the pension plan. This means that a charitable contribution deduction cannot be claimed until the year that the gift is completed. Under this transaction, the gift is not complete until the redemption occurs and the plan receives the cash from the S corporation. In addition, since there is no valid gift until the time of the redemption, the plan is not the owner of the shares and no allocation of income can properly be made to the pension fund. Given the fact that the stock is nonvoting, that there is a plan for the stock to be redeemed or for the warrants to be exercised, no or minimal cash distributions are made and no income tax is being paid on the income earned in connection with those shares, the pension plan is not the beneficial owner of the shares and income should not be allocated to the pension fund. There is no valid purpose for the issuance of nonvoting preferred stock followed by redemption of that stock other than for the avoidance of income tax. The donor could have transferred cash to the pension fund and taken a charitable contribution. There was no need to donate and then redeem the stock other than for the purpose of attempting to assign income of the S corporation to an organization exempt from tax thus reducing the tax liability of the shareholders who owned the voting common stock.

The tax opinion letters obtained by the Permanent Subcommittee on Investigations that I reviewed used by KPMG in connection with the SC^2 transactions are grossly deficient. The letters fail to discuss the impact of the warrants, whether there was a completed gift, assignment of income doctrine and the step transaction doctrine. The tax opinion rendered by Seyfarth, Shaw, Fairweather & Geraldson, dated December 30, 1999, recognizes that this is "a very unusual transaction, and there is almost no statutory, regulatory or other authority addressing the issue . . .." This is an example of how the opinion letters are written to address specific legal authority that may cast doubt on the transaction, but fail to examine all the potential risks to the investor. Rather than present clear legal authority for the transaction on an overall basis, the opinions attempt to clear the roadblocks for individual steps in isolation.

The Tax Reform Act of 1984 (Pub. L. 98-369, 98 Stat. 678) added Internal Revenue Code section 6111 regarding the registration of tax shelters. The FLIP, OPIS and BLIPS cases that we have seen meet the registration requirements of that section. In the cases that we have looked at during our audits, the investor received at least two dollars in tax savings for every dollar invested in the transaction. These shelters were marketed to multiple investors such that the aggregate amount of investment in these shelters exceeded $250,000 and there were five or more investors. With regards to SC^2 transactions, based upon the materials provided by the Permanent Subcommittee on Investigations which I have reviewed, it met the registration requirements of Internal Revenue Code section 6111 for the same reasons as the other shelters mentioned above.

Impact of Tax Shelters on California

Based upon a U.S. General Accounting Office (GAO) study presented in testimony to the Senate Finance Committee, we estimate lost revenue to the state of approximately $3.5 billion from abusive tax shelters. According to the GAO study, potential tax losses covering a multiyear period are estimated to be approximately $85 billion as of September 30, 2003, with $33 billion attributable to listed transactions and $52 billion for nonlisted transactions. Based upon a comparison of state-to-nation tax effect, it is projected that California's potential losses from abusive tax shelters is $1.5 billion for listed transactions and $2 billion for non nonlisted transactions, for a total of $3.5 billion. Our recently enacted tax legislation estimates that as a result of the legislation, the state of California will have increased revenue in each of the next two fiscal years of approximately $90 million and $50 million in the following fiscal year.

The State of California is dedicated to cracking down on tax cheats and abusive tax shelters. In the words of Controller Steve Westly, "California loses hundreds of millions of state tax dollars each year as a result of these sophisticated tax schemes. This is legitimate tax money owed to the state of California that funds our schools, helps our elderly and fuels our emergency and transportation services. With a record deficit currently plaguing our state, we are very motivated to pursue these cases." We have already taken a number of steps to curb the promotion and use of these tax avoidance schemes, including the following:

1. In 1998 we rolled out a computer software program that allows us to track information better so we can trace income from pass through entities to the ultimate taxpayer that should report the income. We were concerned in the early 1990s about abusive transactions involving pass through entities and found that it was very time consuming to manually examine each return and trace the income to other returns. The program has increased compliance and allowed for more efficient auditing of tax returns and tracing of income.

2. On September 13, 2003, California, along with 33 other states, signed a Memorandum of Understanding with the Small Business-Self-Employed Operating Division of the IRS. We have been and will continue to cooperate with the Internal Revenue Service (IRS) in the identification and audit of tax shelters.

We will share information at an earlier stage in the audit process and we will assist each other whenever possible with the audit of tax shelters and tax avoidance schemes. We are coordinating our audit efforts to maximize efficiency.

3. In October of 2003, the governor of California signed into legislation a bill that provides for reporting requirements, increases existing penalties and imposes new penalties for tax shelters. Our bill was modeled after the Tax Shelter Transparency Act bill and we hope that Congress will pass this legislation at the federal level in the near future.

With regards to the enhanced penalties, we have increased the penalty for promoters to fifty percent of the gross income derived or to be derived from the tax shelter activity. We lowered the threshold for the imposition of the accuracy related penalty for corporations. We quadrupled the accuracy related penalty and raised the standard necessary to avoid the penalty.

We added a frivolous return penalty, penalties for failure to disclose reportable and listed transactions and a noneconomic substance transaction understatement penalty. We also added a penalty equal to one hundred percent of the interest due on a deficiency related to a tax shelter. The new and increased penalties generally apply to all open years regardless of when the shelter is "listed."

The new law extends the statute of limitations for issuing notices of proposed assessment on tax shelter transactions to eight years, thus doubling the regular California statute of limitations for tax cases. It creates an exception for confidential communications for written communications between a tax practitioner and the taxpayer/investor. It also makes it easier for the FTB to issue subpoenas.

Another part of our new law provides for a Voluntary Compliance Initiative wherein taxpayers who voluntarily file amended returns and pay the full amount of tax and interest related to tax shelter benefits claimed on their return can avoid the new and increased penalties. We have been and will continue to publicize this program in order to encourage taxpayers to voluntarily comply with the law and to educate the public on the tax shelters that they should not engage in and the consequences of doing so. Our policy is not to settle any tax shelter issues. If taxpayers fail to come in under the voluntary compliance initiative, they will face the higher penalties.

4. We also passed legislation that shut down one of the most egregious tax avoidance scams we have seen. It involved banks that formed solely owned subsidiaries which they registered as investment companies under the Investment Act of 1940 for the purpose of avoiding California taxes. The registration is clearly improper under the Investment Act of 1940. By 2003, all of the banks involved with this shelter withdrew their registration after examination

by and discussions with the Securities and Exchange Commission. Rather than pay tax at one level, which is what the law provides for, they combined unrelated code sections and attempted to pay no state tax whatsoever on the interest income earned on the bank's loan portfolio.

5. We have worked in cooperation with the Securities and Exchange Commission (SEC) on the bank issue noted above.

6. The Executive Director of the FTB, Mr. Gerald Goldberg, chairs the Corporate Income Tax Shelter Working Group of the Multistate Tax Commission (the MTC). Some of the goals of the working group is to share information among the states regarding tax shelters and abusive tax transactions and develop anti-abuse legislative tools. Thirteen states are members of the working group: California, Massachusetts, Alabama, North Carolina, Arizona, Kentucky, Oregon, North Dakota, Montana, New Hampshire, Arkansas, Idaho, Maryland, Illinois and Florida.

7. Apart from the MTC, we have communicated directly with several states and share information concerning the state-level shelters that we have encountered. This has been very useful and we plan to expand those contacts. These states include New York, New Jersey, Massachusetts, Indiana, Ohio, Illinois, Minnesota, Wisconsin, and Texas.

Recommendations

While we are pleased with the progress we have made to identify and close down tax shelters, we think that more needs to be done in order to prevent creative minds from formulating new shelters and schemes that circumvent the new laws. Listed below are some of these recommendations.

1. Extend Sarbannes-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. Mere disgorgement of the profit made on the transaction is not enough to discourage these practices because the taxpayers and their advisors play the audit roulette. If the promoter is caught 1 in 10 times, then 9 out of 10 times they win. Thus, even if they have to pay back $1 million out the $10 million that they earned, they still come out $9 million ahead. In addition, the firm may have insurance to cover these penalties or may self-insure by setting aside funds in the event that penalties are imposed. Requiring an independent firm to sign the return would provide checks and balances within the private sector.

2. Remove registration exemptions for these types of investments. Requiring registration under the 1933 act and other acts will provide disclosure of more information about the transaction and will cost the promoter more. Registration is an expensive undertaking and failure to comply with SEC rules are very costly. Until there is a risk that one may not be able to continue in the business of selling these investments, they will continue to be marketed in new ways. The fact that the tax laws require registration under the Investment Act of 1940 in order to take advantage of the single level of tax provision for registered investment companies is one of the prime reasons we were able to identify and shut down this tax shelter.

3. The AICPA should prohibit all contingency fees and fixed fees not based upon actual hours incurred for tax services. We have seen contingency fees not only in the area of abusive tax shelters but for services in connection with claiming tax credits. Use of contingency fees results in aggressive positions being taken and over inflation of the benefits. This works to the detriment of the taxpayer who not only pays for the advice but also for someone to defend the position taken. Contingency fees are like opium to the accounting firms. Once they start accepting contingency fees, it's very difficult to go back to hourly billing rates because the amounts are very lucrative.

4. Enact whistle blower statutes that would allow people to receive compensation for reporting of tax shelters and abusive transactions. Without the assistance of honest people willing to come forward and disclose information concerning abusive transactions, it is very difficult to uncover them. The information they provide is extremely valuable.

5. Require licensing or registration of tax return preparers. Require educational standards including ethics training. Then, if the preparer files tax returns with abusive transactions that are not properly disclosed, suspend or revoke their right to prepare tax returns. Again, imposing penalties (including disgorgement of revenue) may have some deterrent effect, but nothing is more effective than shutting down the ability to earn a living from one's profession.

6. Raise the ethical standards for tax preparers and advisors. Require a duty to uphold the spirit of the tax laws. Currently, many tax preparation firms take the position that if something is not specifically disallowed or illegal under the tax law, then it is allowable, even if it violates the purpose and spirit of the law.

7. Beef up enforcement agencies. A prominent California tax litigator who defends high-net-worth taxpayers in tax shelter cases commented that part of the reason we are seeing so many abusive tax shelters is that the enforcer backed off. 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 odds of their getting caught have diminished. We have learned the hard way that self-compliance only comes with regular enforcement activities. The IRS and other tax enforcement agencies need more resources to

audit taxpayers who engage in abusive tax transactions. The transactions are highly complex and require smart technicians to unravel the convoluted steps taken in these types of transactions.

8. 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 a certain 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. A taxpayer should not be able to rely upon an opinion that fails to analyze all of the steps in a given transaction.

9. Tax laws should be amended to provide an entity level tax on the amount of income that is passed through to a tax-exempt entity that does not pay the unrelated business income tax on that income. As seen in the SC^2 shelter, tax advisors will manipulate the laws to their advantage. They used the tax provisions that allow pension funds to be S corporation shareholders to attempt to escape income tax on a large portion of income, while not actually distributing all the income allocated to the pension fund. The pass through entity should be required to make cash distributions of the amount allocated to the exempt organization.

10. Tax laws should be amended to clearly state that any reimbursement from the tax preparer or promoter to the taxpayer/investor, whether for tax, interest or penalties, constitutes income to the taxpayer/investor and is not deductible by the payor. Any amounts received by the promoter from an insurer should be taxable to the promoter.

The sale of tax shelter and tax avoidance products is clearly wrong. These abusive tax transactions manipulate the tax laws for the purpose of creating phony losses. They have cost the federal and state governments billions of dollars of tax revenues. The investors pay not only to get into these schemes, but they face large penalties when they are caught. The only ones who come out ahead are the promoters and accommodators who obtained exorbitant fees for selling these tax schemes. As Controller Steve Westly said, "Abusive tax shelters victimize honest citizens who pay their fair share of taxes while the tax cheats profit."

Thank you.

STATEMENT OF MARK T. WATSON

Before the Permanent Subcommittee on Investigations
Committee on Governmental Affairs
United States Senate
November 18, 2003

Chairman Coleman, Senator Levin, and Members of the Subcommittee. Good morning.

My name is Mark Watson. I am here today to provide information to the Subcommittee regarding my experience working at KPMG. In particular, I understand that the Subcommittee wants me to address certain tax strategies that were approved and implemented during my tenure at KPMG.

Before answering the Subcommittee's questions, let me give a brief description of my background and role at KPMG. I am a graduate of Texas A&M University with a bachelor's degree in Finance and a master's degree in Tax.

In 1992, I joined KPMG as a Staff Accountant in the Personal Financial Planning Practice in Houston, Texas. In 1994, I came to Washington for a two-year rotation in KPMG's Washington National Tax Office, which is the group responsible for providing technical tax support to KPMG's field offices. In 1996, I moved to the Dallas, Texas field office, where I continued to work in the Personal Financial Planning Practice. KPMG promoted me to Partner in 1997.

I returned to Washington in 1998 as the partner in charge of the Personal Financial Planning Group for the Washington National Tax Office. I developed significant experience in the areas of individual income tax, fiduciary income tax, and estate and gift taxes. These areas were the focus of the Personal Financial Planning Group of the Washington National Tax Office, which provided technical support to KPMG's field offices regarding such matters. At around this time, the Washington National Tax Office also assumed the additional role of participating in the review and analysis of potential tax strategies that were to be marketed to firm clients and others.

During this time, I reported to Phil Wiesner, who was the partner in charge of the Washington National Tax Office. I also reported to Doug Ammerman, the partner in charge of KPMG's entire Personal Financial Planning Practice. I supervised a staff of approximately eight individuals in the Personal Financial Planning Group of the Washington National Tax Office.

In the summer of 2000, KPMG transferred me out of the Washington National Tax Office for a two-year overseas assignment. After two years, rather than return to a position in the Personal Financial Planning Practice, I decided to leave KPMG. Today, I continue to work in the tax area, focusing on estate planning.

I would be happy to address any questions that the Subcommittee might have.

Thank you.

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Public Accountants and the Tax Shelter Industry
Statement prepared for the U.S. Senate Committee on Governmental Affairs, Permanent Subcommittee on Investigations, Hearings on U.S. Tax Shelter Industry
November 18, 2003.

Calvin H. Johnson
Professor of Law,
University of Texas, Austin

I have been asked to help the Permanent Subcommittee on Investigations to evaluate the tax shelter industry and to advise the committee on the role of public accountants. I have been asked to look especially at two shelters promoted by KPMG, that is, the BLIP and SC^2 shelters.

My general conclusions are that the tax shelter industry has succeeded in doing real damage to the national tax system. Former IRS Commissioner Charles Rossotti has said that the IRS is losing the war against tax shelters: some 80% of the most sophisticated taxpayers are avoiding their legal share of tax. I think the objective measures support his assessment. Real or effective tax are running at a maximum of 10% from taxpayers the Congress wants and needs to tax at 35%. The tax system is not in healthy shape.

Every day well-trained, well-paid and highly motivated tax professionals have been launching vicious attacks on the tax base and they have had considerable success. KPMG destroyed considerably more tax with its BLIP and SC^2 shelters than the $75 million fees that they took in from selling them. Uncle Sam seems losing the war against tax shelters and tax shelter industry.

I applaud the Congress and the Treasury for adopting retroactive remedies for the BLIPs transaction, and hope they will do it again for other shelters, including the SC^2 shelter. Congress and the IRS should set up an office of "legislative audits" to find shelters and fix them retroactively.

I also applaud proposals to preserve the independence of certified public accountants by prohibiting CPAs from offering tax shelters and other advice to the public companies.

Finally, I also support a dramatic increase in the penalties for promoting shelters, for failing to register shelters and for giving opinions that turn out to be inaccurate.

1. BLIPS and the "Flagrant Disregard"

KPMG should not have sold the "Son of Boss" or "BLIP" shelter or told their customers that the shelter was more likely than not to prevail if challenged. For a goodly fee, KPMG sold its opinion so as to free clients from penalties for taking tax deductions for what KPMG knew to be artificial losses. The tax loss claimed on sale of taxpayer's partnership interest was not an accurate description of the taxpayer's economic position. Since 1960, the Treasury Regulations have provided that "only a bona fide loss is allowed" and that "substance and not form shall govern in determining a deductible loss."[1] The partnership anti-abuse regulations have been out since 1994 and they take away losses on sale of partnership interests that do not reflect the true income of the partner or the intent of the statute.[2] In ACM v. Commissioner, on October 13, 1998, the Court of Appeals denied the deduction of the "artificial" or "phantom" losses from a marketed corporate tax shelter that bears a strong family resemblance to the BLIP.[3] On August 14, 2000, the IRS identified the loss in Son of Boss or BLIP shelter as a "listed transaction," that is, a potentially abusive tax shelter because it entailed "an artificial loss" which does not "correspond to any actual economic loss" [4] KPMG stopped selling the BLIP shelter to new customers in September 2000, but it continued to give its opinion that the phantom loss would be allowed to its existing customers.

KPGM's legal position in BLIPS was rejected by Congress, Treasury and the tax community. The legal position behind BLIPs and Son of Boss is that the tax law is so blind that liabilities that the market understands to reduce value will nonetheless not be recognized by the tax law in calculating true net cost or basis. In BLIPs and related shelters, the taxpayer who buys the shelter contributes cash or other cost to a partnership or corporation. At the same time, the corporation or partnership assumes liabilities of the taxpayer that are not booked by the accountants. Accountants, for example, require that booked liabilities be fixed, they ignore rents and other future costs, and they do not require the costs of satisfying an option be booked until the option is exercised. As a matter of economics the liabilities assumed by the entity reduce the value of the partnership interest or stock. But KPGM's legal position is that those liabilities will be ignored as a matter of law when the partner calculates its net or adjusted cost for the shares or partnership interest. The taxpayer sells the stock or partnership interest and reports an artificial tax loss in the amount by which the assumption reduces the value of the stock or partnership interest in fact. There is no question that GAAP accounting books only certain liabilities, and ignores many other future costs. There is no question that tax often follows the accounting principles, even down the paths of bad economics. Still KPGM's legal position that tax law would endorse the artificial losses by ignoring assumption of economic liabilities seems to have upset the tax world.

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[1] Treasury Reg. §1.165-1(b)(1960). Bruce Lemons, James Whitmire, Randy Bickman, *Selling the "Noneconomic Loss Doctrine,"* 96 TAX NOTES 415 (2002) try to argue that the bona fide loss requirement of the regulations refers only to timing of the loss and does not affect artificial losses. They argue, for instance, that section 1014 (step up in basis at death) produces artificial losses. For example if a taxpayer inherits an appreciated building and then sees it burned down, there is no economic loss, but there is a tax loss measured from the section 1014 fair market value basis at death. Section 1014 is premised on the assumption that the taxpayers capital investment is the value of the building. Section 1014 may well be bad tax accounting but there is no question that losing a valuable building is an economic loss, and bears little resemblance to the artificial or phantom losses from packaged tax. In any event, there is no reasonable basis for assuming that Treas. Reg. §1.165-1(b) governs only timing and does not affect losses that artificial in total and forever.

[2] Treasury Reg. §1.702-2(a)(3)&(b)(proposed May 17, 1994 and adopted Dec. 29, 1994).

[3] ACM v. Commissioner, 157 F3d 231 (3d Cir. 1998)

[4] Notice 2000-44, 2000-2 C.B. 255 (Aug. 14, 2000).

In 2000, Congress amended the assumption of liabilities provisions of section 358 retroactively to take away cost basis when the corporation assumed future obligation of a shareholder.[5] The BLIP transaction claimed there was a "hacker's window" or fault in section 358, created by clever mal-interpretation, and it was not part of the beautiful system that Congress intended to write. Section 358, which provides that basis in shares is reduced by liabilities assumed, was crafted by the American Law Institute and then adopted in the Internal Revenue Code of 1954. Section 358 represented the best that Congress could do with the advice of the best tax minds and tax professionals in the country. The section 358 system was not supposed to be so easily destroyed. The amendment to section 358 to fix the BLIPs or Son of BOSS fissure was enacted on December 22, 2000, but it was retroactive by more than a year to transactions that occurred after October 18, 1999. 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.

I applaud Congress on making the cure retroactively so as to catch people who had created and exploited the hacker's window. The tax law can not be made so perfect that it can withstand the attacks by Skunk Works operations such as KPGM's, no matter how smart Congressmen are about learning the details of the tax law. Every morning a large, well-paid, well-trained and high-motivated cadre of tax professionals called accountants, lawyers and investment banks wake to spend their day on vicious attacks on the tax system and sometimes for all their pay they succeed. Congress will need to go back and fix the system and repair the rips from such attacks once it sees what damage the attack is doing. Litigation over whether something is an abuse, moreover, is no way to run a tax system and retroactive legislation or regulation amendment avoids litigation.

The fix of Son of Boss or Blips should be viewed as a good precedent and Congress should do it more often. Indeed, I would advise that the IRS and Congress should set up a permanent institution of "legislative audits" in which they identify abuses arising from misinterpretation or misapplication of the law in shelters and protect the tax system from attack as soon as possible by retroactive legislation.

On June 23, 2003, the Treasury issued temporary regulations making consistent corrections to the assumed liabilities rules for partnerships, and those amendments took away the loss from the BLIP shelter. With the invitation of Congress, the amended partnership-assumed-liabilities regulations are retroactive by almost four years, also to October 19, 1999.[6] The Treasury amends the law retroactively only when the original position represents a serious misinterpretation of the intent of the law. I applaud the Treasury for making its Regulations retroactive so as forego expensive litigation and to catch the people who had created and exploited the hacker's window. That retroactive legislation represents the Treasury's appropriate response to the call of its duty to defend the American tax base.

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[5] Community Renewal Tax Relief Act of 2000, §309, enacting IRC §358(h)(December 22, 2000) effective retroactively to Oct. 19, 1999.
[6] Temp. Treasury Reg. 1.752-6T, T. D. 9062 (June 23, 2003) applicable to transactions after October, 18, 1999.

B. John Williams, the former chief counsel of the IRS, usually takes the position that IRS should not over-do its enforcement of tax law, and he usually takes the position that the term "abusive tax shelter" is just an emotional reaction.[7] Nonetheless, for BLIPS and Son of BOSS, he got emotional:

> I am very concerned that promoters continued to promote -- and taxpayers continued to participate in -- "son of boss" transactions following issuance of Notice 2000-44, which identified "son of boss" and similar transactions as a listed transaction. I am also more than concerned to hear that even today these transactions or similar transactions may be being promoted. In my view, "son of boss" transactions are almost uniformly clearly abusive and will not withstand scrutiny by any court. In this circumstance, enforcement of the law is clearly necessary; otherwise, such flagrant disregard of the Notice will undermine voluntary compliance and the public's confidence in the IRS. I cannot foreclose the possibility of a public resolution initiative for "son of boss," or any other transaction that has been listed as a reportable tax avoidance transaction.[8]

It may well be that former Chief Counsel Williams overreacted, although indeed the retroactivity of the Congressional and Treasury cure indicates he was not alone. Still, when former Chief Counsel Williams gets upset at such flagrant disrespect, we can be assured that there is something to get upset about. KPMG should not have sold or given its opinions on BLIPs.

2. The Destructive Power of SC^2.

The shelter that KPMG is offering called "SC^2" involves a very serious hole in the tax base. Everyone can have a tax haven in one's own back yard. The gaping hole is serious enough and so inconsistent with the intent of subS that the loophole is going to have to be fixed by both regulations and legislation and it needs to be done fast and retroactively.

The important idea behind SC^2 is that a tax-exempt shareholder is allocated the taxable income and gains of a subS corporation, but the tax-exempt entity never gets to see any of the money from the income or gains. A subS corporation is not generally a taxable entity. It just allocates the tax items calculated at the corporate level to its shareholders in strict proportion to their fractional ownership of stock. Since 1996, tax exempt entities have been allowed to be owners of subS corporations.[9] Thus, for example, if a subS is 90%, or, for that matter, 99.9% owned by a tax exempt shareholder, then 90% to 99.9% of the any capital gain or income the subS corporation reports becomes immune from federal tax. The plan works best if an ESOP is the tax exempt

[7] B. John Williams, Jr., Statement to Senate Finance Committee Hearing on Tax Shelters: Who's Buying, Who's Selling and What's the Government Doing About it? (Oct. 29, 2003), 2003 TAX NOTES TODAY [ELECTRONIC EDITION] 209-33.

[8] B. John Williams, Jr., Speech to the Chicago Bar Association, Federal Taxation Committee (February 25, 2003), 2003 TAX NOTES TODAY [ELECTRONIC EDITION] 40-20.

[9] IRC § 1361(c)(6), added by section 1316(a)(2) of the Small Business Job Protection Act of 1996.

entity owning the shares. In 1997, Congress exempted ESOPs from tax on unrelated taxable income and that means that even any business income can be shielded from all tax.[10]

In SC^2 the tax-exempt shareholder, however, will never see any of the income allocated to it for tax purposes. The real owners who are high-bracket shareholders have have warrants to buy more shares of the subS corporation. With enough warrants, the real owner can convert the tax exempt shareholder from being a 90-99.9% shareholder to being a 10% to 1/10th% shareholder. Corporate shares have meaning only as a fraction of the whole and the new shares issued to the high-bracket shareholders dilute the tax-exempts shares to the final small fraction.

During the time that the warrants are outstanding but not exercised, there is an agreement that shareholders will receive no dividends. The tax exempt shareholder interest is also not voting so that the tax-exempt can not manage corporate assets nor change the arrangements. The stock can also not be sold. The tax-exempt shareholder is basically just an accommodation party – one's own pension fund works well for that. The tax-exempt shares are not worth much – this is nonvoting, nondividend paying stock that will shrink to a small percentage of assets when the warrants are exercised, so that tax-exempt shareholder will receive a modest price for redemption of its shares, and perhaps a side fee, but nothing else. The high bracket shareholders exercise their warrants and own all or substantially all the shares of the corporation. The interim income or gain that was allocated to the tax exempt shareholder becomes the property of the high bracket shareholder. When that income or gain is distributed to the high bracket shareholder, it is treated as if it were previously taxed amounts and it is first a recovery of the owner's basis and then 15% capital gain.[11]

Section 1361(b)(1)(C) of the Internal Revenue Code attempts to prevent income being taxed to a low or zero tax shareholder while it really received by a higher bracket taxpayer by preventing a corporation eligible for SubS status from having a second class of stock. All income items, of whatever tax character, must be allocated strictly according to what fraction of the common shares any one shareholder has. But for section 1361(b)(1)(C), a high bracket shareholder could put shares into the hands of children or tax exempt nominees, hold an interest that is convertible into shares and by conversion grab all of the income that had been previously allocated to the low tax shareholders. The one-class of stock rule also prohibits the "fruit of the tree" from being taxed to someone who does not own the tree itself. In a subS corporation there can be no slicing of since asset into an income interest and a capital interest. The owner of the capital interest must be taxed on the income interest.

There is, however, a very ill-advised regulation safe harbor that on its face allows avoidance of the second class of stock rule. Treasury Reg. §1.1361(*l*)(4)(*iii*)(C) provides that if an option has an exercise price that is more than 90% of the value of the underlying stock at the time that the option is issued, then the option is not a second class

[10] IRC § 512(e)(3), added by section 1523(a) of the Taxpayer Relief Act of 1997.
[11] IRC §1368(c)(1)

of stock. For the SC^2 stock, that safe harbor is thought to be extraordinarily easy to meet by bootstrapping. The stock held by the tax exempt entity has no value except for the modest price that the tax exempt shareholder will get after the warrants are exercised. In the meantime, the stock is non-saleable, nonvoting and gets no dividends. The value of the stock is thus just the redemption price that the tax-exempt shareholder will receive, discounted by the time value until the option will be exercised and also discounted by the chance that the stock might not be redeemed.

The value of the tax-exempt's shares bear no relationship to the value of assets being sheltered from tax. There can be $10 billion of taxable income or gain put into the S corporation and given haven from tax, but if there are enough warrants outstanding the the tax-exempt shareholder ultimate fractional interest is trivial. A tax exempt might be rational to redeem its shares for $2.69. Any value of more than $2.69 is just window dressing to fool the IRS.

The IRS can and should beat the SC^2 retroactively. The one-class-of-stock rule was intended to prevent tax of income to one taxpayer, while another would own the remainder or corpus and the real owners of the corpus are the high bracket shareholders. There is also no way that the tax exempt shareholder is going to be allowed to keep the 90-99% of the assets, notwithstanding that the income from the assets were allocated to the tax-exempt shareholder. When the safe harbor test is understood to be a smart rule adjusting to get the accounting to describe the economics, the option itself can not be allowed to reduce the value of the stock under the safe harbor test. The IRS needs to issue a Notice that retroactive to the first SC^2 transaction, the safe harbor of Treasury Reg. §1.1361(*l*)(4)(*iii)*(C) will be amended so that it does not apply unless the option price is also over 90% of the fractional value of subS assets represented by the underlying shares subject to the option, and that the test will be reapplied if any shareholders make a contribution to the corporation.

Full litigation should show that as a matter of substance over form, the tax exempt shareholder is not the real owner of the 90-99% or the income allocated to it and is not the economic owner of the shares. But litigation on substance over form is always a long and sloppy thing and the safe harbor of Treasury Reg. §1.1361(*l*)(4)(*iii)*(C) does not help any. A retroactive amendment of that regulation to destroy subS status will forego litigation and reach results consistent with an accurate accounting for the economic situation. The ultimate goal of tax accounting, like all accounting, is to describe the economics with clarity and accuracy.

The inevitable exercise test is too lax to capture many of the schemes like SC^2 set up to allocate the tax items to the tax exempt shareholder while giving the high bracket taxpayer the real beneficial or economic ownership of the income. The law needs to be worried about the cases in which the high bracket shareholder *might* end up as the real owner, because those "*mights*" get turned into "*wills*" in the hands of aggressive planners.

When warrants and options are outstanding the IRS can not tell who will ultimately get the interim income of the subS. The future is very hard to ascertain, Philosopher Yogi has told us, because it has not happened yet. The simple solution consistent with the solution of current law – the outright prohibition of a second class of stock -- would simply prohibit options on subS stock, and that I think is the remedy that that is going to have to be required eventually. This gaping hole needs to be fixed quickly. As long as tax exempt shareholders are allowed to be owners of subs corporations, any rule allowing options is going to be a serious problem.

It is time also to stop allowing ESOPs to be shareholders of a subS corporation. Subchapter S was written to prevent double taxation of corporate income, not to give a tax haven to business income that has never been taxed. A tax incentive for ESOPs is a terrible idea because it causes employees to under-diversify their investments. Employees via ESOPs invest their life savings in the same company on which their livelihood depends and when that company goes bust both the livelihood and nest egg evaporate. ESOP ownership of subS corporations is just an invitation for tax schemes like SC2, for the awful purpose of risking destruction of employees' livelihood and nest egg all at once.

There may also be an issue of a tax deduction when the tax exempt shareholder becomes an owner. That is just a red hearing, however, especially when the option price is down toward the $2.69 end of the spectrum. The real issue is allocation of income to the tax exempt shareholder, which the tax exempt shareholder never sees.

3. CPAs can not offer tax shelters.

In this post-Enron world, Certified Public Accountants should not be offering sleazy tax shelters or indeed any tax-minimization or client-loyal advice to public companies. The remedy is simple: Firms auditing clients for certification for SEC-required financial statements need to separate their auditing and advising functions into two unrelated companies, by spin-off or by sale.

The Certified Public Accountant is a cop, who needs to be independent, even skeptical and hostile to the firm it is auditing. This practice of CPAs selling sleazy shelters to public firms undercuts auditor independence. It is much like a CPA arriving and announcing

> "I am your auditing Certified Public Accountant this year, and the model of rectitude and independence,... "

and then opening up his trench coat, showing off his wares, and asking,

> "... and would you like to buy some fake Rolexes from me?"

Auditor independence is crucial to our capitalist economy because financial statements so profoundly influence the flow of precious investment. When financial statements mislead investors, capital goes to less meritorious activities. Or capital is utterly wasted, as happened, for instance, in Global Crossing and Enron.

Cheating financial statements, certified by auditors, make it difficult for legitimate, successful enterprises to raise capital by selling stock. When diversified investors do not have reliable information about the firm, they must underbid for stock of the firm to take account of risks that the stock is a "lemon," worth less than the available information suggests. When foreign or diversified investors cannot count on accurate financial reports about stocks, they flee the market.

In every part of the globe, if diversified investors do not have legal protection and accurate information, the market for stock is anemic. Firms must then raise their capital from bank financing. When banks lend, they want to control corporate decisions. Misleading financial reports may provide a short-term advantage to the company that cheats, but the cheating hurts the common good of all companies in the economy by raising the cost of equity capital or making it entirely unavailable.

Cheating financial reports also steal from individual investors who rely in good faith on a company's audited financial statements. Certified Public Accountants do not seem to understand the intensity of the justifiable anger of investors at losses they incurred because auditors taught their audited clients how to mislead the market. Auditors were supposed to have stopped the deception. It is imperative that the SEC's auditor independence rules ensure that audited statements will not betray investors' trust.

The critical even sacred role of the accountant in the proper functioning of the stock markets and capitalist system means that an auditor firm must be zealously loyal in protecting the interests of investors. The auditor must always place investor protection above accommodating management goals. The interest of an auditor that thinks of itself as a friend of management in provision of non-audit services inherently conflicts with the auditor's responsibility to maintain the necessary zeal to audit the company on behalf of investors. The efficient market is the auditor's true client. An auditor owes *no* duty to the audited firm, except insofar as enhancing the reliability of all financial reports makes equity capital cheaper for all.

As Chief Justice Burger, on behalf of a unanimous Supreme Court put it,

> the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. [12]

[12] United States v. Arthur Young & Co., 465 U.S. 805, 817-818 (1981).

He said further that "[i]f investors were to view the accountant as an advocate for the corporate client, the value of the audit function itself might well be lost."[13]

There is no reason to define "independence" narrowly. The free competitive market will provide all the business advice that a client is willing to pay for. If CPA firms are prohibited from giving business advice, because they are cops, the competition will adjust quickly and good advice will still be available. There is no harm to the system in prohibiting the CPA from engaging in activities that might in fact be harmless to independence. Broad prophylactic prohibitions are appropriate.

Sale of tax shelters or tax minimizing advice to the audited firms makes it impossible to maintain the necessary degree of skepticism about financial reports. No human being can be zealous in defeating the IRS for the benefit of the client on the one hand and maintain the necessary level of independent skepticism on the other hand.

CPA sales of tax advice, moreover, put the CPA in the position of auditing his own product. For example, if KPMG with its consigliore hat on has sold the audited client a BLIP, then KPMG with its cop hat on can not be expected to say "we sold you bad product and you need to accrue and pay a tax liability." No man is a proper judge of his own sleaze. The principle that a CPA can not judge its own product goes beyond the the product, narrowly defined. There were many products with names like "Son of Boss" or whatever, that relied on the assumption that the tax law would be dumb and blind and would fail to recognize real economic liabilities. KPMG having sold a client on the (mistaken) principle that real economic liabilities will be ignored for tax will not be properly hostile to that principle when it shows up in a tax shelter sold by another promoter.

Auditing committees, formed under Sarbannes-Oxley to supervise the CPAs, are also going to need to take heed of the damage that tax shelters do to auditor independence under current law. An auditing committee that approves a CPA firm that is going to audit its own work or audit tax principles that it has sold to other public companies has breached its duties to the investing public. In my opinion, an investor who loses money in reliance statements that turn out to be incorrect that were audited by a CPA firm that compromised its independence should be able to recover personally from the members of the audit committee who approved the CPA.

4. Remedies under the Bad Man theory.

I suspect that there is no reason for KPMG to regret ever having sold BLIPs and other shelters. KPMG constructed and sold the BLIP and similar shelters and gave its opinion that they would work because it concluded, after careful deliberation, that the legal penalties it would face for wrong doing were less than the profitable fees it would make, when the penalties were discounted by time and by the considerable chance that KPMG would avoid penalties or avoid getting caught. Some observers have concluded

[13] *Id.* at 819-20 n.15.

that the penalties, e.g., for failing to disclose potentially abusive tax shelters, are trivial.[14] The fact that KPMG sold the BLIP is superb evidence that the penalties were not high enough to prevent the "flagrant disregard" of the anti-BIPS Notice. The Wall St. Journal has reported staff estimates that KPMG made $75 million dollars from sale of BLIPs and SC^2.[15] They clearly made the assessment that the discounted value of the penalties would be under $75 million, and I think they were right.

KPMG is a "bad man" under Oliver Wendell Holmes, Jr.'s meaning of the term. Holmes has told us, famously, that the law must be written under the assumption that it will need to shape bad men:

> A man who cares nothing for an ethical rule which is believed and practiced by his neighbors is likely nonetheless to care a good deal about being made to pay money, and will want to keep out of jail if he can.[16]

We can not presume that the promoters who sell and give opinions on abusive or potentially abusive tax shelters have ethical feelings toward their Uncle Sam, that is, toward the U.S. or us. A system needs to be constructed under which it is in the objective interest of the promoters and opinion writers not to write erroneous opinions and not to sell transactions that fail to comply with the law as ultimately determined, even if they do not want to do that. Accuracy should be understood here as the amount that would have been required had all issues gone to final judgment after full litigation, but without the full litigation. It must be in the self interest of the promoters and opinion writers not to undercut the accurate reporting of tax and to tell their clients that it would be too dangerous to tolerate errors in tax on the down side.

Unfortunately, as a matter of strict economics, the penalties needed to make it in the self interest of the bad man to report tax accurately are rather high. For example, if there is a 10% chance of an audit, a 20% chance of the auditor identifying the transaction, a 50% chance of a government lawyer with a good case surviving the hazards of litigation, then the chances of correction of the error are only 10%*20%*50% or 1%. The penalty necessary to make it in the interest of a bad man to report tax accurately with only a 1% chance of correction must be a no-fault penalty of 100 times the deficiency. The penalty of 100 times deficiency is simple math, necessary to offset the 1/100 chance of its getting imposed.[17] Minor adjustments in the accuracy penalty, say from 20% to 30%, are not going to do it. Nobody wants to impose the economically mandated penalty of a 100 times tax due for every error. The bad man is going to win this war.

The alternative is to increase the audit rate, and to increase the education and talent of IRS auditors and lawyers. The IRS' Office of Tax Shelter Analysis, for

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[14] David Shurberg, David Gilberton & Bruce Larson, *Failure to Comply with Tax Shelter Disclosure Regulations: What's at Stake?*, 55 TAX EXEC. 135 (2003).
[15] Cassell Bryan-Low, *KPMG Didn't Register Strategy,* WALL ST. J., Nov. 17, 2003 at C9.
[16] Oliver Wendell Holmes, Jr., *The Path of the Law*, 10 HARV. L. REV. 457, 459 (1896).
[17] The seminal work is Michael Allingham and Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 11 J. OF PUB. ECON. 325 (Nov. 1972).

example, is modestly staffed. It has seven program analysts, one manager and no attorneys.[18] I doubt their total annual budget would cover the annual Holiday Parties for the Skunk Works factories they are competing against. 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. Jail time for underreporting tax also reduces the monetary penalty we would need to impose to keep the bad man in rein -- professionals tend to be easily deterred. The penalty structure required by the bad man theory and neutral economics is rather higher than anyone wants to adopt, so we are looking for cheap remedies, to reach some better state of compliance.

One remedy that might help some is to give the Federal Government a private right of action to go after promoters and opinion writers for the damage that they do to the tax system when their opinions prove to be in error and their shelters fail. Sometimes the taxpayer is caught and is solvent, so that the federal government is hurt only by the cost of catching the client taxpayer. Still, the government should be able to collect its auditing, litigation and collection costs if the promotion or 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 case that the IRS did not catch the client but should have. The Federal Government should also be able to turn over the suit for damages to aggressive plaintiffs lawyers for a reasonable fraction of the return. The plaintiffs' lawyers need to go after the promoter's houses and Cayman Island trusts. Sometimes the government is just not creative or aggressive enough in litigation.

Before anyone dismissing the economic or bad-man theory penalties entirely, they also need to be aware of the extraordinary damage to the tax system which these shelters do. As Former IRS Commissioner Charles Rossotti stated at the time of his departure from office, the IRS is losing the war against tax cheats, especially the wealthiest and most sophisticated among them, because the IRS can not keep up with them. The majority of major tax cheats, he said, in some categories 80%, will be allowed to get away without paying their legal share.[19]

I do not see any objective evidence for optimism better than view. KPMG was able to charge $75 million for its abusive BLIP and SC^2 shelters because its customers avoided many times that amount in taxes. On my figures the real or effective tax rate that any corporation faces is not above 10%, as shown by the fact that the market for tax exempt bonds now allows any taxpayer to buy their way out of tax on capital by taking a 10% reduction in interest paid. The market for tax exempt bonds is a thermometer that measures the health of the entire tax system. That thermometer tells us that the tax

[18] Sheryl Stratton, *Inside OTSA: A Bird's Eye View of Shelter Central at the IRS,* 100 TAX NOTES 1246 (Sept. 3, 2003). There are about 70 IRS attorney's working on tax shelters within the Large and Midsize Business Division of the IRS. *Id.*

[19] David Cay Johnston, *Departing Chief Says the I.R.S. is Losing Its War on Tax Cheats,* N.Y. TIMES NOV. 5, 2002, at A1; *Rossetti gives Oversight Board End-of-Term Report* (Sept. 25, 2002), 2002 TAX NOTES TODAY [ELECTRONIC EDITION] 188-5.

system is in terrible shape.[20] Congress, by its orderly process of law, has determined that the burdens of war and of government need to be distributed such that taxpayers better able to pay tax should pay tax at 35%. When Congress can in fact collect no more than 2%-10% from its best sources, then worse sources --poor folk and middle class voters--have to make up the difference. Great nations fail because they let their tax system fall apart and this nation's tax system is well on the way.

We have a measure to monitor how the tax shelter wars are going. When the market for long-term tax exempt bonds shows that taxpayers are willing to forego interest on the order of 34-35% of fair market value taxable interest, then we will know that we are doing a pretty good job across the economy. But we are a very long way from that level of compliance.

[20] Calvin H. Johnson, *A Thermometer for the Tax System: The Overall Health of the Tax System as Measured by Implicit Tax,* 56 SMU L. REV. 13, 23 (2003)(showing that maximum real tax rate has been between 11% and 2% over the last 5 years).

PREPARED STATEMENT OF JEFFREY EISCHEID, PARTNER, PERSONAL FINANCIAL PLANNING, KPMG LLP, ATLANTA, GEORGIA

NOVEMBER 18, 2003

Representatives of KPMG are here today at the Subcommittee's invitation to discuss the tax services offered to KPMG clients in the past. Our representatives are prepared to provide the Subcommittee information regarding these complex tax strategies.

KPMG would like to take the opportunity to place this issue into an appropriately broader context.

There are four main points the firm would like to call to your attention:

1. The tax strategies being discussed today represent an earlier time at KPMG and a far different regulatory and marketplace environment. None of the strategies — nor anything like these tax strategies — is currently being presented by KPMG.

2. The strategies presented to our clients in the past were complex and technical, but were also consistent with the laws in place at the time, which were also extremely complicated.

3. The strategies did undergo intensive and thorough review at KPMG — a review process that resulted in vigorous, sometimes even heated, debate internally.

4. KPMG understands that the regulatory environment and marketplace conditions have changed. This understanding has led to significant changes within KPMG over the past three years from a policy, procedural, operational and structural perspective, and we are anxious to continue to demonstrate our commitment to improved clarity and fairness in the tax laws.

We would like to elaborate on each of these points.

First, the tax strategies that the Subcommittee will review were all presented by KPMG under regulatory and marketplace conditions that now do not exist. None of the strategies are currently being presented by KPMG — nor do we today present any aggressive tax strategies specifically designed to be sold to multiple clients, like FLIP, BLIPS, OPIS and SC2.

The tax strategies under examination by the Subcommittee were presented offered at a time when the U.S. economic boom was creating unprecedented individual wealth. That wealth generated demand for tax advice aimed at achieving tax savings. All major accounting firms, including KPMG, as well as prominent law firms, investment advisors and financial institutions offered tax advice, including these types of tax strategies, to clients.

KPMG responded to this highly competitive environment by presenting clients with strategies that could provide tax and non-tax benefits, and helping them implement those strategies. As you will hear at the hearings today and on Thursday, other firms often provided investment advisory and other non-tax services in connection with these transactions. All of these relationships were consistent with legal and professional requirements.

Second, it is true that these strategies were complicated and that the tax consequences turned on careful and detailed analyses of highly technical tax laws, regulations, rulings, and court opinions. But all of these tax strategies were consistent with the laws in place at the time and still applicable today.

It is important to note that no court has found them to be inconsistent with the tax laws and, in some cases, the IRS has agreed that taxpayers should be allowed to retain a portion of the tax benefits they claimed as a result of implementing a strategy.

For all of the strategies being reviewed by the Subcommittee, KPMG provided our clients with a "more likely than not" opinion as to their tax consequences. In other words, we informed our clients that based on the facts and actions they took, they would have a "more likely than not" — or a greater than 50 percent — chance of prevailing if the IRS challenged the transaction.

The tax laws are complicated and often times ambiguous and unsettled. As a result, KPMG's opinions regarding these tax strategies were long, detailed and technical. Our clients were advised about how the timing of a transaction might affect their tax situation in any given year. They were also told that, in addition to a possible tax benefit, the law required a transaction to have a business purpose, profit, charitable or other non-tax motive. They were required to provide us with representations to that effect.

All of our clients were sophisticated and typically had their own attorneys, accountants and investment advisors. In each step of the process, KPMG made it very clear to the clients that they were undertaking complex transactions on which the law was ambiguous and often had not been clarified by either the IRS or the courts.

Our third point is that, because we understood that these tax strategies might be subject to an IRS challenge, KPMG put them through a rigorous review process before they were approved and offered to clients. That process was thorough, detailed and independent. After mid-1997, both KPMG's Washington National Tax ("WNT") and Department of Professional Practice — Tax ("DPP") groups were involved in reviewing whether KPMG could provide a "more likely than not" opinion on these strategies before they were presented to multiple clients. The tax strategies also underwent very careful analysis of the IRS requirements for registering tax shelters in effect at the time.

Many tax partners with different areas of expertise participated in the review process. That, combined with the fact that we were dealing with a "more likely than not" opinion, is the reason there was a lively debate among partners over the interpretation and application of tax laws, regulations, rulings and opinions. It is also why it sometimes took many months for KPMG to review and approve or reject a strategy. Many of the materials provided to the Subcommittee document this lively internal debate.

Lastly, we understand that the regulatory environment and marketplace conditions have changed, and that we have had to change too. The manner in which we marketed some tax strategies, like SC2, to multiple clients is not something we do or would do today.

In recent comments, Senator Levin has pointed to telemarketing of aggressive tax strategies as a prime example of questionable practices. KPMG did make "cold calls" to potential clients in connection with the SC2 strategy. While these calls were intended only to pre-screen S-corporations to determine if they were suitable for an SC2 presentation, we agree in retrospect that they reflected poor judgment.

We want the Subcommittee to know that KPMG has also carefully, thoroughly and painfully examined — and reexamined — the past tax practices and policies of our firm. This introspective review has led to a number of substantial and meaningful changes over the past several years at KPMG.

We have learned important lessons from the past practices of our firm and the tax services profession. First and foremost is that we must hold the conduct of everyone in KPMG to the highest and most rigorous standard. Today, the standard by which we judge that conduct is whether any actions could in any way risk the reputation of the firm or our clients. If it could, we will not do it. Our reputation, our integrity and our credibility are simply too important to put at risk.

Some of the more significant changes and new procedures in place at KPMG include:

1. We have substantially changed KPMG's tax services and offerings. Today, KPMG offers our clients tax services that are tailored to address their distinct business objectives and tax planning needs. We no longer present or implement aggressive tax strategies specifically designed to be sold to multiple clients, like FLIP, BLIPS, OPIS, and SC2. The look-alike tax strategies provided on a large scale to clients in the past have all been discontinued. Additionally, KPMG does not and will not accept any new engagements for advice and opinions on tax shelters that have been listed and deemed abusive by the IRS.

2. 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.

First, we have created the new position of Partner in Charge of Tax Risk and Regulatory Affairs. This partner analyzes each tax strategy proposed by the firm to determine if it could in any way 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.

Finally, the Department of Professional Practice - Tax reviews all tax strategies to ensure that they are in compliance with the firm's policies and procedures.

Each of these partners has veto power over any tax strategy proposed. If any tax strategy puts KPMG or our clients at risk, is not technically correct and defensible or is inconsistent with

KPMG's policies or procedures, it will not be approved. All of these partners also operate independently from our tax operations and business development functions.

3. We have also revised our procedures with respect to list maintenance and registration obligations under the Internal Revenue Code. In early 2000, KPMG established the Practice Procedure and Administration group in Washington National Tax as the contact point for analysis of disclosure, list maintenance and registration issues. KPMG's procedures and training programs have been updated continuously since that time, tracking developments in the law and fine tuning our compliance processes.

4. Many of the practices and positions responsible for developing past tax strategies are no longer part of the firm. In 2002, two practices in particular, Stratecon and Innovative Solutions, were eliminated. These practices were responsible for developing tax strategies specifically designed to be presented to multiple clients. Many of the partners who were part of these practices are no longer with the firm. We have also abolished positions such as National Deployment Champions and Area Deployment Champions, which were charged with marketing these tax strategies to our clients. We also eliminated the Tax Innovation Center, which was responsible for marketing look-alike tax strategies designed to be sold to multiple clients.

5. Our tax training program now focuses on technical developments rather than marketing strategies. We have discontinued weekly tax partner calls, training programs and other activities that focused on marketing tax services. Tax partner calls and training now concentrate on changes in the law and technical tax developments.

6. In 2002, KPMG implemented a firmwide Compliance and Ethics Hotline. This hotline is designed to encourage anyone within KPMG to report their concerns about any potentially unethical, improper, or illegal conduct within the firm. In addition to the confidential hotline, longstanding channels of communication are available to our employees, including our network of professional practice partners, Area Risk Management partners, the Office of General Counsel, and the Department of Professional Practice.

7. We have put in place more stringent rules about offering tax services to executives at our SEC-audit clients. As you know, consistent with the Sarbanes-Oxley Act, the Audit Committees of our SEC-audit clients must pre-approve all services provided by KPMG to the company, including tax services. We have also applied this discipline to tax advice offered to executives of SEC-audit clients. We disclose to the Audit Committees of these clients the names of the executives who receive personal tax services from KPMG, regardless of whether the company or the executive is paying for them, and require Audit Committee approval for certain types of transactions and services to executives. Where our audit client has a more restrictive policy, we scrupulously abide by it.

8. We are constantly looking at additional steps we can take to improve and enforce compliance with these policies and practices. We encourage anyone at KPMG — partners or staff — to bring to our attention immediately any practices or policies that are inconsistent with these guiding principles and procedures. We also encourage everyone at KPMG to provide suggestions to us on any additional policies or procedures that would help ensure that we are providing the highest quality tax services and advice to our clients.

We believe that our tax advice was sound. But we realize that it is not enough for KPMG to come before the Subcommittee and say we stand behind the technical compliance of the tax services we provided. With these policies and procedures in place, KPMG is confident that the past practices involving tax strategies would not happen at the firm today.

KPMG takes seriously our responsibility to restore confidence and trust in the accounting profession. We want to work with Congress — as well as the IRS and other policymakers — as you consider sound and responsible approaches to better define what tax strategies are allowable under the law and to further strengthen the enforcement of the tax code, including increased resources for the IRS and improved coordination among regulatory agencies.

Thank you.

Testimony

of

Richard J. Berry

Senior Tax Partner

PricewaterhouseCoopers LLP

Before the

Permanent Subcommittee on Investigations

of the

Senate Committee on Governmental Affairs

November 18, 2003

Chairman Coleman, Ranking Member Levin, and Members of the Subcommittee:

My name is Rick Berry and I am the Senior Tax Partner of PricewaterhouseCoopers LLP.[1] I am privileged to be entrusted by my partners with the leadership and direction of our Firm's Tax practice within the United States.

There has been a significant amount of concern expressed in recent years about tax shelters by tax administrators, regulators and legislators, including this Subcommittee. I welcome the opportunity to share with you the significant changes we at PricewaterhouseCoopers have made in our Tax practice to deal with these issues and better serve our clients.

Our Tax practice in the United States is comprised of over 6,500 professionals. Through their efforts, we assist our clients with a variety of complex tax issues. We provide a full array of federal, foreign, state and local tax services to large multi-national corporations, middle market companies and individuals. These services range from preparing individual tax returns to advising large multi-nationals on mergers and acquisitions. Our approach is to develop long-term relationships with our clients and to serve each of them as a trusted advisor, providing specific services to match their individual circumstances and needs.

[1] "PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity. PricewaterhouseCoopers LLP refers to the member firm conducting business in the United States.

Our tax practice has evolved considerably over the past few years, especially in the area of interest to this Subcommittee, tax shelters. In the 1990's there was increasing pressure in the marketplace for firms to develop aggressive tax shelters that could be marketed to large numbers of taxpayers. This had not been a traditional part of our tax practice, but regrettably our firm became involved in three types of these transactions between 1997 and 1999. The individual transactions are described below. Although the total number of transactions that were done by our firm was limited to 76 over a three-year period, we acknowledge that we should not have done any. Since late 1999, we have taken strong action to prevent our involvement in transactions like these again.

Foreign Leveraged Investment Program (FLIP): This was a complicated structured transaction designed to take advantage of special attribution rules to shift basis from a tax indifferent party to a U.S. tax party, thereby enabling an investor to shelter income or claim a significant loss. In 1997 and 1998, we participated in 12 and 38 FLIP transactions, respectively. In 1999, we withdrew from the seven transactions then in progress and refunded our fees. Since then, we have not done any of these transactions.

Contingent Deferred Swap (CDS): This was another complicated structured transaction involving the use of debt instruments to generate interest deductions and create an opportunity to convert ordinary income into capital gains. In 1998 and 1999, we participated in 11 and 15 CDS transactions, respectively. Since then, we have not done any of these transactions.

Bond and Options Sales Strategy (BOSS): This was the largest of these three strategies. It was designed to shelter gains through a complex series of sale, loan and dividend arrangements. In 1999, there were approximately 120 of these in progress. In late 1999, our firm shut down all of these and refunded all of our fees. None of these transactions were ever completed. Since then, we have not done any of these transactions, nor any of its successors.

In late 1999, the firm decided to get out of this business. The factors leading to this decision included damage to our business reputation, embarrassment caused to our clients, people and firm, the changing regulatory environment, and a desire among our partners to focus on our core tax business. As a result, we disbanded the group of approximately ten professionals who were responsible for the development and marketing of these transactions.

A positive consequence of this experience was our development of a comprehensive quality review program and its implementation in 2000. The purpose of this program is 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 tasked with developing quality and review procedures to ensure that we do not get involved in the types of transactions previously described.

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. Under the procedures established by this group, all of our tax related services must go through a quality review.

The quality review process is comprehensive and has differing levels of review depending upon the complexity of the issues involved. Even the most routine of our tax services are reviewed, often by a second partner. In most instances, the second partner is required to be a technical expert in the subject matter in question. When multiple tax issues are involved, there will be participation by multiple subject matter experts in the technical and business analysis. If the advice to be rendered is considered a third party opinion, then an additional review is undertaken by a national quality and risk management partner.

If the strategy involves a tax planning idea with potential applicability to more than one client, the strategy will undergo a significant review under procedures in place since 2000. The procedures begin with a required description and technical analysis, review and support by appropriate specialists, and a qualification review by a quality and risk management partner and a member of the Tax leadership. If these conditions are satisfied, the idea must still be unanimously approved by a committee of experts. Finally, if the committee approves the strategy, it will be resubmitted to Tax leadership for a final assessment as to whether it should be disseminated to the practice.

Since 2000, we have also worked with the IRS to address issues relating to the registration and list maintenance requirements of the tax law. In June 2002, our firm entered into a closing agreement with the IRS and made a settlement payment. Additionally, we agreed to an IRS review of all of the ideas we have broadly disseminated and the IRS has not found any of them to be subject to the registration and list maintenance rules. Moreover, we provided the IRS with our quality control procedures for their review and we were told by the IRS that our procedures were comprehensive, thorough, and effective. We continue to cooperate with the IRS and fully abide by the terms of our agreement.

Our experience almost four years ago served as a wake up call to the Tax practice. Our partners were adamant that we get out of this business immediately. We shut down the largest transaction and returned all of our fees. We settled with the IRS. We implemented comprehensive quality control procedures to ensure that the firm would never again be engaged in the marketing and development of potentially abusive tax products. As a firm, this was the best thing that could have happened to us. We acknowledge our actions and we have learned from this regrettable mistake.

Thank you for the opportunity to appear before you today and to share our experiences with you. I look forward to answering any questions.

Written Statement of Mark A. Weinberger
Vice Chair – Tax Services
Ernst & Young LLP
Senate Permanent Subcommittee on Investigations
November 18, 2003

My name is Mark Weinberger. I am submitting this statement on behalf of Ernst & Young LLP as a partner of the firm. I joined the firm as Deputy Vice Chair -- Tax Services in May 2002 and have served as the firm's Vice Chair – Tax Services since April of this year. I appreciate the opportunity to participate in addressing the important matters being considered by your Subcommittee.

The subject of tax shelters is complex, and the complexity begins – but certainly does not end – with the definition of what constitutes a tax shelter. The Treasury Department, Internal Revenue Service, courts, lawyers, and other practitioners have wrestled with the definition again and again. I am not going to try to either recount or settle those debates today. When I discuss tax shelters today, I am referring to tax products that have been widely marketed and are intended to generate tax benefits substantially in excess of any anticipated economic or business benefits, generally to shelter the taxpayer's income from other sources. Beginning in the mid-1990s, these products were marketed with increasing frequency by investment banks, law firms, financial service firms, and other professional service firms - including ours.

The stock market boom and the proliferation of stock option awards in the 1990s created an unprecedented number of individual taxpayers with large gains and significant potential tax liabilities. Initially, in an effort to be responsive to client needs, we and other firms looked for legitimate and appropriate tax planning ideas to meet their needs. Perhaps reflecting the tenor of the times, these efforts rapidly evolved into competitive and widespread marketing of those ideas.

Selling and marketing are an essential part of any business, but we should not allow any part of our tax practice, no matter how small, to be dominated by a "sales mentality." Our past involvement in the type of activities that are the focus of the Subcommittee's attention is not reflective of our – and we believe your – expectations of our role as professionals. Ernst & Young has more than 23,000 employees in the United States. That number includes more than 6,000 tax professionals who provide a wide range of tax services to our more than 22,000 tax clients. The revenues derived from the work under scrutiny by the Subcommittee never accounted for more than one-half of one percent of our firm's revenues. Our core tax practice was, and is, assisting our clients in their efforts to comply with the tax law and reduce their tax liability in a manner that is appropriate and consistent with the tax law. We are committed to doing business in ways that embody the highest professional standards.

To make sure that we stay true to who we are as a firm, we have implemented a host of policy, procedural and organizational reforms designed to create the highest quality professional environment. In addition, we have entered into a settlement agreement with the Internal Revenue Service regarding tax shelter registration and list maintenance requirements. And, we have disbanded the group that had been involved in developing and marketing the tax products of the type at issue. This has nothing to do with the merits of past transactions; it has to do with what we want to be as a firm.

We have made a number of organizational changes that are relevant in the context of this hearing. Ernst & Young has:

- 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.

The Americas Director for Tax Quality, the Tax Technical Review Committees, and the Tax Review Board have many different responsibilities and bring different skills to bear. One of their common responsibilities is to provide the appropriate levels of review to ensure that we do not engage in activities inconsistent with our professional goals.

In addition to our most recent initiatives, we continue to adhere to our policies under which we do not recommend transactions that have been listed by the IRS as potentially abusive tax shelters or are "substantially similar." Furthermore, we do not enter into confidentiality agreements related to tax services.

With regard to our audit clients, Ernst & Young has implemented policies that go beyond the requirements imposed by the Sarbanes-Oxley Act and the SEC independence rules. While SEC rules require "careful scrutiny" by audit committees for certain types of transactions, we have gone further and will simply not recommend such transactions to clients. Additionally, we will not provide any tax services to executives of our SEC registrant audit clients unless the client's audit committee has specifically approved the services, even if the executives are paying for the services themselves.

Finally, as part of our efforts to move forward, earlier this year Ernst & Young executed a Closing Agreement with the Internal Revenue Service that resolved an examination of our tax shelter registration and list maintenance compliance. A key aspect of that agreement is our commitment to implement a Quality and Integrity Program to promote the highest standards of practice and ongoing compliance with laws and regulations.

As part of the Quality and Integrity Program, Ernst & Young:

- Has implemented a comprehensive centralized process to capture, analyze, and maintain information for assessing our list maintenance and registration obligations.

- Has provided for a firm-wide review of the application of the rules in registration determinations by a "national review staff."

- Will perform audits of compliance with our program at least annually.

- Will require, at least annually, certification by our professionals that they have complied with the registration and list maintenance requirements.

IRS Commissioner Mark W. Everson referenced our Closing Agreement in his testimony before the Senate Finance Committee on October 21, 2003:

> "We are pleased that Ernst & Young has cooperated fully with the IRS in resolving these matters. This represents a real breakthrough and is a good working model for agreements with practitioners."

In closing, we believe these initiatives, individually and collectively, will foster the highest standards of professionalism within Ernst & Young. We believe these policies are the right course for our firm and our clients.

That said, in the years ahead, there surely will be disagreements between the Internal Revenue Service and taxpayers. Our tax laws are enormously complex and there is more than ample room for disagreement on any number of issues. Where the Service and taxpayers differ, those differences should reflect (on both sides) open, fair, and honest disagreement over well-reasoned and good-faith interpretations of the rules as applied to the particular taxpayer's facts and circumstances.

Let me assure you that we know who we are and where we want to be. We have taken, and are taking, numerous steps to ensure that quality and professionalism are the touchstones for everything we do.

In conclusion, let me say that we have enjoyed an open, cooperative and constructive working relationship with both Majority and Minority staff, and I look forward to responding to your questions.

INTRODUCTORY REMARKS OF THOMAS R. SMITH, JR.

Before the Permanent Subcommittee on Investigations
U.S. Senate Committee on Governmental Affairs
November 20, 2003

Thank you Mr. Chairman, Senator Levin and Members of the Subcommittee.

My name is Tom Smith. I am a partner of the law firm of Sidley Austin Brown & Wood, and I am pleased to answer your questions today, to the extent I can. I joined Brown & Wood in 1963, and have spent my career as a securities lawyer. I am not a tax lawyer. From 1996 to the May 1, 2001 merger of Brown & Wood and Sidley & Austin, I was the Managing Partner of Brown & Wood.

Mr. Chairman, our firm wants to cooperate with the Subcommittee to the maximum extent it can. The area of tax work that brings us here today is an area that our firm no longer participates in. Unfortunately my personal files on these matters were lost in the destruction of our office in the World Trade Center, and Mr. R.J. Ruble, the person at our firm most knowledgeable about these matters, is not available to you or us. Thus, we are limited in the information we can provide.

Mr. Ruble is no longer a partner of the firm. He was expelled from the partnership on October 24, 2003 for activities in violation of the partnership agreement – that is, for accepting undisclosed compensation and for refusing to explain his conduct to the firm. As a result, we are not confident that the information Mr. Ruble has given to us in the past – and upon which we have relied – is accurate, and we have so advised the Committee staff, the Internal Revenue Service, and other interested parties.

That said, let me tell you a bit about the tax practice at Brown & Wood. Of the approximately 10 tax partners at Brown & Wood before the merger, Mr. Ruble was virtually the only one who engaged in this practice, although he consulted with others on discrete issues. At the time Mr. Ruble began providing concurring opinions to individual taxpayers, Brown & Wood had an opinions committee and expected partners to seek the advice of that committee, or of their colleagues at the firm, on novel or unsettled legal issues. In addition, Brown & Wood required approval of tax opinions by a second tax partner. After the merger, the firm maintained and expanded the size of the opinion committee, and further enhanced its policies in this area. The purpose of this policy was to help ensure the quality and consistency of tax advice provided by the firm and to provide an electronically maintained library of tax opinions that all tax lawyers could access. No set of procedures will stop an individual from acting improperly if he or she is unwilling to abide by the rules of our profession and to engage in blatant acts of deceit and concealment. Nonetheless, we have hired a tax attorney whose principal responsibility is to monitor our internal procedures and our compliance with evolving requirements of the IRS.

Prior to the merger of Brown & Wood and Sidley & Austin, and as part of the transition planning, it was decided that the combined firm would stop providing individual tax opinions that this Committee is considering and would re-orient the tax practice to the corporate transactional work that was central to both firms' practices. This action reflected the decision of Brown & Wood and the combined firm to redirect the efforts of the firm to our core tax work and did not, and does not, reflect on the quality of the work performed earlier. I understand that no court has decided that Mr. Ruble's tax opinions were wrong, much less rendered in bad faith.

Although Mr. Ruble confirmed that he had stopped issuing opinions of this type, the firm discovered that additional opinions had been issued after the merger. Mr. Ruble said those opinions were "the last in the typewriter" and were being rendered because he had pre-merger commitments to provide them to clients. He was told to stop issuing any such opinions; he assured the firm that he had stopped. In fact, he lied to us, evaded the controls we had in place and breached the trust we reposed in him.

We had and have procedures in place designed to ensure that all of our lawyers – partners, associates and others – act in compliance with applicable laws and the highest ethical standards. In a law partnership, the effectiveness of procedures of this sort is highly dependent upon the trustworthiness of our partners.

Both Sidley Austin Brown & Wood and I personally want to thank you for the open, cooperative and professional treatment we have received from both the Majority and Minority staff.

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November 18, 2003

VIA FEDERAL EXPRESS

The Honorable Norm Coleman, Chairman
The Honorable Carl Levin, Ranking Minority Member
Permanent Subcommittee on Investigations
Committee on Governmental Affairs
United States Senate
Washington, D.C. 20510-6250

Dear Messrs. Coleman and Levin:

The following responds to the three questions raised in your letter to me of November 6, 2003 concerning the hearings you are holding on the development, marketing, and implementation of tax products designed to be sold to multiple clients. You indicated that you intend to focus in particular on the Bond Linked Issue Premium Structure (BLIPS), the Offshore Portfolio Investment Strategy (OPIS), and the Foreign Leveraged Investment Program (FLIP), as well as the S-Corporation Charitable Contribution Strategy (SC2). I have no knowledge of the latter transaction. However, you asked me three questions concerning the other three transactions. I cannot, of course, ethically disclose confidential information acquired in connection with representation of clients. I can, however, respond to your questions without disclosing client confidences, and my responses are as follows:

1. Sutherland Asbill & Brennan LLP ("SAB") has had no involvement in the development, marketing or implementation of the transactions that your letter of November 6, 2003, refers to as FLIP, OPIS and BLIPS. Nor did SAB prepare, comment on, or have anything to do with any legal or tax opinions that may have issued in connection with these transactions. SAB does represent individual taxpayers in controversies arising out of audits by the Internal Revenue Service (the "IRS") with respect to transactions that the IRS has characterized as within that described grouping.

These taxpayers engaged SAB long after they had entered into these transactions.

The Honorable Norm Coleman, Chairman
The Honorable Carl Levin, Ranking Minority Member
November 18, 2003
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2. SAB has represented the major accounting firms in connection with lawsuits filed against those firms, none involving any of the transactions described above. SAB has never represented any accounting firm in any litigation or other controversy involving any such transaction. Our representation of accounting firms in matters unrelated to these transactions and of individual clients in tax controversies concerning these transactions thus would not give rise to any conflict of interest.

Whenever SAB and a prospective client discuss representation in a matter that could involve an accounting firm whom we represent in unrelated matters, it is the firm's policy to inform the prospective client that we represent the accounting firm and that we could not accept a representation related to any claim against the accounting firm.

3. In representing clients, SAB acts in conformity with all professional and legal requirements. SAB does not "negotiate" mass settlements with the IRS. The IRS will not negotiate global resolutions. It will, however, listen to arguments made on behalf of clients. The IRS then makes its own decision as to whether it will offer a global settlement and, if so, what it will be.

Very truly yours,

N. Jerold Cohen

N. Jerold Cohen

NJC/mjr

STATEMENT OF WILLIAM BOYLE

TO THE U.S. SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

OF THE COMMITTEE ON GOVERNMENTAL AFFAIRS

November 20, 2003

Chairman Coleman and Ranking Member Levin and members of the Committee, thank you for inviting me today.

My name is William Boyle. I am a former employee of Bankers Trust. I joined Deutsche Bank when it acquired Bankers Trust. I left Deutsche Bank two years ago and am now an independent consultant.

I welcome the opportunity to speak today about a transaction called BLIPS. The subcommittee requested that I appear for an interview, which I was pleased to do last week. The subcommittee also requested that I appear today to testify, and I am pleased to do so voluntarily.

Mr. Chairman, I was not involved in BLIPS at its inception. The BLIPS transaction was first proposed to Deutsche Bank in early 1999. Deutsche Bank played a banking role in the BLIPS transactions. My personal involvement in BLIPS began around June of 1999 when I became a vice-president in the structured transactions group of Deutsche Bank.

BLIPS was developed for clients of KPMG, an accounting firm. I understand it was designed by KPMG or Presidio Advisers, an SEC-registered investment advisor, or both.

BLIPS involved an interest-rate swap and investments in foreign currency option contracts and foreign and domestic fixed income securities. As part of BLIPS, Deutsche Bank issued to investors approximately 56 loans from September 1999 to October 1999. The total issue price (the stated principal amount plus premium) of these loans was approximately $7.8 billion. The average size of the loan issued to the BLIPS investor by the bank was approximately $139 million.

The bank lent money to the investors, and it executed transactions as directed by the investors' investment advisors. As a major global bank, Deutsche Bank was able to provide financial services for such transactions. These services included providing large loans, custody services, foreign exchange option trading, and interest rate derivatives.

The transactions were not designed by Deutsche Bank. The bank did not present BLIPS to investors – or in any other way market, sell or promote it. Deutsche Bank did not provide any tax advice to any of the investors. Nor did the bank discuss with any investor any potential tax benefits of the investment.

Deutsche Bank took several risk-management steps to assure that its actions in the BLIPS transactions were limited to its role as the executor of the financial transactions. Let me summarize those actions:

First, before making the loans, Deutsche Bank conducted an internal review process. The internal groups that reviewed the bank's provision of services were Deutsche Bank Private Banking, Global Markets, Tax, Legal, Credit Risk Management, Treasury and Compliance.

Second, each of the BLIPS investors agreed in writing that Deutsche Bank had not provided them with any tax, legal, investment or other advice, and that they had received such advice from expert professionals. One paragraph of that agreement read: "You have been independently advised by your legal counsel and will comply with all Internal Revenue Laws of the United States."

Third, the bank received written representation letters from KPMG, Presidio and each investor that described the limited scope of Deutsche Bank's involvement in the BLIPS transactions. This was done so that there would be no misunderstanding.

Fourth, Deutsche Bank consulted with a prominent outside, independent law firm for its counsel. The law firm drafted and reviewed the transactional documents pertaining to the bank. It also provided Deutsche Bank with a legal opinion, which has been provided to the committee. This opinion concluded, among other things, that Deutsche Bank was not a promoter or organizer of the BLIPS transactions -- and that Deutsche Bank had no responsibility to register the transactions as tax shelters.

Regarding the tax treatment, Deutsche Bank understood that the BLIPS transactions involved potentially favorable federal income tax benefits that could be claimed by the investors.

In discussing the tax issues, it is important to describe the role of a bank. Deutsche Bank provides banking services for a transaction. As such, it is not customary or appropriate to provide legal or tax advice to its clients. Nor is it customary or appropriate to determine in advance whether a client's tax position will later be sustained. Historically, that is not a role banks are authorized to play.

Deutsche Bank's role as the executor of the financial transactions meant that the determination of whether the investors' tax position would be sustained was outside of its banking role. Such a determination was the appropriate responsibility of the investors' lawyers and accountants. However, Deutsche Bank carefully considered its involvement in BLIPS and sought independent legal advice that it was complying with its responsibilities.

Mr. Chairman, that concludes my oral statement. I would be pleased to answer questions.

# # #

SUBMISSION BY DEUTSCHE BANK AG

TO THE U.S. SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

OF THE COMMITTEE ON GOVERNMENTAL AFFAIRS

November 20, 2002

You have requested that William Boyle appear before this Committee and Mr. Boyle has agreed to make himself available and to provide an oral statement and answer questions posed by the Committee. Mr. Boyle is a former vice president with Banker's Trust who joined Deutsche Bank at the time that company was acquired. Mr. Boyle is now an independent consultant.

In a letter on November 6, 2003, to Deutsche Bank, the Committee asked nine questions regarding the development, marketing and implementation of certain tax products. We welcome the opportunity to address those questions.

This submission specifically addresses two products -- one named Bond Linked Issue Premium Structure, which was called BLIPS, and its predecessor, Offshore Portfolio Investment Strategy, or OPIS. Mr. Boyle's personal involvement in BLIPS began in June 1999. Mr. Boyle had no involvement in the OPIS transactions.

At the outset, it is important to describe Deutsche Bank's limited role regarding these two transactions. Deutsche Bank did not design, market, sell or promote either the OPIS or BLIPS transactions. Deutsche Bank's role instead was limited to providing ordinary banking services.

The bank's involvement in the OPIS and BLIPS transactions involved financial activities performed by the bank in the ordinary course of business. That is, the bank's role was limited to executing the financial transactions as a lender, and as a counter party to certain financial instruments. Put in simple terms, the bank lent money to the investors and executed transactions as directed by the investors' investment advisors. Deutsche Bank was not an investor in BLIPS or OPIS.

Background

It may be beneficial to the Committee to have some background about how these two transactions came about. Deutsche Bank was approached by KPMG, one of the world's pre-eminent accounting firms, and Presidio Advisors LLC, an SEC registered investment advisor, to provide financing and trade execution for the OPIS and BLIPS transactions.

Deutsche Bank made a loan to each OPIS and BLIPS investor. OPIS involved the purchase of Deutsche Bank common stock and equity derivatives. The BLIPS transaction involved an interest-rate swap and investments in foreign currency option contracts and foreign and domestic fixed income securities.

Focusing on BLIPS, a foreign exchange investment program, will help explain Deutsche Bank's role. As a major global bank, Deutsche Bank was approached because it can provide varied, complex and sophisticated financial services on highly structured transactions including those involving international foreign exchange transactions. In these cases, Deutsche Bank was able to provide a large loan, custody services, foreign exchange option trading, and interest rate derivatives.

The OPIS and BLIPS transactions were designed and developed by KPMG and/or Presidio Advisors for KPMG clients as part of a Presidio investment program. Deutsche Bank played no role in designing the programs. And Deutsche Bank did not present them to investors -- that was the role of KPMG and Presidio.

Before executing the financial activities associated with OPIS and BLIPS, Deutsche Bank conducted an internal review process. The internal groups that reviewed the bank's provision of services were Deutsche Bank Private Banking, Global Markets, Tax, Legal, Credit Risk Management, Treasury and Compliance.

Deutsche Bank acted as a lender in approximately 62 OPIS transactions from June 1997 to March 1999. The average size of the loan issued to the OPIS investor by the bank was approximately $48 million. The approximate total amount of credit provided by the bank in the OPIS transaction appears to be approximately $3 billion. Deutsche Bank fees were approximately $35 million.

Regarding BLIPS, Deutsche Bank issued approximately 56 loans from September 1999 to October 1999. The total issue price (the stated principal amount plus premium) of these loans was approximately $7.8 billion. The average size of the loan issued to the BLIPS investor by the bank was approximately $139 million. Deutsche Bank revenues were approximately $44 million.

Steps to Assure Deutsche Bank's Limited Role in BLIPS

After the initial approach, Deutsche Bank took several steps to assure that its role was narrowly limited, and that all other parties understood those limitations. Deutsche Bank's efforts in this direction were focused on two important areas:

* First, each of the BLIPS investors agreed in writing that Deutsche Bank had not provided them with any tax, legal or other advice, and that they had received such advice from expert professionals. The bank also received written representation letters from KPMG, Presidio and each investor that delineated the limited scope of Deutsche Bank's involvement in the BLIPS transactions so that there would be no misunderstanding.

The language in the BLIPS investor representation letter reads: "Deutsche Bank has had no involvement in, and accepts no responsibility for, the establishment, promotion or marketing of the Strategy."

Another paragraph reads: "Neither you nor any member of your immediate family was approached by Deutsche Bank to enter into the Strategy or any Transaction but, in fact, you were approached by Presidio Growth LLC to enter into the Strategy and the Transactions."

* Second, Deutsche Bank consulted with a prominent outside, independent law firm for its counsel on Deutsche Bank's role in BLIPS. The law firm drafted and reviewed the transactional documents pertaining to the bank. It also provided Deutsche Bank with legal opinions that concluded, among other things, that Deutsche Bank was not a promoter or organizer of the OPIS and BLIPS transactions - and that Deutsche Bank had no responsibility to register the transactions as tax shelters. This was another way to confirm that the bank's role was limited to a banking function.

Tax Implications

It is important to describe more fully the limited role of a bank. It is not customary or appropriate for a bank that only provides financial services for a transaction to provide legal or tax advice to its clients or to determine in advance whether a client's tax position will later be sustained. Historically, that is not a role banks are authorized or empowered to play.

Deutsche Bank understood that the OPIS and BLIPS transactions involved potentially favorable federal income tax benefits that could be claimed by the investors. The bank confirmed in writing that such investors would obtain legal and tax advice from their own professional advisors regarding any potential tax consequences.

As noted earlier, Deutsche Bank did not provide any tax advice to any of the investors. Nor did the bank discuss with any investor any potential tax benefits of the investment. Here it is important to quote two additional paragraphs from the representation letter, in which each BLIPS investor represented and acknowledged to Deutsche Bank.

* Paragraph No. 2 of the representation letter stated: "Deutsche Bank makes no guarantee or representation whatsoever as to the expected performance or results of the Strategy or any transaction (including the legal, tax, financial or accounting consequences thereof), and you have not engaged in the Strategy or entered into the Transactions in reliance upon any such guarantee or representation."

* And paragraph No. 3 stated: "You have been independently advised by your legal counsel and will comply with all Internal Revenue Laws of the United States."

Deutsche Bank's role as the executor of the financial transactions meant that the determination of whether the investors' tax position would be upheld was outside of its banking role and was the appropriate responsibility of the investors' lawyers and accountants.

With regard to registration as a tax shelter, KPMG and Presidio represented to Deutsche Bank that it had either registered the OPIS or BLIPS transactions with the Internal Revenue Service pursuant to IRC § 6111 of the Code or, it had (in the case of Presidio based upon advice from independent tax advisors) determined that it was not required to register the OPIS or BLIPS transactions under such provision.

In addition, Deutsche Bank retained Shearman & Sterling to prepare and review the legal documentation pertaining to the bank's involvement in the transaction and to ensure that it was complying with applicable law. Shearman & Sterling's advice included a legal opinion that the bank was not acting as a tax shelter "promoter" or "organizer" of either the OPIS or BLIPS transactions for purposes of the registration requirements and the list maintenance requirements of the Internal Revenue Code and did not have any obligations to register the transactions as tax shelters under IRC § 6111. Deutsche Bank followed and reasonably relied on the advice of Shearman & Sterling.

Deutsche Bank was aware that KPMG's tax experts had concluded that KPMG could issue a "more likely than not" tax opinion that the BLIPS and OPIS transactions were sustainable. To date, we are unaware that any court has issued a ruling regarding these transactions. The bank also learned that Brown & Wood, an international law firm with extensive experience in financial products and taxation, was comfortable issuing the same level of tax opinion for an investor. Deutsche Bank's outside counsel, Shearman & Sterling, reviewed drafts of these tax opinions and counseled Deutsche Bank on its involvement with the transactions.

Deutsche Bank relied on its outside auditors, KPMG, to affirm their independence and to address any issues that could impact upon KPMG's audit independence. Deutsche Bank was not an investor in these transactions, and derived no favorable tax treatment as a result of these transactions.

Conclusion

Regarding the OPIS and BLIPS transaction, Deutsche Bank believes it acted at the time in accordance with all applicable laws and regulations and that the bank relied upon sound counsel to guide it.

Deutsche Bank continuously monitors changes in the law and the regulatory environment and adapts its business practices, policies and procedures to comply with the ever-changing legal and regulatory environment. Deutsche Bank is cognizant of the Internal Revenue Service's highly publicized tax shelter initiatives and is committed to complying with all applicable rules related to tax shelter registration and disclosure.

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TESTIMONY OF DOMENICK DEGIORGIO BEFORE THE SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS NOVEMBER 20, 2003

Members of the Subcommittee:

My name is Domenick DeGiorgio, and I am Managing Director at the New York City office of Bayerische Hypo-und Vereinsbank A.G. ("HVB"). HVB is an international bank and financial services organization, headquartered in Munich, Germany, and with offices worldwide. Currently HVB employs over 400 people in its New York office, with a payroll approaching $100 million.

From 1997 through 2002, I was an officer of HVB's subsidiary, HVB Structured Finance Inc. Our group specialized in advising customers who needed specially tailored financial products, and in assisting such clients in achieving their business or investment goals using HVB's global financial resources. This business necessarily involves very complex transactions and a wide range of specialized financial services on the part of the HVB. I would note that HVB disbanded the Structured Finance group earlier this year as we refocus on our core business activities in Europe.

I have been asked by the Subcommittee to describe HVB's participation in a number of transactions it describes as tax shelters. I am pleased to be able to appear before the Subcommittee today. I want to begin by stating that HVB is eager to respond to the Subcommitte's inquiries and that we have complied with applicable laws and regulations. Indeed, we have actively cooperated with both the IRS and this Subcommittee, because we recognize the effects that abusive tax shelter transactions may have in undermining confidence in our tax system.

Simply put, with one exception, HVB did not participate in any of the transactions the Subcommittee has asked about, including the ones denominated by the abbreviations "FLIP," "OPIS," "COBRA," or "LILOs." As I will describe in a moment, we did provide financial services for a small number of clients who participated in the so-called "BLIPS" transactions. However, we never organized, promoted or marketed the BLIPS transactions, nor any transaction that was being entered strictly for tax purposes. Furthermore, we never gave, nor even offered, tax opinions or advice regarding the tax treatment of our transactions; for we are a bank, not tax advisors. We did consult with our own outside tax attorneys regarding the implications of the BLIPS transactions for HVB under the applicable provisions of the Internal Revenue Code of 1986. The specific details of such advice are of course privileged under the attorney-client privilege; however, it should suffice for present purposes to say that HVB satisfied itself that we met all of our legal and tax obligations with respect to these transactions.

The Subcommittee has asked me in particular to describe how HVB became involved in the BLIPS transactions that we funded for approximately thirty customers in 1999 and 2000. These customers were brought to HVB by Presidio Advisors, an investment advisory firm. I, and HVB, knew from prior business relationships some of the principals of Presidio Advisors, who were former employees of the international accounting firm KPMG. I was initially contacted by one of the Presidio partners in approximately early August, 1999. He advised me that Presidio had developed a structured investment program for a number of high net-worth individuals, and he asked me if HVB would be interested in providing banking services, including loans, foreign currency transactions, and transactions involving interest rate derivative products. He stated that one of our principle competitors, DeutscheBank, had provided similar financial services for a number of clients who participated in the same investment program, and Presidio was trying to diversify the financial services providers for the investment program. I agreed that HVB might be interested in providing such banking services, and I requested additional information about what would be expected of us.

Over the course of approximately the next month, we received a considerable amount of information about the BLIPS investment program, including a draft set of the transaction documents that DeutscheBank had been using, and an unsigned draft of an opinion by KPMG regarding the tax consequences of the investment program for the investors. This information was provided to us in order for HVB to understand the transactions and to determine what banking services we would be required to provide.

We of course knew that the BLIPS investment program, like practically all investments, could have United States income tax consequences for the investors, including substantial losses if the program was terminated early. Not being tax professionals ourselves, we relied on the KPMG opinion to assure us that the transaction met all applicable tax laws for the investors, and we did not separately perform our own comprehensive evaluation of the tax consequences for those investors. Rather, as we generally do when asked to participate in transactions in the ordinary course of our business, we focused on our own potential for profit and risk of loss from the transaction. Likewise, we did not view it as our role to evaluate comprehensively the investors' purposes for entering into the transactions or the potential tax consequences of the transactions for them. The investors were to be sophisticated, high-net worth individuals who presumably had considerable business and investment experience, and the tax and other legal consequences of the transactions were the subject of opinions by some of the nation's best law and accounting firms. Further, the transactions had previously been funded by a prominent competitor, and it was represented to us that the investors could and would meet our own, conservative internal lending criteria. At the time (the last half of 1999), the IRS had not made any adverse determination regarding these transactions, and we consulted with our own attorneys about whether our participation in the program created any legal issues for the bank. As a result of all of these factors, we concluded that the bank's expected role in the BLIPS transactions was appropriate and complied with applicable laws and regulations.

In approximately early September, 1999, I and other HVB employees met in our offices in New York with several principals from Presidio Advisors, who described the investment strategy for us. We also carefully reviewed the banking services that would be required of HVB, including the "premium" fee structure for the loan, how the customers would meet the bank's lending criteria and "know your customer" requirements, and what would happen if the investment strategy were terminated by the investors after 60 or 180 days rather than running the full 7 expected years. Again, the potential tax consequences of the transactions were discussed, but were by no means the sole, or even the central, focus of our discussions at our meeting.

Over the course of the subsequent weeks, the members of my group at HVB confirmed that the bank could provide the various kinds of services required of it for the investment program. We also obtained, through our ordinary credit approval procedures, authorization to loan as much as $1 billion in the last few months of 1999 to participants in the investment program, provided of course that they met our usual lending criteria. The credit approval memorandum, which went through several drafts, fully described the investment strategy, which could run as long as 7 years or could terminate as early as 60 days after the loans were made. It also discussed the ordinary risk analyses, credit protection procedures, collateral arrangements, and other routine matters as well as, to the extent we knew them, the business purposes and tax consequences of the entire series of transactions. I would reiterate, however, that we did not fully analyze all the possible tax ramifications that the transactions might have for investors, relying on KPMG to do that for its own clients.

After we obtained credit approval for a series of transactions, we began processing the particular loans for approval and preparing to provide the other banking services that would be demanded of HVB. Each of the borrowers was required to meet our lending criteria and "know your customer" requirements, and we requested a substantial amount of documentation and verifications from them. Personnel from Presidio, which was the investment advisor for the transactions, and from KPMG, the tax advisor on the transactions, assisted us in compiling this information. Assisted by our own attorneys, we also drafted the transaction documents to meet our requirements.

Ultimately, HVB funded approximately eleven of these transactions in 1999, and another tranche of eighteen of them in early 2000. The average size of these loans was approximately $71 million and the bank extended credit totaling approximately $2.2 billion in the entire series of transactions. Ultimately all of the investment programs were terminated after Stage I, approximately 60 days after they were entered, and all the loans HVB made were fully repaid, with full interest, at that time.

In August, 2000, the IRS published Notice 2000-44, in which the IRS stated its position that the tax benefits that investors might claim from transaction like the BLIPS transactions would not be allowed. HVB immediately ceased its participation in the program in view of the IRS's announced position. The loans that were still outstanding at that time were subsequently fully repaid, and that was the end of our involvement with BLIPS.

The Subcommittee has asked me to address a number of specific questions regarding the BLIPS strategy. I want to preface this portion of my testimony by reiterating that HVB's role in the transactions was limited to traditional banking services, and that some of the Subcommittee's questions would be better addressed to other participants. Take, for example, the question whether HVB performed "any analysis of auditor independence issues in light of KPMG's role in auditing the Bank's financial statements filed with the U.S. Securities and Exchange Commission." This first of all assumes that the bank files financial statements with the SEC, which it does not. Further, while we recognize that auditor independence is a serious issue, we must point out that we were approached by Presidio, not KPMG, regarding these transactions and that KPMG was involved to the extent of serving its tax clients, who ultimately became HVB customers. We did not consult KPMG for tax advice regarding HVB's role in these transactions, we consulted an outside law firm for our own tax advice. Moreover, we did not market, either jointly with KPMG or on our own, the BLIPs product to any of our existing customers. At the time that these transactions occurred (in 1999), the present restrictions on auditor independence that are embodied in the Sarbanes-Oxley Act and SEC regulations of course had not yet been enacted. But even under the present regulatory framework, these facts might present no auditor independence questions, and certainly under the rules that were then applicable in 1999 we did not perceive such an issue.

The Subcommittee has also asked about the "development and accuracy of the formal representations made by and to HVB in connection with the BLIPS transactions." Most of the "representations" made in connection with these transactions were of an entirely routine nature for a lending transaction. For instance, the investors represented the they had their own independent advisors and were not relying on HVB for tax, accounting, or financial advice, and HVB acknowledged that the transactions were conducted under arms' length terms and that our compensation was within the range of market rates for our services. Further, Presidio (the sponsor of the investment program) and KPMG (the tax advisor) specifically represented that they would comply with section 6111 of the Internal Revenue Code by either registering the transactions as tax shelters or determining that they were not required to so register. After obtaining legal advice on this issue, we again relied on these representations.

As I noted previously, HVB did consult its attorneys with respect to the U.S. tax implications of the BLIPS transactions for HVB, and we remain confident that they were properly and accurately reported by the bank. Independent of this Subcommittee's investigation, we have already received over two dozen summonses from the IRS with respect to examinations of investors in these transactions, and we have provided to the IRS the same documentation that we have provided to this Subcommittee. To date, the IRS has not questioned HVB's role in the transactions, and we remain certain that we have done everything properly.

The last question that the Subcommittee has asked me to address concerns HVB's "review and approval process related to financing or implementing transactions that appear to have tax avoidance as a significant purpose." Although we certainly were generally aware the investors could have tax consequences at various stages of the program, including tax losses if the investors terminated after Stage I, we relied on KPMG's opinion in this regard. Moreover, we followed our regular loan approval processes in entering the transactions in this program; we did nothing extraordinary or unusual here.

We recognize, of course, that the Subcommittee may recommend legislation that might change HVB's or any other financial institution's legal obligations with respect to structured financial products and services or the tax implications of such transactions. We would be happy to work with the Subcommittee with respect to such legislation, and we look forward to a productive exchange of views with the Subcommittee on this subject.

Statement
of
JEFFREY GREENSTEIN
Chief Executive Officer
Quellos Group, LLC

Before The
U.S. Senate Permanent Subcommittee on Investigations
November 20, 2003

Mr. Chairman, Senator Levin, and Members of the Subcommittee:

My name is Jeff Greenstein. I appreciate the opportunity to appear before this Subcommittee. I am the chief executive officer of the Quellos Group, LLC, based in Seattle, Washington. Since our founding in 1994, we have focused on providing asset management services to institutional and individual clients.

We understand and very much respect the Subcommittee's responsibilities in this area and its interest in ascertaining whether there is a need for a change in public policy.

You have asked me to address tax-advantaged investment strategies with names including BLIPS, SC2, FLIP and OPIS. With respect to BLIPS and SC2, we have no experience with these structures whatsoever, and, therefore, I am not in a position to comment on them. I am able to discuss investment and structural aspects of the latter two strategies with the Subcommittee today, although I do not have tax expertise and thus am unable to provide meaningful insights into the tax aspects of either of those strategies. In addition, we have not worked for years with any accounting firms on tax strategies such as those being discussed today.

As you have heard, prior to our involvement, the international accounting firm of KPMG developed FLIP in the 1990s to provide its clients with a tax-saving investment strategy. In the course of many conversations and meetings, KPMG advised us that its senior tax experts, many of whom had Treasury or IRS experience, had carefully researched the existing statutes and regulations, and that KPMG's national tax office had concluded that these transactions would likely yield favorable tax treatment for its investors under the Internal Revenue Code.

By way of history, our introduction to KPMG occurred in 1995, in a matter completely unrelated to what we are here to discuss today. We were working with a client of ours to restructure a portion of an investment portfolio in order to meet its investment objectives. Given the importance of analyzing any investment portfolio on an after-tax basis, our client asked us to review our portfolio recommendations with its tax advisors at KPMG. At the client's request, I spoke with its advisors at KPMG.

As a result of this prior interaction, KPMG later contacted us to see if we would apply our investment expertise to assist it with a series of securities transactions related to one of its tax strategies. This strategy later came to be known as FLIP. In particular, KPMG asked us to execute an investment strategy consistent with a set of pre-defined criteria that they had designed and provided to us. KPMG told us that if these transactions met their pre-defined criteria, certain favorable tax consequences would likely be achieved.

Our role as investment advisor was to identify, analyze and implement the specific stock and option transactions that were required to execute the KPMG FLIP strategy, so that investors would have a reasonable prospect of earning an economic profit. Indeed, they did have such a prospect, which was in fact realized by a number of FLIP and OPIS investors. This profit potential was directly linked to the gradual appreciation of the publicly-traded shares of one of the world's major financial institutions. KPMG specifically approved the stock and option transactions after it had determined that the transactions met its criteria for obtaining favorable tax treatment for its clients.

A 1997 agreement between KPMG and Quadra memorialized our different roles. In the agreement, KPMG confirmed its responsibility for the tax aspects of the strategy, while agreeing that Quadra only had responsibility for providing investment advice. KPMG was, and remains, an international accounting firm with an excellent reputation, and we relied on its tax analysis and advice. A prominent national law firm concurred with KPMG's tax analysis.

KPMG began introducing FLIP to potential investors during late 1996. Subsequently, the accounting firm of Coopers & Lybrand – now PricewaterhouseCoopers or PWC – developed a similar strategy with similar tax attributes, and also sought and received our assistance in providing investment-related advice and execution services. PWC provided a detailed tax opinion, which was consistent with KPMG's earlier conclusion that the Internal Revenue Code likely afforded favorable tax treatment.

In late 1998, we were approached again by KPMG with respect to a variation of the FLIP transaction known as OPIS. It was our understanding that KPMG had been offering that strategy to clients through another investment advisor, The Presidio Group, but that The Presidio Group had exhausted its capacity for implementing transactions. KPMG then requested our assistance with executing the OPIS strategy. In this instance, all of the investment and structural aspects of the strategy were fully developed by KPMG before we were contacted, and the nature of the financial instruments and securities transactions had been fully specified. We implemented the trades and executed the documents required, as prescribed by KPMG.

In summary, I want to reiterate that our focus historically, and today, has been to assist our clients in meeting their financial and investment objectives, using thoughtful, sophisticated, disciplined, and well-researched portfolio management. This core competency presented us with the business opportunity to work with some of the most respected professional services firms in the world. Neither KPMG nor any other party looked to us to provide a tax opinion on the KPMG tax strategies. To the contrary, with regard to the appropriate tax treatment of the transactions, we relied on the judgment of multiple unrelated and well-respected tax experts.

As professional investment advisors, we have only provided investment services in connection with transactions that we concluded, after careful analysis, offered investors a reasonable opportunity to earn profits. We have always focused on helping our clients meet their investment and financial objectives, and pride ourselves on the work we do.

Mr. Chairman and Senator Levin, this concludes my prepared remarks. I would be pleased to answer any questions you may have.

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PREPARED TESTIMONY OF
COMMISSIONER OF INTERNAL REVENUE
MARK W. EVERSON
BEFORE THE
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE
HEARING ON ABUSIVE TAX SHELTERS
NOVEMBER 20, 2003

INTRODUCTION AND OVERVIEW

Mr. Chairman, Senator Levin and Members of the Subcommittee, thank you for inviting me to discuss the subject of abusive tax avoidance transactions. We appreciate the interest the Subcommittee has shown in this issue, particularly in examining the proliferation of these transactions. The work of the Subcommittee has highlighted the need for greater transparency with respect to potentially abusive tax avoidance transactions and the need for increased penalties on participants and promoters.

The focus of the Subcommittee's first day of hearings was the mass marketing of tax shelters by some professional advisors. Beginning in the mid-1990s, some professional firms shifted their focus from their historic role of trusted advisors to that of professional salesmen.

According to the witnesses that appeared before you on the first day of the hearing, the biggest accounting firms no longer engage in mass marketing. If this is true, we believe that IRS efforts may have played a significant role in this development. We believe some promoters and taxpayers may have recognized the increased risk of detection of tax returns claiming tax benefits from abusive tax avoidance transactions. In any event, it is my view that this problem is significant, and we need to increase our diligence and effort in this area.

The Treasury Department and the IRS have responded by taking aggressive actions against participants in and promoters of abusive tax avoidance transactions. As a core element of these efforts, the Treasury Department and the IRS proposed in March 2002 to create a web of disclosure through a series of administrative and legislative initiatives.

The Treasury Department and the IRS didn't wait for the enactment of the legislative proposals, but moved forward with all of the administrative actions described in the March 2002 proposals, and almost all have been completed. These actions have been important steps in creating the transparency and certainty needed to combat abusive transactions. The legislative proposals would complete and reinforce these actions by simplifying the disclosure rules and imposing meaningful penalties on taxpayers and promoters who fail to provide the IRS with requested information.

One of the top priorities of the President's 2004 Budget Request for the Treasury Department was to strengthen the integrity of the nation's tax system by deterring inappropriate tax avoidance and evasion (especially among high income taxpayers).

As was made clear at the first day of the Subcommittee's hearing, issues of professional practice must be a priority. Tax professionals are vital to our system of voluntary compliance. They advise taxpayers on sophisticated legal transactions that involve complex rules and fine legal judgments. The tax laws are complex and taxpayers are permitted to take aggressive positions within the bounds of the law. Tax professionals should assist taxpayers in navigating through this challenging landscape to determine their fair share of taxes. Instead, we have seen far too many instances in which tax professionals have helped taxpayers avoid paying the taxes rightfully owed.

We are looking for ways to encourage best practices and ethical professional behavior by tax professionals, as well as discourage participation in abusive tax avoidance transactions. A key thrust in this effort is transparency, that is, the rules that the Treasury Department and the IRS have put in place to require the disclosure to the IRS of transactions that constitute abusive tax avoidance transactions or potentially abusive tax avoidance transactions.

The IRS and the Treasury Department are committed to ensuring compliance with the rules governing the promotion of tax avoidance transactions by tax professionals. The IRS is currently conducting well over 100 examinations of promoters. As part of the examinations, we are requesting investor lists and other information, and, if necessary, issuing summonses for those lists and other information. As a consequence of the examinations, we are reviewing numerous transactions to determine whether they should have been registered under section 6111 of the Internal Revenue Code, and whether investor lists should have been maintained under section 6112 of the Code.

Tax professionals, including lawyers and accountants, must comply with the law requiring registration of tax shelters and the keeping of investor lists. Many entities have provided us with the information we have sought pursuant to our requests. Others have been less forthcoming. We will continue our efforts to assure adherence to the law by promoters of potentially abusive tax avoidance transactions, including the use of summons and summons enforcement actions where necessary to obtain the information to which we are entitled. We will not hesitate to use the tools at our disposal to gather information about transactions, the taxpayers who invest in them, and the promoters who sell them.

QUESTIONS POSED BY THE SUBCOMMITTEE

In your letter of invitation, you asked the IRS to address four specific questions at this hearing. To the extent possible, I will address those questions in order.

(1) The scope of the potentially abusive and illegal tax shelter problem including the role played by professional firms, the estimated overall cost to the U.S. Treasury from these tax shelters, and the IRS' efforts to combat these tax shelters.

Estimates vary on the size of this problem. Unfortunately, it is very difficult to make a precise determination based on the many different interpretations and definitions of abusive tax shelters. The October 2003 GAO report on abusive tax shelters also acknowledged this difficulty. Whatever the actual volume of abusive tax shelters, we recognize that there is a significant compliance problem and we are taking aggressive action to address it, utilizing existing regulatory, administrative, and enforcement tools. For example, in our Large and Mid-Size Business Division (LMSB), we currently have 118 promoter cases open for investigation. In addition, in our Small Business/Self Employed Operating Division (SBSE) there are 41 technical tax shelter promoter investigations open. The audits began in LMSB in 2001, with 22 entities under investigation. As is apparent, we have increased the number of audits significantly. This includes large accounting firms and major law firms, as well as banks and a number of boutique and mid size promoters.

There are three ways the IRS finds out about questionable transactions. One, taxpayers and promoters are required to disclose or register questionable transactions and maintain investor lists under sections 6011, 6111 and 6112 of the Code. Two, the IRS identifies questionable transactions through its examination process. Three, the IRS and the Treasury Department learn about transactions through tips, some of which are anonymous tips through the Office of Tax Shelter Analysis ("OTSA") Hotline.

As I have indicated, disclosure is critical to our ability to identify and address abusive transactions early on. In February 2003, the IRS issued final regulations under Code Sections 6011, 6111 and 6112 to improve and enhance the disclosure of potentially abusive transactions by taxpayers, the registration of those transactions by "material advisors" (which would include "promoters"), and the maintenance of customer lists by those advisors. These regulations are designed to improve our information about potentially abusive transactions, promoters who market abusive transactions and those taxpayers who invest in abusive transactions. The regulations require taxpayers to disclose "reportable transactions" on their returns and to the IRS' Office of Tax Shelter Analysis, or OTSA. In addition the regulations require promoters to register their tax shelters with the IRS, and promoters and other persons to maintain lists of investors in their tax shelters and furnish those lists to the IRS upon its request.

A reportable transaction may not necessarily be an abusive transaction. But by subjecting a broad range of transactions to disclosure, we increase the likelihood of the IRS detecting the most abusive transactions. The increased likelihood of detection by the IRS alters the risk/reward calculus for potential investors entering into abusive transactions.

The number of disclosures received from taxpayers has increased significantly since 2001. We expect to receive more taxpayer disclosures pertaining to calendar year 2003 than with respect to any previous year.

Coordination with the States

Another way in which we are combating abusive transactions is through our work with the States. The IRS and state tax officials announced a new nationwide partnership to combat abusive transactions in September 2003. Under agreements with individual states, known as Memoranda of Understanding, the IRS and states will share information on abusive transactions and those taxpayers who participate in them. The agreements creating this partnership are designed to enable both state and federal governments to move more aggressively in the fight to ensure all taxpayers pay their fair share of tax. As of November 12, 2003, forty-two states, the District of Columbia, and the New York City Department of Finance have agreed to partner with the IRS on this initiative.

Under the initiative, the IRS and states will exchange information about a range of abusive tax avoidance transactions. This will allow the IRS and state agencies to avoid duplication and to piggyback on the results of each other's work. The states and the IRS will then share information on any resulting tax adjustments, reducing the need for duplicating lengthy taxpayer examinations by both a state and the IRS.

In addition to greater cooperation in sharing leads in the area of abusive transactions, the partnership with the states includes joint outreach and education activities to more effectively counter the claims of those marketing tax schemes and scams.

Initial data provided by the California Franchise Tax Board in response to an IRS request for state information relative to a high profile transaction the IRS currently is examining resulted in the identification of additional participants the IRS had not yet identified. As a result, the IRS will be able to protect statutes of limitations and bring additional participants into compliance.

Over the recent past, the IRS has taken a number of other noteworthy actions to combat abusive transactions. You are probably familiar to varying degrees with most or all of these actions. They center on greater transparency and developing and using a web of information to curb these transactions at the front end.

(2) With respect to BLIPS, OPIS, FLIP, SC2, COBRA, BOSS, and Son of BOSS, since 1995, the approximate total number of persons who have used each tax product and total amount of tax revenues lost as the result of each tax product.

It is difficult for us to identify the total number of persons who have used each tax product. We are, however, using examinations of promoters to secure investor lists to identify the participants. We have received a number of disclosures and, as the changes in the disclosure regulations take full effect and the number of listed transactions increases, we anticipate receiving more. There will be those who do not disclose, however, which will make it more difficult for us to get a complete picture. That some may choose not to disclose is why it is important for Congress to enact the change to the registration rules proposed by Treasury and IRS that will complete the information web on which the IRS relies to assist in finding non-disclosing taxpayers. That is also why it is important that the IRS maintain and strengthen its examination program so it continues to be capable of detecting undisclosed transactions.

Within our Operating Divisions, we have management information systems that track the activity on cases of known investors. Within our Office of Tax Shelter Analysis (OTSA), we can track the activity on cases of known investors through all sources.

We can provide the following data on specific transactions:

Notice 99-59 —The OTSA database contains transactions totaling $356 million in potential tax dollars.

Notice 2000-44— The OTSA database contains 2,208 transactions totaling $5.4 billion in potential tax dollars.

Notice 2001-45 — The OTSA database contains 322 transactions totaling $631 million in potential tax dollars.

(3) Whether, to your knowledge, professional firms are now routinely developing and marketing complex tax products for sale to multiple clients and, if so, the impact and implications of mass marketing these tax products, including whether professional firms may be, at times, misleading taxpayers regarding the legal validity of the products they are selling, and whether IRS oversight of tax professionals selling generic tax products poses new and different enforcement issues than reviewing the tax returns reflecting individualized tax planning advice.

Our promoter investigations have established that organized and comprehensive marketing strategies have been utilized by professional firms to sell abusive tax products that have been developed. These include transactions that were structured for the use of, and were marketed to, multiple investors, rather than a single investor. We have also seen indications that abusive transactions have moved "down market" through more widely-marketed promotions by lesser known professional firms to less affluent taxpayers. Such a development increases the likelihood that taxpayers may be misled or may be inadequately equipped to assess the tax avoidance proposals presented to them.

While circumstances differ from transaction to transaction, information received from investors suggests that some of these transactions, which are complex, may not have been fully understood by taxpayers, who consequently may have relied on the representations of the promoter.

A significant priority in the Service's efforts to curb abusive transactions is our focus on promoters.

Initiatives focused on promoters can provide a number of benefits. Promoters are required to maintain investor lists that identify taxpayers who participate in or purchase potentially abusive tax avoidance transactions that are "reportable" or "listed" under the Service's rules. By auditing the promoters and obtaining investor lists and following up with audits of those investors, we can deter the promotion of as well as the interest in such products. That is, these activities alter the risk/reward ratio for potential investors.

The IRS has included accounting and law firms in its investigations of tax shelters and related promoters. The IRS has included these firms because it believes that, in the instances in which the IRS has acted, these firms were acting as promoters of tax shelters, and not simply as tax or legal advisers.

Where the IRS believes a firm has failed to comply with the registration or list-keeping rules, the Service will not hesitate to audit.

The IRS conducts promoter examinations to determine whether a promoter has complied with regulations requiring identification of potentially abusive transactions by registering such transactions and maintaining and providing investor lists to the IRS upon request.

Through the promoter audits, we have shown that we are willing to use the tools at our disposal to obtain the information promoters are obligated to provide to us. Through the disclosure regime, including transactions and investor identities, generated by these efforts, we are demonstrating that the risk of detection and audit is serious and must be factored into the risk-reward calculus by promoters and investors alike. Mr. Chairman, we believe we can do more in this area and you can expect us to continue our efforts.

In regard to this question, I further want to point out several noteworthy actions we have taken in connection with our promoter efforts.

KPMG/BDO Seidman

In July 2002, the Justice Department, on behalf of the IRS, filed suit in federal court in Washington, D.C. against KPMG LLP, asking the court to compel the firm to disclose information to the IRS about tax shelters it had marketed since 1998.

In a similar suit filed in Chicago, the Department asked the federal court there to enforce summonses issued to another firm, BDO Seidman, LLP, for information related to its marketing of tax shelters since 1995.

Jenkens & Gilchrist

Earlier this year, the Department of Justice on behalf of the IRS petitioned the United States District Court, Northern District of Illinois, for enforcement of five administrative summonses and a John Doe summons served on Jenkens & Gilchrist. The summonses ask the law firm to provide information on certain listed transactions or other potentially abusive transactions organized or sold by the firm's Chicago office and to identify taxpayers who may have invested in them.

This was the first case of its kind involving a law firm.

Sidley Austin Brown & Wood LLP

In October, the IRS received approval from the United States District Court, Northern District of Illinois to serve a John Doe summons on Sidley Austin Brown & Wood, asking the law firm to identify taxpayers who may have invested in listed transactions or other potentially abusive transactions organized or sold by the firm.

Grant Thornton

On September 17, 2003, the Department of Justice, on behalf of the IRS, filed a petition in the U.S. District Court, District of Columbia, to enforce nine administrative summonses issued to the accounting firm, Grant Thornton LLP.

The summonses were issued as part of an IRS examination to determine Grant Thornton's compliance with tax shelter registration and list maintenance requirements, including identifying taxpayers who may have invested in potentially abusive transactions organized and sold by the firm.

Finally, the IRS has entered into closing agreements with professional service firms resolving issues related to those firms' compliance with the registration and list maintenance requirements that apply to the marketing of tax shelters. The agreements required payments to the IRS to resolve the issues. More important, however, the agreements require procedures that will prevent the future occurrence of the kind of practices that led to the IRS's audits and to the payments to the IRS to resolve the issues. In particular, the agreements ensure ongoing compliance with the registration and list maintenance provisions of the Internal Revenue Code and regulations. One of the agreements provides for the firm to implement a Quality and Integrity Program to ensure the highest standards of practice and ongoing compliance with the law and regulations. The IRS may, upon its request, review documents prepared as part of this program.

We are pleased with the full cooperation the IRS has been afforded by the firms that have entered into closing agreements in resolving these matters. This represents a real breakthrough and is a good working model for future agreements with practitioners.

Disclosure Initiative

In December 2001, the IRS announced a 120-day disclosure initiative that ended on April 23, 2002. The initiative provided taxpayers an opportunity to disclose questionable transactions to the IRS. Under the terms of the initiative, if taxpayers provided all relevant information about the disclosed transactions or items, including the identity of the promoter of the transaction, the IRS would waive certain accuracy-related penalties that might apply to those transactions and other questionable items that resulted in an underpayment of tax.

The IRS has used the disclosures to identify tax shelter promoters and to connect promoters to particular listed transactions. We are examining the activities of these promoters to determine whether they complied with their legal obligations to register certain transactions and maintain investor lists. Upon receipt of the investor lists from promoters, the IRS will be able to identify other taxpayers who participated in abusive transactions and failed to disclose them.

(4) Any recommendations you may have to ensure that professional firms develop and market generic tax products that comply with the law, the IRS learns of potentially abusive tax products marketed by professional firms to multiple clients, potential buyers are fully informed of risks associated with such tax products, or to address other tax shelter development, marketing, or implementation concerns.

As I indicated previously, we believe transparency is a key element in addressing abusive tax transactions. Transparency includes the disclosure of information *by* taxpayers and promoters and the disclosure of information *to* taxpayers and promoters.

In terms of disclosure of information by taxpayers and promoters, we will continue to rely on regulatory requirements for registration, disclosure, and maintenance of investor lists to provide the information we need to identify and monitor potentially abusive transactions. Transparency is critical to our early identification and would be significantly enhanced by the legislative change proposed by the Treasury Department that would expand the scope of the registration rules. We need to ensure that questionable transactions are registered and subject to IRS review. This is critical to our ability to identify and address abusive tax practices early on. The majority of taxpayers are honest and want to comply with the tax laws. By providing quicker guidance on tax transactions, we can enhance voluntary compliance.

I believe that tax professionals are an integral part of our effort to ensure that the Internal Revenue Code is administered fairly and appropriately. The majority of tax professionals recognize their obligations to the system as well as their obligations to their clients, and they have expressed dismay about the inappropriate behavior of some of their colleagues. I have asked the Deputy Commissioner for Services and Enforcement to develop and coordinate a unified strategy for improving confidence in the integrity of tax professionals, a strategy that will encourage best practices and deter improper and unethical practices.

The Treasury Department and the IRS intend to make changes to Circular 230, which governs professional conduct. Among the subjects we are closely examining in this regard are the standards employed in legal opinions regarding tax shelter transactions. I have asked the new Deputy Commissioner for Services and Enforcement, to make the strengthening of Circular 230 one of his priorities.

Moreover, the Treasury Department has solicited support for a number of legislative proposals intended to curb abusive transactions. We appreciate that these proposals have been included in several Senate bills. If the IRS or Treasury Department identify the need for additional legislation, we will bring those areas to the attention of Congress. We appreciate this Subcommittee's efforts to secure passage of that legislation.

In terms of disclosure of information to taxpayers and promoters, the Service intends to continue to emphasize its provision of published guidance. The published guidance program is an important tool that the IRS can use to increase disclosure and compliance. The IRS has in recent years made significant progress in accelerating and increasing its issuance of published guidance and our intention is to continue to improve our performance in this area.

Informing taxpayers through published guidance of abusive transactions will discourage participation in them. And there is another side to the coin – a very positive one that is sometimes forgotten. Some transactions that are worthy of IRS scrutiny may nevertheless prove to be sound under the law. 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. In addition, through published guidance in non-shelter areas, we can save audit resources that we can then devote to areas with higher risk of noncompliance.

CONCLUSION

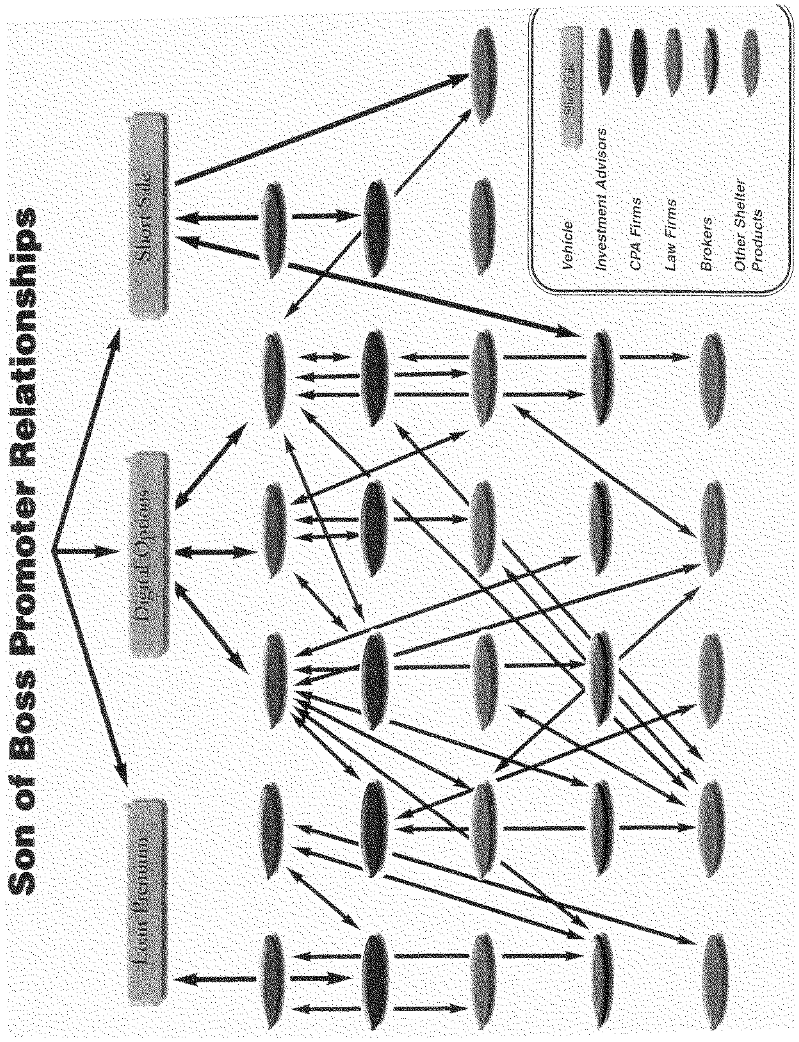
Mr. Chairman, we are firmly committed to curbing abusive tax transactions. They are an affront to honest taxpayers and practitioners and undermine confidence in the fairness of our tax system. The Congress and our taxpayers have every right to expect diligence, care and professionalism from the IRS in this effort, and I will do my utmost to see that those qualities are applied to our effort, and that there is no compromise of taxpayer rights.

Abusive transactions can and will continue to pose a threat to the integrity of our tax administration system. We cannot tolerate the promotion of or participation in abusive transactions. The stakes are too high and the effects of an insufficient response are too corrosive. We have put in place the foundation and structure to begin to attack these transactions in a systematic way. Certainly we will need to do more and we will need to do it better.

If professional service firms have in fact curtailed their marketing activities, as indicated in the testimony on the first day of the Subcommittee's hearing, we think it likely that IRS efforts played a significant role in this development. Some promoters and some taxpayers may be recognizing the increased risk of detection and audit of tax returns claiming tax benefits from abusive tax avoidance transactions. In any event, we must continue to be diligent.

Senate Finance Committee Chairman Grassley recently said, "The IRS should be able to enforce the tax code and respect taxpayers' rights at the same time. We can't have people abusing the tax code, and we can't have the IRS abusing taxpayers. It's as simple as that." I heartily agree. The IRS must demonstrate and execute a balanced approach if taxpayers are to remain faithful to our system of self-assessment. I believe the IRS has made progress in meeting these concerns.

I would be very pleased to answer any questions Members of the Subcommittee might have.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Short Sale
Investment Advisors
CPA Firms
Law Firms
Brokers
Other Shelter Products

Testimony Concerning
the
Public Company Accounting Oversight Board

PCAOB
Public Company Accounting Oversight Board

William J. McDonough
Chairman, Public Company Accounting Oversight Board

Before the
Committee on Governmental Affairs
Permanent Subcommittee on Investigations
United States Senate

November 20, 2003

PCAOB
Public Company Accounting Oversight Board

TESTIMONY

Chairman Coleman, Ranking Member Levin and Members of the Subcommittee –

I am pleased to appear before you today on behalf of the Public Company Accounting Oversight Board ("PCAOB" or the "Board"). I would like to begin by commending the Subcommittee's investigation of the role of professional firms, including accounting firms, in the development, marketing and implementation of abusive tax shelters. Indeed, the evidence you have accumulated has served as a wake-up call that we all – whether corporate leader, legislator, or regulator – must heed.

The Permanent Subcommittee on Investigations was quick to see the wide-ranging ramifications of the financial scandals at Enron, Adelphia, WorldCom, HealthSouth and other companies. Those corporate collapses left the impression – not just with investors, but with ordinary Americans, and even with the world community – that public company financial reporting is not to be trusted, and that professional advisors, including investment bankers, lawyers, and even a company's outside accountants, will help unscrupulous executives cook the books. When their trust was broken, the American people did what they ought to – they asked their elected representatives to fix it. Congress responded by enacting the Sarbanes-Oxley Act of 2002, which, among other things, created the PCAOB. In addition, through the Permanent Subcommittee's series of hearings on the role of financial institutions in Enron's collapse, you have continued to respond to the public's concerns regarding corporate integrity and financial reporting reliability.

I am both proud and humbled to appear before you today as Chairman of the PCAOB. Among the many reasons I took on this job were my own strong convictions about the need for an aggressive response to the corporate scandals and the lack of leadership in the private sector. It is a privilege to have the opportunity to act on those convictions by helping to build an organization, in the form envisioned by Congress, to restore the linchpin of the American financial system – trust in the integrity of financial reporting.

Introduction

A little over a year ago, the Congress passed and the President signed the Sarbanes-Oxley Act of 2002 (the "Act").[1] The Act established the PCAOB and charged it with "oversee[ing] the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public

[1] P.L. No. 107-204 (2002).

interest in the preparation of informative, accurate and independent audit reports for companies the securities of which are sold to, and held by and for, public investors."[2/] To carry out this charge, the Act gives the Board significant powers over the practice of auditing the financial statements of public companies. Specifically, the Board's powers include authority to –

- register public accounting firms that prepare audit reports for issuers;
- conduct inspections of registered public accounting firms;
- conduct investigations and disciplinary proceedings concerning, and to impose appropriate sanctions where justified upon, registered public accounting firms and associated persons of such firms;
- enforce compliance by registered public accounting firms and their associated persons with the Act, the Board's rules, professional standards, and the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants; and
- establish auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers.[3/]

Overview of the Board's Organization

Since the initial Board members took office in January, the Board has taken a number of steps to position it to carry out its core programs. Starting from scratch in January 2003, the Board has grown to over 100 full-time professional staff. Earlier this year, the Board opened offices in Washington, D.C. and New York City, as well as an information technology center in Northern Virginia. The Board will be opening regional offices in Atlanta, Dallas and San Francisco in the near future. The Board also adopted bylaws and established ethics rules and standards of conduct for Board members and staff and developed a budget of approximately $68 million for its first fiscal year (calendar year 2003). The Securities and Exchange Commission (the "SEC" or "Commission") approved that budget in April, and we have sent invoices to public companies and other issuers of securities – based on their relative equity market capitalizations, in accordance with the Act – to fund it.

2/ Sarbanes-Oxley Act, Section 101(a).

3/ Sarbanes-Oxley Act, Section 101(c).

PCAOB
Public Company Accounting Oversight Board

TESTIMONY

Registration

The Act and the Board's rules require all U.S. accounting firms that prepare or issue audit reports on U.S. public companies, or play a substantial role in the audit of a U.S. public company, to be registered with the PCAOB.[4/]

Registration is critical to the Board's regulatory oversight of public accounting firms' audit practices. As a legal matter, registration is the predicate for the Board's other oversight programs – compliance with auditing and related professional practice standards, inspections, investigations, and discipline. In addition, registration provides the Board with valuable information about the firms that apply for registration.

Registration of a public accounting firm is not automatic upon our receipt of an application. In order to approve an application, the Board must determine that registration of the applicant is consistent with the Board's responsibilities under the Act to protect investors and to further the public interest in the preparation of informative, fair and independent audit reports for public companies. To make that determination, the Board has been and remains committed to a careful and fair review of all applications. The Board received its first registration application on August 7, 2003, and, as of November 17, 2003, the Board has and has considered the applications of, and registered, 665 audit firms.

Inspections

The Act requires the Board to conduct a continuing program of inspections of the audit practices of registered public accounting firms. The purpose of these inspections is to assess the degree of compliance of each registered public accounting firm, and associated persons of that firm, with the Act, the rules of the Board, the rules of the Commission, and professional standards, in connection with its performance of audits, issuance of audit reports, and related matters involving issuers.

Through the Board's inspection program, we will have extensive contact with registered firms and with their personnel. It is the tool we will use to assess the quality of the audits that have been conducted and, when necessary, to exert pressure to change auditor behavior. It will provide us with a view – at times through a microscope, and at other times from a bird's eye – into the registered firms' audit practices to see

[4/] Non-U.S. accounting firms that prepare or issue audit reports on U.S. public companies, or play a substantial role in the audit of a U.S. public company, must register with the PCAOB next year.

how they are implementing applicable auditing and related professional practice standards, how they are complying with applicable laws and rules, where they are doing well, and where improvements are needed. Our inspections program will provide a unique new source of evidence relating to audit quality and to the symptoms of any weaknesses in audit quality, ranging from competence and methodology to judgment and integrity.

Our inspections will focus on a number of areas that have not been the traditional focus of the profession's own peer reviews of audits. These include –

- the "tone at the top" of registered firms – we want to know the nature of the messages that are coming from the leadership of the firms and their frequency, and whether the messages are received and acted on;

- audit partner compensation and promotion – we are going to look into what behaviors are rewarded and reinforced through compensation and promotions; and

- the firms' communication and training practices with regard to all audit professionals.

On October 7, 2003, the Board adopted final rules relating to inspections. Under the final rules –

- regular inspections are to take place annually for those firms that issue audit reports for more than 100 U.S. public companies;

- other firms are subject to regular inspections every three years; and

- special inspections may be authorized by the Board at any time.

Earlier this year, we began conducting limited inspection procedures on the four largest accounting firms, which agreed to cooperate with the Board's inspectors even before they were registered. Those inspections are well underway now. Beginning in 2004, we will conduct annual regular inspections of all firms with more than 100 public company audit clients, as required by the Act, and we will conduct triennial regular inspections of registered firms with 100 or fewer public company audit clients.

Of particular importance, given the Subcommittee's investigation, our work programs for this year's limited procedures include a focus on evaluating the independence implications of non-audit services that firms have provided to audit clients. Based on this work, we will not only assess whether the firms comply with existing independence requirements, but we will also assess whether there are any factors present that have adversely affected audit quality. Because we are inspecting the four largest firms, and a variety of selected audit engagements, we expect to gain an understanding of the firms' audit work on an overall basis, which will help us to determine whether further action is needed.

Investigations and Discipline

The Act authorizes the Board to conduct investigations when there are indications that a registered firm or an associated person may have violated the Act, the Board's rules, provisions of the securities laws and the Commission's rules related to financial reporting and auditing, or professional standards. The Act further authorizes the Board to use the results of those investigations as the bases for disciplinary proceedings. If a violation is established in those proceedings, the Act authorizes the Board to impose a range of sanctions on the firm or associated person who committed the violation, up to and including barring such firms from auditing public companies in the future and barring such persons from association with registered firms.

On September 29, 2003, the Board adopted an extensive set of rules relating to investigations and disciplinary hearings. The PCAOB is also in the process of staffing a Division of Enforcement and Investigations, which will have responsibility for carrying out the Board's investigative work and conducting its disciplinary proceedings.

Professional Standards

Title I of the Act also gives the Board the authority to establish auditing and related professional practice standards to be followed by registered public accounting firms, and persons associated with such firms, when they audit and issue opinions on the financial statements of public companies.[5/] In addition to auditing standards, those standards include related attestation work, standards for quality controls, ethics standards, and independence standards. Early on, the Board decided to establish professional standards by creating within the PCAOB a standards-setting office, made up of highly-skilled experts, rather than by delegating the standards-setting function to a professional organization of accountants, such as the American Institute of Certified Public Accountant's ("AICPA") Auditing Standards Board.

In addition to this general standards-setting authority that Title I of the Act confers on the Board, Section 201 of the Act expressly authorizes the Board to adopt

5/ See Sarbanes-Oxley Act, Section 103.

regulations specifying non-audit services – in addition to those specified in the Act – that may not be provided to audit clients.[6/] Section 201 also permits the Board, on a case-by-case basis, to grant exemptions from the Act's prohibitions on providing certain non-audit services to audit clients, but only to the extent necessary or appropriate in the public interest and consistent with the protection of investors.

The Act required the Board to adopt initial or transitional standards as part of the process leading up to the SEC's determination, pursuant to the Act, that the PCAOB was capable of carrying out its responsibilities under the Act.[7/] Accordingly, on April 16, 2003, the PCAOB announced the adoption of certain interim standards to be used by registered public accounting firms and associated persons in the preparation and issuance of public company audit reports, and the SEC approved those standards as part of its April 25, 2003, determination. The interim standards include the accounting profession's existing standards on auditing, attestation, quality control, ethics and independence. Further, where the SEC's rules on independence are more restrictive, the interim standards require that registered public accounting firms and their associated persons comply with the SEC's more restrictive requirements.

When the Board announced these interim standards, we also announced the process we intend to use to establish permanent auditing and other professional standards. The process will include soliciting comment from the public, in addition to the views of an advisory group formed pursuant to the Act. Under the Board's rules, that advisory group will be composed of individuals with a variety of expertise, including accountants, issuers, investors, regulators and others. We also plan to use other means to obtain expert advice, such as *ad hoc* task forces, roundtable discussions (which we have already held on certain issues), and other public hearings.

6/ Section 201 of the Act specifies the following non-audit services that may not be provided to an audit client: (1) bookkeeping or other services related to the accounting records or financial statements of the issuer; (2) financial information systems design and implementation; (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker, dealer, investment adviser, or investment banking services; and (8) legal services and expert services unrelated to the audit.

7/ Sarbanes-Oxley Act, Section 103(a)(3)(B).

Statutorily Established Standards-Setting Priorities

The Act itself sets forth the PCAOB's initial standards-setting agenda. First and foremost on this agenda is a standard for the auditor's attestation on management's assessment of internal control over financial reporting, as required by Section 404 of the Act. This provision required both the SEC and the PCAOB to promulgate rules. Section 404(a) required the SEC to promulgate rules requiring management to assess and report on the effectiveness of internal control. The SEC did so in June 2003, and its rules now require public companies to file such reports, with annual reports for fiscal years ending on or after June 15, 2004. Section 404(b) requires registered public accounting firms to attest to management's report on its assessment of internal control, consistent with attestation standards established by the PCAOB. In order to have a permanent standard in place in time for auditors to use in audits completed in June 2004, the PCAOB has already begun developing the standard, by holding a public roundtable discussion on internal control in July 2003 and issuing a proposed standard at a public meeting held last month.

Good internal control over financial reporting is essential for a public company to meet its obligations to protect its investors. Thus, the professional standards that the PCAOB is setting in this area are central to the mandate to protect investors and vital to furthering the public interest in the preparation of informative, fair, and independent audit reports.

While addressing Section 404 is the PCAOB's most pressing standards-setting assignment, it is far from the only one. The Act also mandates that we establish requirements for audit documentation, for second-partner reviews, and for quality control standards for audit firms, and we are diligently and rapidly working on those subjects. Therefore, last week the Board proposed a standard on audit documentation, together with a proposed amendment relating to documentation to the interim standard on using the work of another auditor.

The PCAOB has also announced plans to review systematically all of the interim professional standards, including the interim ethics and independence standards, and to determine whether they should be modified, repealed, or made permanent. We plan to consider and establish priorities for conducting this review once we have formed a standing advisory group, in order to obtain the benefit of the group's advice.

Current Rules on Auditors' Provision of Tax Services

As directed by the Act, the SEC adopted new independence rules in order to implement Title II of the Act in January of this year. These rules, which became effective in May 2003, address key aspects of auditor independence with special emphasis on the provision of non-audit services. The rules expressly prohibit eight categories of non-audit services, as required by Section 201 of the Act,.[8/] The SEC's rules also implement the Act's requirement, in Section 202, that all auditing services, and those non-audit services that do not satisfy a *de minimis* threshold, be preapproved by the company's audit committee.

Neither the Act nor the SEC's rules prohibit tax services that are preapproved by the company's audit committee (unless, of course, those services also fall into one of the categories of expressly prohibited services). Rather, the Act expressly recognized that accountants "may engage in any non-audit services, including tax services," that do not fall into one of the prohibited categories, provided that each service is approved in advance by the audit committee.[9/] The SEC's adopting release on its new rules noted that there had been considerable debate regarding whether an accountant's provision of tax services for an audit client could impair the auditor's independence. The SEC determined not to prohibit tax services, however, in part because audit firms – both large and small – have long played a part in return preparation and have advised their clients on the complexities of the tax code and how it affects the client's tax liabilities. Thus, the SEC "reiterated its long-standing position that an accounting firm can provide tax services to its audit clients without impairing the firm's independence * * * [and] may continue to provide tax services such as tax compliance, tax planning, and tax advice, to audit clients, subject to normal audit committee pre-approval requirements * * *."[10/]

While the SEC made clear that it did not consider conventional tax compliance and planning to be a threat to auditor independence, it distinguished such traditional services from the marketing of novel, tax-driven, financial products, which the SEC noted raise some serious issues. The SEC's release thus cautioned that audit committees should "scrutinize carefully" the retention of the auditor in a transaction initially recommended by the auditor. Moreover, the release referred to the recommendation of the Conference Board's Commission on Public Trust and Private Enterprise that, as a "best practice," auditors not provide advice on "novel and debatable" tax strategies and products.[11/] Further, since the SEC's release, the AICPA has also suggested that "advice on tax strategies having no business purpose other

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8/ See supra note 6. Section 201 also authorizes the Board to add to the Act's eight categories of prohibited non-audit services.

9/ See Sarbanes-Oxley Act, Section 201(a).

10/ Securities Act Release No. 8183 at § II.B.11 (January 28, 2003).

11/ Id. at note 112.

than tax avoidance is an appropriate dividing line for activities that should be prohibited to auditing firms registered under the Sarbanes-Oxley Act."[12/] Thus, there appears to be consensus that auditors ought not to be selling abusive tax shelters to public company audit clients.

The PCAOB's Tools to Evaluate and Address the Use of Abusive Tax Shelters to Manipulate Financial Statement Earnings

The PCAOB has a variety of tools to help address problems caused by the use of tax strategies designed to inflate financial statement earnings. First, as part of the Board's inspections of registered firms' audits of public companies' financial statements, we will identify, and examine how firms audit, questionable, tax-oriented transactions. We will also look for auditors' involvement in structuring transactions that they sell to their audit clients. The Joint Committee on Taxation found that Enron's auditor, Arthur Andersen, had promoted and provided an opinion on two of the 12 structured transactions that the Joint Committee examined and challenged. Given Arthur Andersen's involvement in the transactions, the Joint Committee also questioned the firm's ability to audit the transactions with impartiality.

Because we are only beginning to build our inspections program, we cannot today assess the current extent of promotion and use of corporate tax shelters and products to public company audit clients. We will, however, scrutinize the accounting and financial statement presentation of transactions that we discover through our inspections program, including specifically through our reviews of selected audit engagements. In addition, by looking at auditor compensation, promotion, and retention issues, our inspections will identify a firm's policies and practices that create incentives for firm audit personnel to promote such transactions to their clients.

Therefore, while existing laws and regulations may not ban auditors from promoting and giving tax opinions on complex, structured transactions to their audit clients, both auditors and public companies should expect heightened scrutiny of such transactions. The prospect of that scrutiny may help to influence the relevant parties – corporate managements that are attracted to the transactions, audit committees that must approve auditors' work on the transactions, and auditors that must attest to the propriety of the accounting treatment of the transactions – not to engage in questionable transactions.

Second, through our authority to discipline registered firms and associated persons, we may impose stiff penalties for failing to audit such transactions adequately

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[12/] "SEC Proposals on Auditor Independence, Non-Audit Services Affect Tax Practitioners," 83 The CPA Letter at 1, 4 (February/March 2003).

and impartially. These penalties include revoking a firm's registration and banning individual accountants from working on audits of public companies. We also have lesser sanctions in our arsenal, such as imposition of an independent monitor to review the firm or person's audit work and of tailored audit quality control measures.

Finally, the Board has the authority to commence a standards-setting project to address problems related to audit quality, including, for example, by adopting new auditing, ethics or independence standards. The Board's authority to prohibit a registered firm from providing certain non-audit services is restricted, however, to limiting the services that a registered firm may provide to an audit client, and the Board cannot directly prohibit a registered firm from selling tax shelters to non-audit clients. Therefore, even adding to the list of prohibited services may not ensure that an auditor who has sold such a strategy to a non-audit client is any more impartial when he or she audits a similar transaction purchased by an audit client from another promoter.

The Board also has the authority, however, to develop and impose additional auditing procedures. If registered public accounting firms and their associated persons conduct audits properly and impartially, then the financial statement effects of aggressive – even if arguably legitimate – tax-oriented transactions should be transparent, which would essentially defeat the purpose of transactions whose only purpose is to make the financial statements look better. The Internal Revenue Service's list of punishable abusive tax shelter devices may, by necessity, lag practice (such that by the time a transaction joins the list, the field has already moved onto another type of transaction), but outside accountants audit the financial statements of companies who choose to engage in these transactions on a current basis. Just as Arthur Andersen had year-round offices at Enron's headquarters, the auditors of the largest companies are often "in the field" auditing much of the year. In addition, companies that engage in complex transactions typically ask their auditors to bless such transactions before completion, in order to be sure of the transaction's financial accounting treatment.

Abusive, or even very aggressive, tax strategies undertaken primarily to have an impact on a public company's financial statements may be difficult for regulators and other investigators to find, but auditors are in a unique position to identify them. If the accounting profession chooses to rise to this challenge, then it will reap the benefits of renewed confidence in the integrity of its professionals. If the accounting profession shrinks from the challenge, then we will address it for them.

Conclusion

With the Congress's vision in establishing authority for independent standards-setting, registration, inspection, investigations and discipline, you have given the PCAOB the responsibility and the tools to build a new future for auditing public companies. I have faith that my fellow Board members and our staff will live up to your expectations.

I have not been shy about telling members of the accounting profession that we expect a lot from them, and that they will have to work harder than they could have imagined before enactment of the Sarbanes-Oxley Act. We will scrutinize accounting records, accountants' practices, and we will adjust the rules as necessary. In the wake of Enron and Arthur Andersen, the accounting profession was weighed and found wanting, but it was given a meaningful shot at redemption. In my mind, facilitating that redemption, and not just punishing miscreants, is a key objective – one that the Board must not lose sight of even when we are, as we will need to be, tough on the profession.

What's at stake for all of us is the trust of the American people in our markets and the companies that drive our economy. We have an opportunity to reclaim that trust. As we work toward that objective, my fellow Board members and I look forward to a long and constructive relationship with this Subcommittee.

Thank you.

For release on delivery
9:00 a.m. EST
November 20, 2003

Statement of

Richard Spillenkothen

Director

Division of Banking Supervision and Regulation

before the

Permanent Subcommittee on Investigations

Committee on Governmental Affairs

United States Senate

November 20, 2003

Introduction

Thank you for the opportunity to testify today on the Federal Reserve's continuing efforts to advance corporate governance, risk management and internal controls at banking organizations. I would like to note that my testimony today reflects the views of Federal Reserve supervisory staff, and not necessarily those of the Board of Governors.

Numerous governance, accounting, and legal compliance failings within publicly held companies, including those delineated in this Subcommittee's investigation of the Enron debacle, have been identified over the course of the past two years. The Subcommittee's current investigation into the role of professional firms in the development, marketing, and implementation of abusive tax structures highlights once again the critical need for effective corporate governance, risk management and internal controls to guide organizations' business practices and activities, thereby promoting compliance with all laws and regulations and safeguarding firms' franchises.

Federal Reserve staff has not reviewed the specific abusive tax structures that I understand to be the focus of today's hearing, and, as you know, bank supervisors are not tax experts, nor are they responsible for the oversight of tax compliance by banking organizations or their customers. However, I appreciate the opportunity to talk to you today about our supervisory requirements and expectations for banks involved in complex structured transactions, some of which are tax driven, and about some of the continuing enhancements to our supervisory processes to better address banking organizations' risk management and internal control infrastructures.

Perhaps to an even greater extent than those in other industries, financial services organizations face substantial challenges in ensuring that risk management practices and internal controls are designed to fully address the wide range of traditional and more recently-identified nontraditional risks emanating from the products and services offered by a rapidly evolving financial industry. While these financial products provide many legitimate benefits to bank customers and to the economy as a whole, they can also be misused, and in the process, create risks for banking organizations. With recent events such as corporate accounting scandals and large bankruptcies, banks have learned that involvement in some transactions can result in significant legal costs and reputational damage, in addition to major losses on extensions of credit. All of these risks need to be recognized by senior management of banking organizations and effectively managed and controlled. In this regard, it is the longstanding expectation of the Federal Reserve that banking organizations have comprehensive corporate governance programs to ensure that the entire range of an organization's activities and practices are in full compliance with all applicable laws and regulations.

Banking organizations appear to be actively responding to the lessons of recent events. Supervisory assessments of management processes around structured transactions indicate that various additional control mechanisms, such as internal business review committees and more intense due diligence by key risk control functions within banks, are being instituted to assure appropriate senior-level management attention to proposed transactions, particularly to the legal and reputational risks involved.

Role of Supervisors

At the outset, it is important to provide some background on the Federal Reserve's role as supervisor of banking organizations and our relationship with other supervisory authorities in carrying out our responsibilities. The primary focus of the Federal Reserve's supervision is ensuring an institution's safety and soundness, as well as compliance with banking and consumer laws and regulations, in a way that protects the deposit insurance fund and the consumer, while promoting stability of the financial system.

To accomplish these goals, the Federal Reserve uses a risk-based approach to supervision in which examiners focus primarily on areas posing the greatest risk to the banking organization, and on the overall adequacy of an organization's risk management and internal controls as measured against not only regulatory standards and expectations, but also against the evolving practices of well managed firms. To promote the proper functioning of these systems, examiners review selected transactions across business lines to identify whether written policies and procedures are being followed.

In the case of more complex transactions and business practices that can pose higher levels of operational, legal and reputational risk, examiners seek to determine whether the banking organization has a process in place for obtaining its own legal, tax and accounting approvals from key control functions within the organization and, when appropriate, from third party professionals. Examiners are not legal or tax experts, and as has become increasingly apparent, abusive tax structures are often designed to resemble legitimate tax transactions and, by their very nature, can be highly complex, varied, and extremely difficult to detect. With the exception of the banking and consumer protection laws for which the Federal Reserve has enforcement responsibility, examiners are not trained to identify violations of non-banking laws or compliance with the tax code. Nor are they qualified to perform an independent legal or tax analysis of transactions or business practices.

It is the responsibility of each banking organization to develop an appropriate control structure to ensure that all transactions entered into are legal and in the long-term best interest of the banking organization, and that they do not compromise the organization's financial condition. While banking organizations have the responsibility to perform their own due diligence of transactions and business activities, it is important to note that banking organizations, of necessity, rely to a considerable extent on other parts of the financial and legal infrastructure. Accounting and legal firms are key components of that infrastructure. To the extent these important components of the financial system are not performing their appropriate duties, the operations of banking organizations will inevitably be affected.

When weaknesses in corporate governance or risk-control infrastructures are identified by the Federal Reserve, other bank supervisors, functional regulators, or law enforcement authorities, the Federal Reserve stands ready to use its full complement of supervisory and enforcement tools. The supervisory objective is to ensure that banking organizations implement appropriate corrective actions to address any financial weaknesses, promote compliance with laws and sound banking practices, and protect the federal deposit insurance fund.

Supervisory Requirements and Expectations for Banking Organizations

Some basic principles and expectations for banking organizations guide our work in assessing business activities and risks. First, and most obviously, banking organizations must obey the law. In particular, they must have policies and procedures in place that are followed by their employees to ensure that they are in compliance with all laws and regulations. The laws most commonly applicable include banking, consumer, securities and tax laws, whether federal, state or foreign.

Second, banking organizations should perform thorough due diligence on the transactions or business activities that they are involved in and check with key legal, accounting and tax authorities within their own organizations, as well as independent third-party professional experts when appropriate. However, banking organizations ordinarily should not be held legally responsible for the judgments, actions or malfeasance of their customers, or third-party professional advisers. Nor, as a general rule, should they be required to second guess their customers' accountants, tax or legal experts, or to police their customers' and third-party professionals' business activities. Such an expectation would require, inappropriately, banking organizations to assume management responsibilities outside of their control, create potential legal liability that would compromise their ability to perform their role as financial intermediaries or threaten their safety and soundness, and place significant costs on banking organizations to audit the activities of their customers and professional advisers.

On the other hand, banking organizations should not, of course, participate in activities that they know or suspect to be illegal, and they must maintain controls and procedures to ensure that they are not knowingly facilitating illegal activities by their customers or business associates. Moreover, banking organizations should not engage in borderline transactions that are likely to result in significant reputational or operational risks to the organization.

Third, in those cases where a banking organization does become aware of fraudulent or criminal activities by their employees, customers, or business associates, they are required by federal law and the Federal Reserve's and other bank regulators' regulations to file Suspicious Activity Reports (SARs). If for any reason a banking organization does not fulfill this obligation, the SAR would be filed by the bank's supervisor. SARs are available electronically to all the federal, state, and local law enforcement agencies with interests in investigating and prosecuting crimes involving banking organizations. This includes the Criminal Investigations division of the Internal Revenue Service.

Fourth, the role of banking organizations is to assume and manage all the attendant risks related to their activities as financial intermediaries. Before banking organizations offer new products and engage in new activities, they should evaluate all the dimensions of risks, including credit, market, legal, operational and reputational risks. In light of recent events, banking organizations are re-evaluating the risks related to both their traditional and their new products, recognizing that as financial markets and practices change, legal and reputational risks may manifest themselves in new ways or in magnitudes not previously recognized. Moreover, as practices and products change, banking organizations must build appropriate mitigating controls to manage the evolving risk exposures and ensure that a process is in place to assess the effectiveness of those controls over time.

Finally, banking organizations must recognize that although they are not directly accountable for the actions of their customers or the third-party legal and accounting professionals with whom they have business dealings, to the extent their names or products are implicitly associated with misconduct by those parties, additional legal and reputational risks may arise. Such risks may ultimately lead to significant costs and if these risks are not recognized and addressed, they could affect an organization's financial health. Banking organizations should be particularly vigilant that any business relationships with third-party legal and accounting professionals do not cloud the independence of those professionals, rendering their opinions and recommendations unreliable. Moreover, a banking organization must also seek to ensure that any non-audit or other business relationships with the external audit firm engaged to opine on the organization's public financial statements do not contravene the auditor independence standards.

Supervisory Activities

For its part, the Federal Reserve focuses its supervisory activities on reviewing the methods used by banking organizations to identify, evaluate, and control all dimensions of risk associated with the organization's business activities, including operational, legal and reputational risks. Safety and soundness is dependent on strong overarching corporate governance programs that clearly establish an organization's risk appetite and tolerance levels. Such programs must be fully supported by written policies and procedures and well-developed control infrastructures that dynamically evolve to maintain effectiveness as new products and risk combinations or conflicts of interest emerge and new business initiatives are undertaken.

Active independent risk management, internal audit, and compliance functions are crucial elements of each banking organization's control process.

Recent events have influenced the thinking of supervisors as well as banking organizations on effectively targeting resources toward more vulnerable points within an organization's risk-management structure. In particular, events have reemphasized that in developing the scope of a supervisory review, factors used to prioritize reviews should go beyond standard balance sheet measures of risk to include an individual customer's or business line's overall contributions to revenues or profits. Highly profitable or rapidly growing business lines, relationships, or new products and services, in addition to large credit or market exposures, are also activities for which the adequacy of internal checks and balances needs to be appropriately tested and, where warranted, reinforced.

Clearly events of the past two years have focused banking organizations' and bank supervisors' attention on the legal and reputational risks associated with complex structured transactions. For its part, the Federal Reserve has initiated a number of actions to strengthen our supervisory processes and to promote the remediation of identified problems.

As a result of our examination of banking organizations' relationships with Enron, the Federal Reserve, along with other bank and securities regulators, conducted special reviews of banking and securities investment firms to develop a more complete understanding of how each institution oversees its structured financing activities and controls the associated risks. In conducting these reviews and in our supervisory follow-up, the Federal Reserve has been clear regarding our expectations that banking organizations should have effective internal controls that comprehensively assess the risks associated with legal compliance, including compliance with tax laws. Formal, Enron-related supervisory enforcement actions taken publicly by the Federal Reserve last summer, in coordination with other regulatory and law enforcement authorities, underscore supervisory expectations regarding the need for banking organizations to address weaknesses in internal controls and risk management relating to complex structured transactions. In addition to ongoing supervisory efforts, we are also working with other bank and securities regulators to develop supervisory guidance on appropriate controls and risk management systems relating to complex structured transactions, including those specifically designed for tax purposes.

The Federal Reserve has used the lessons learned over the last couple of years to make some refinements to our risk assessments and supervisory programs for large complex banking organizations. Specifically, we have increased our emphasis on, and review of, organizations' management of legal and reputational risks. Among other things, increased focus has been put on the adequacy of new product approval processes, the management of large or highly profitable customer relationships, and controls over the use of special purpose entities. Examiners are also increasing efforts to review basic internal control infrastructures at banking organizations, including examination of board and management oversight and reporting, corporate-wide compliance activities, and internal audit functions.

Conclusion

In closing, it is clear that effective corporate governance programs and internal control processes will continue to be crucial to the success of banking organizations and corporations more broadly. These programs and processes must be rigorous and they must adjust to ensure the detection and control of all risks stemming from new products and services and from their interactions with existing businesses. Equally important to the effective identification and management of new and emerging risks, however, is a robust internal control infrastructure that enables organizations to maintain compliance with all laws and regulations, including tax laws.

Supervisors will continue to focus on risk management and control processes in order to foster safety and soundness, financial stability, and compliance with applicable laws and regulations. Supervisory activities will continue to reinforce recent actions taken by banking organizations to address weaknesses and, whenever necessary, require further corrective action. Supervisory efforts are directed at encouraging banking organizations to enhance their new product review and approval procedures, and to strengthen their overall approach to identifying, managing and controlling legal, reputational and other operational risks.

Of course, no system of official oversight is failsafe, and supervisors cannot detect and prevent all control or management failures. However, strong and effective supervision, including the use of supervisory enforcement tools, bank managements' recognition of the need to maintain sound corporate governance, risk management and internal control infrastructures, and the workings of market discipline, should result in continued improvements in the management of legal and reputational risks.

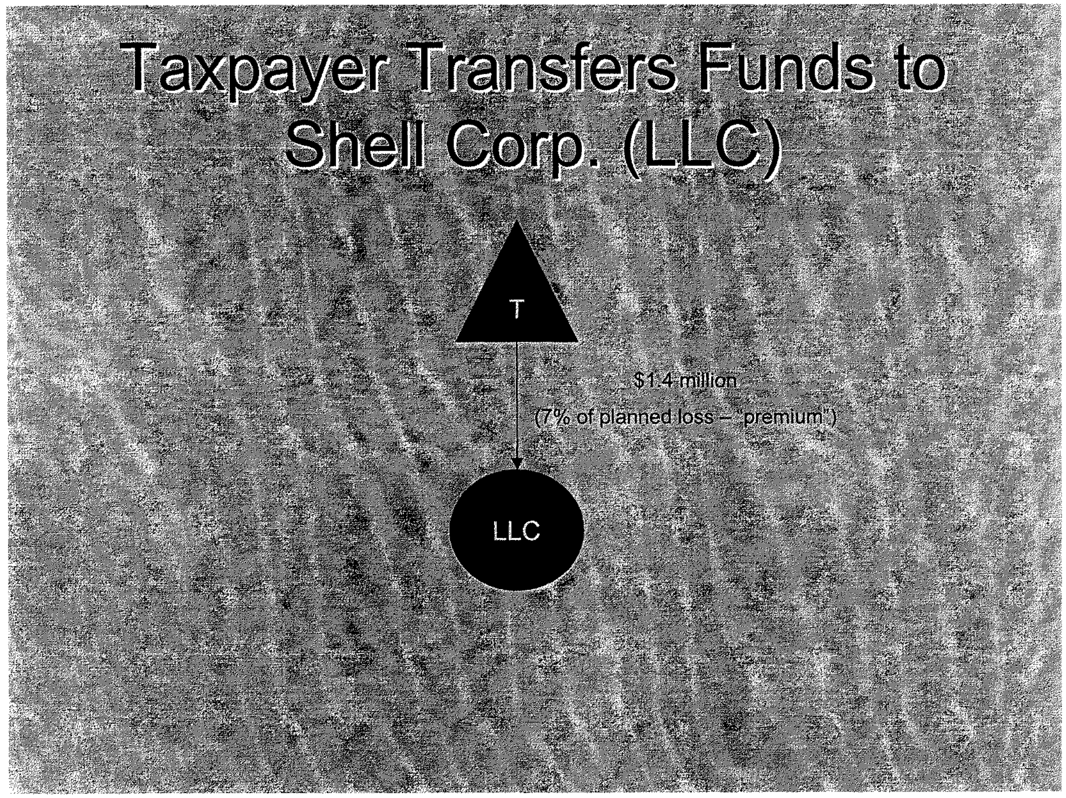
BLIPS

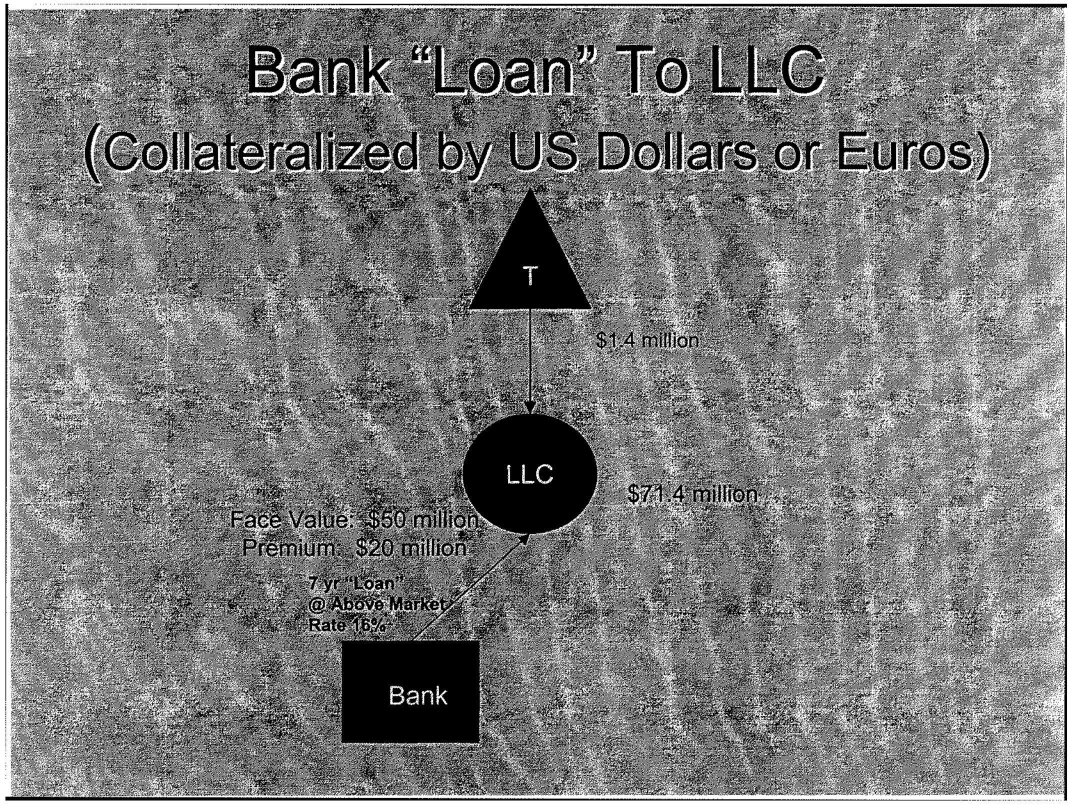
Bond Linked Issue Premium Structure

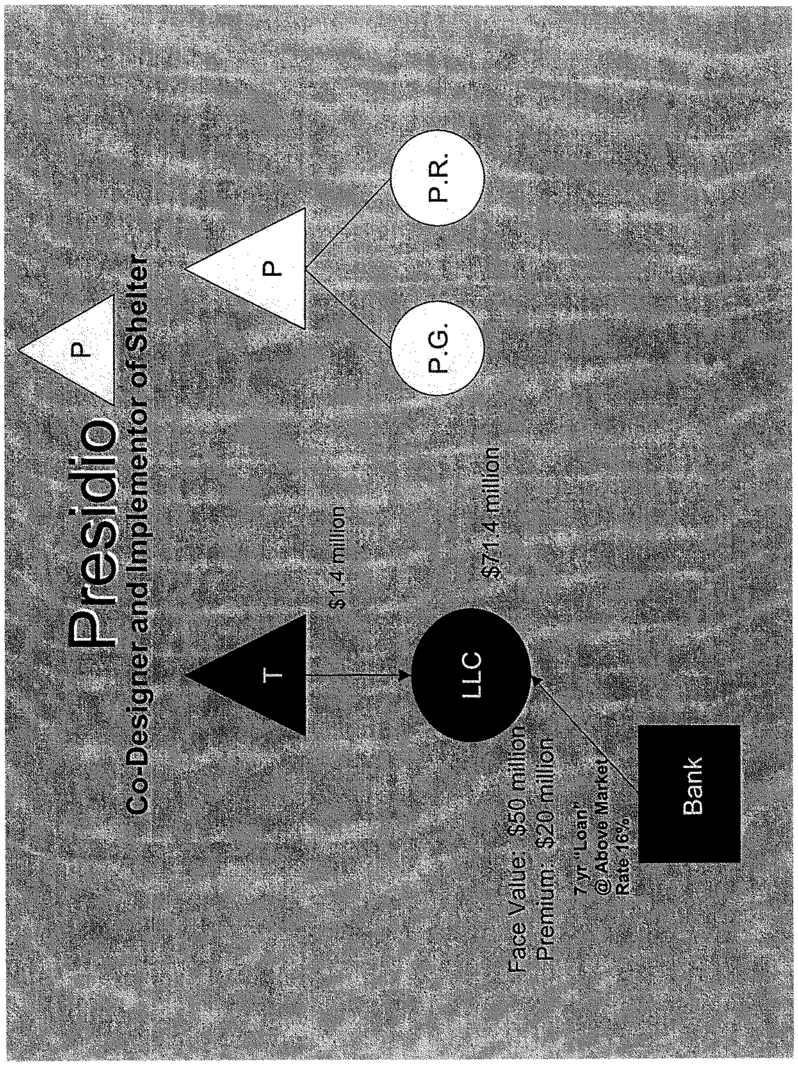
Prepared by U.S. Senate Permanent Subcommittee on Investigations, Subcommittee Staff of Senator Carl Levin, November 2003

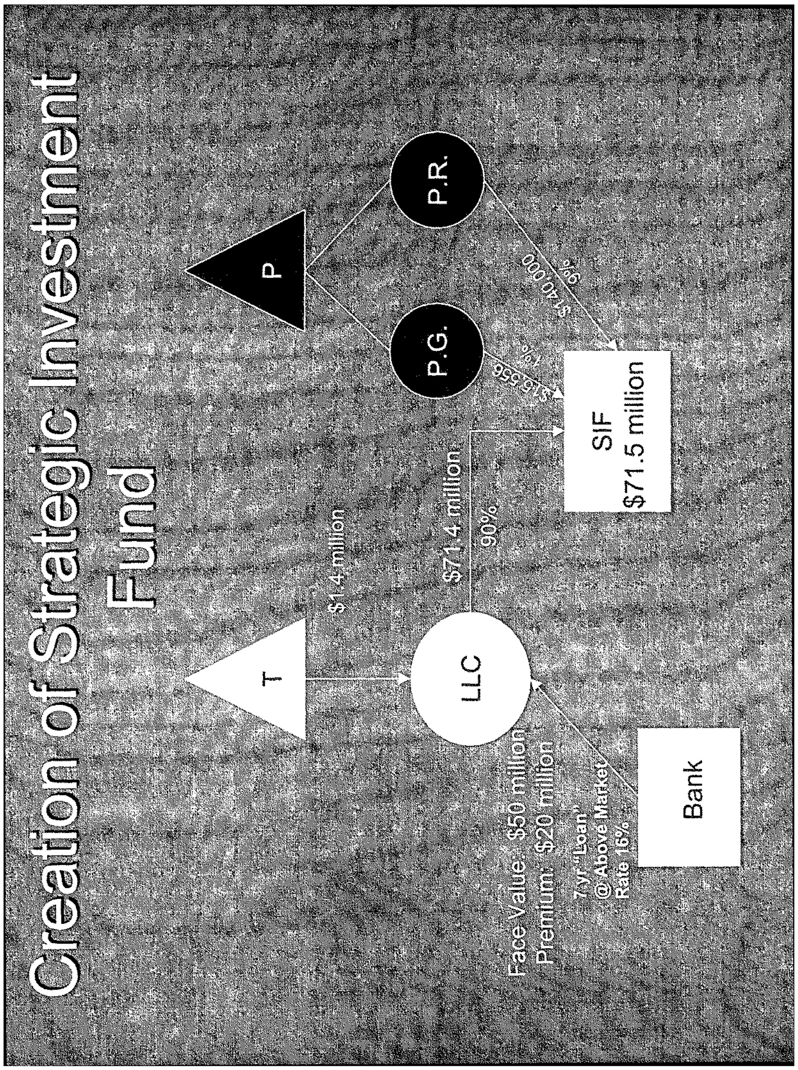
Embargoed
Until Monday, November 17, 2003

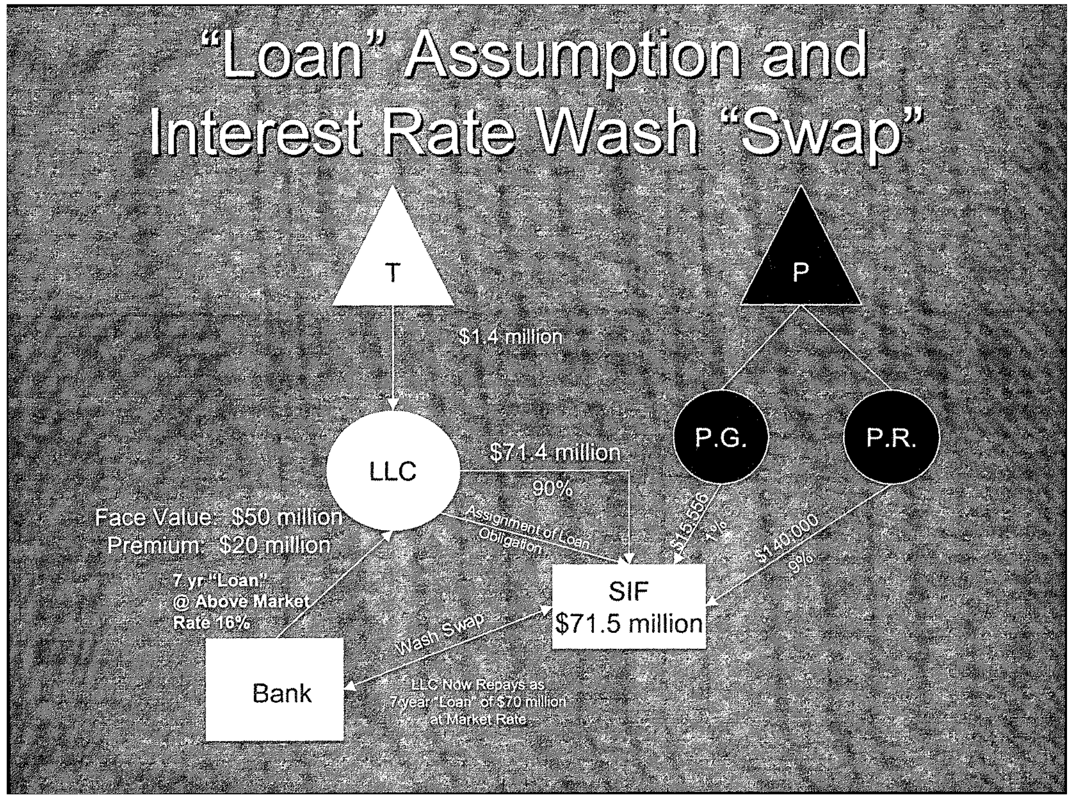
Permanent Subcommittee on Investigations
EXHIBIT #1a

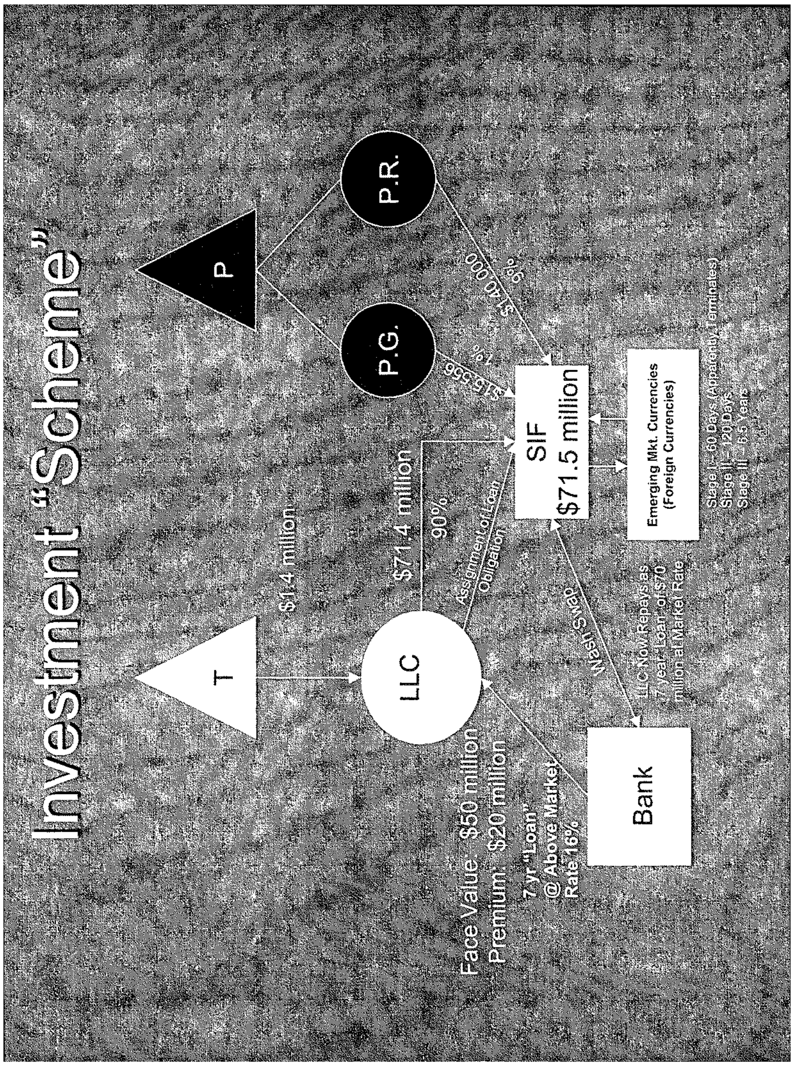

Taxpayer Transfers Funds to Shell Corp. (LLC)
T
$1.4 million
(7% of planned loss – "premium")
LLC

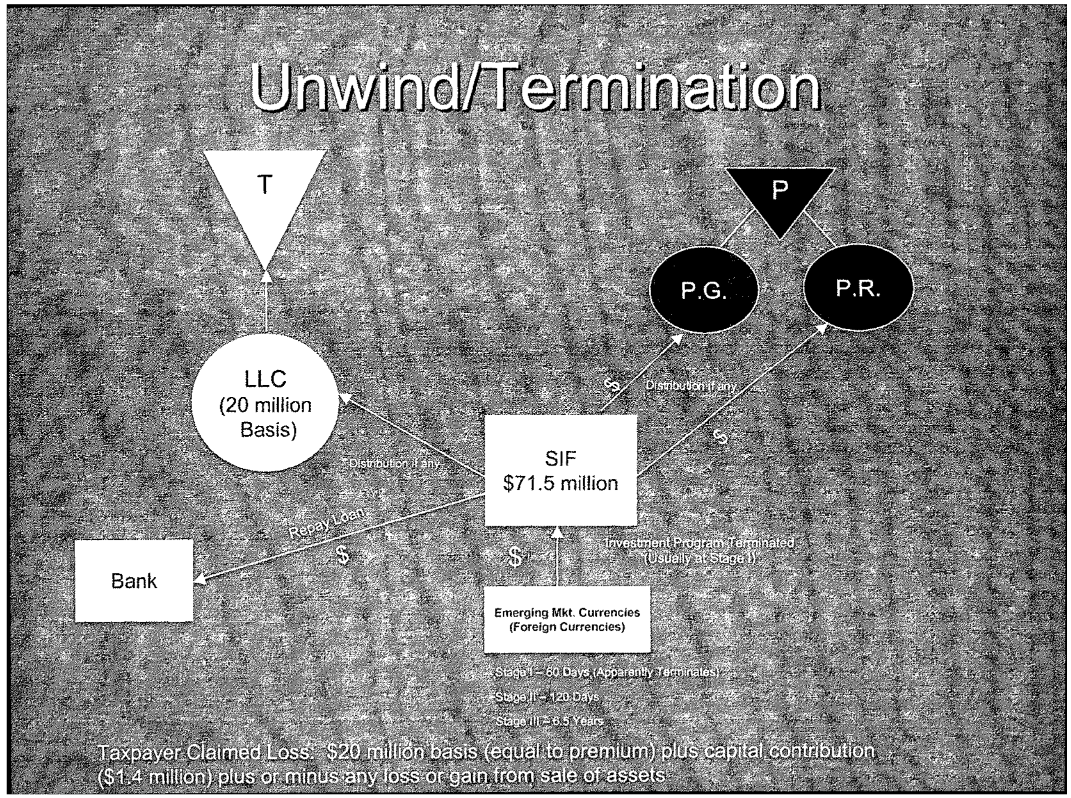

Bank "Loan" To LLC
(Collateralized by US Dollars or Euros)
T
$1.4 million
LLC
$71.4 million
Face Value: $50 million
Premium: $20 million
7 yr "Loan"
@ Above Market
Rate 16%
Bank

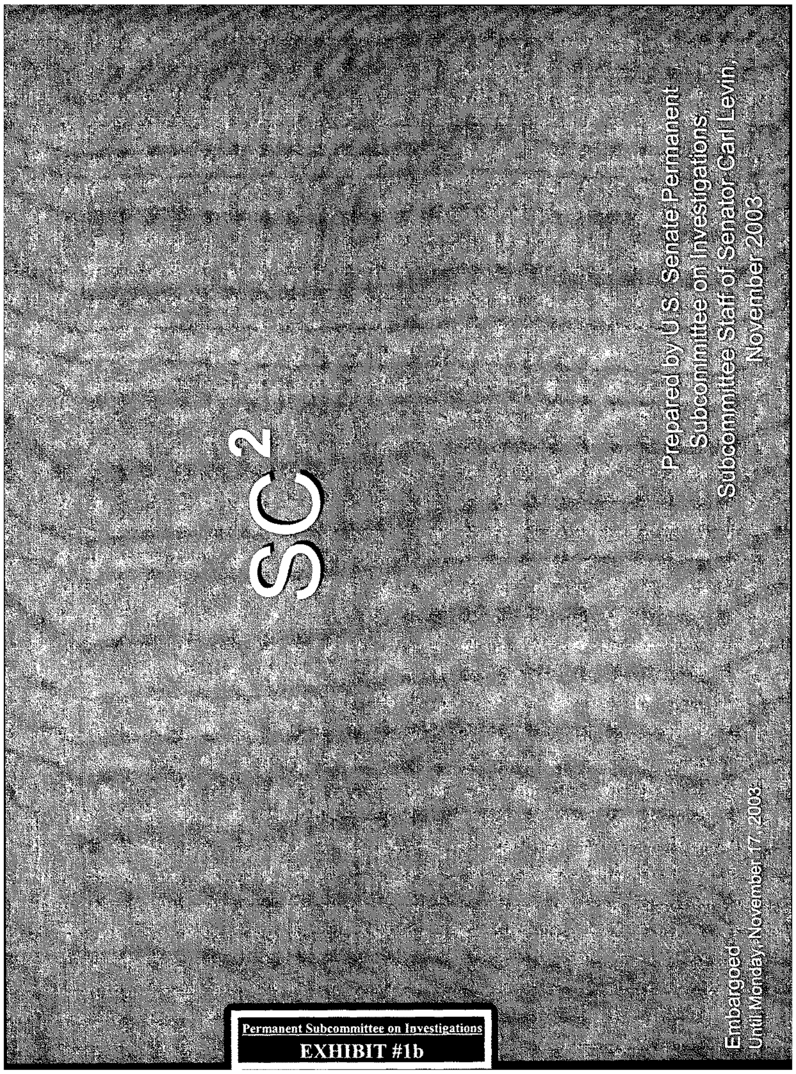

Presidio
P
Co-Designer and Implementor of Shelter
P
P.G.
P.R.
T
$1.4 million
LLC
$71.4 million
Face Value: $50 million
Premium: $20 million
7 yr. "Loan"
@ Above Market
Rate 16%
Bank

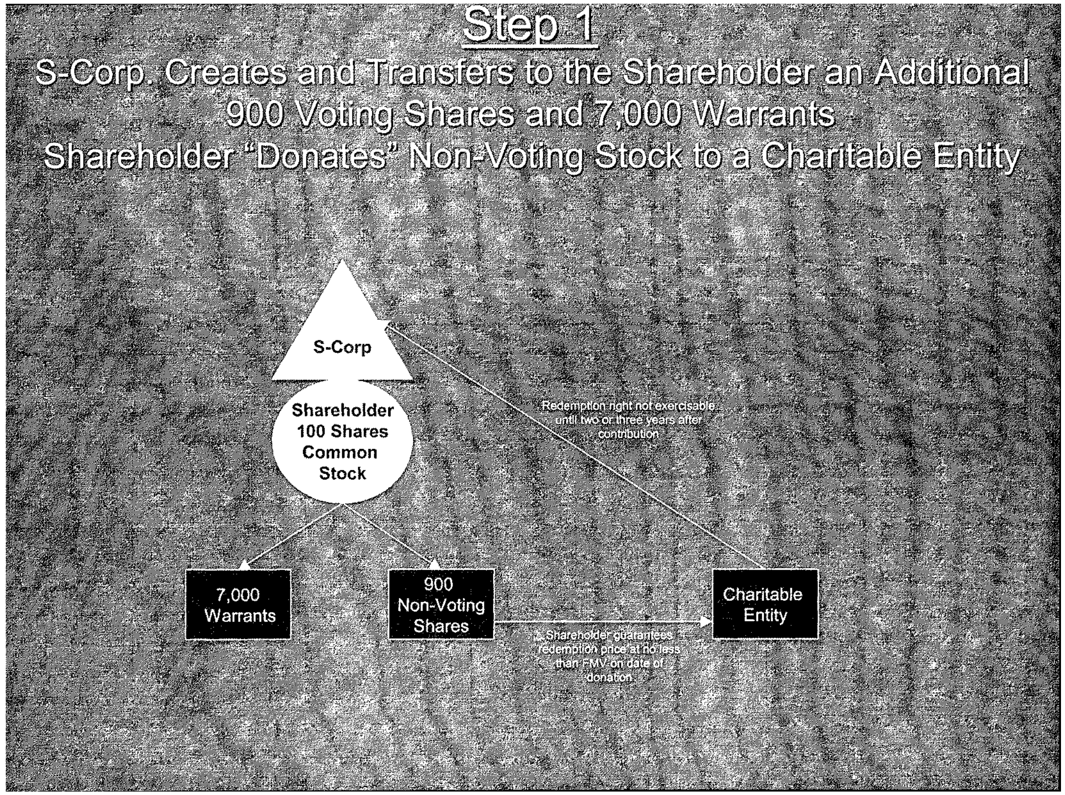

Creation of Strategic Investment Fund
T
$1.4 million
LLC
Face Value: $50 million
Premium: $20 million
7 yr "Loan"
@ Above Market
Rate 16%
Bank
$71.4 million
90%
SIF
$71.5 million
P
P.G.
P.R.
$15,556
1%
$40,000
9%

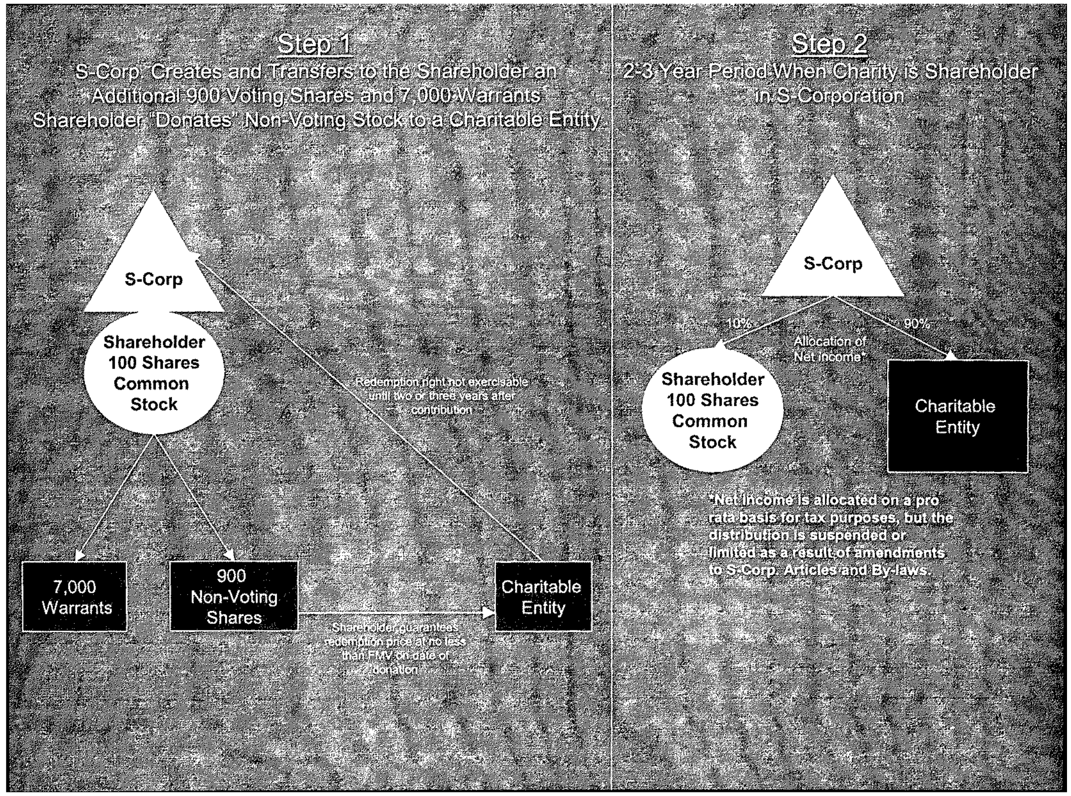

"Loan" Assumption and
Interest Rate Wash "Swap"
T
P
$1.4 million
LLC
P.G.
P.R.
$71.4 million
90%
Assignment of Loan Obligation
$15,556
1%
$140,000
9%
Face Value: $50 million
Premium: $20 million
7 yr "Loan" @ Above Market Rate 16%
SIF
$71.5 million
Wash Swap
Bank
LLC Now Repays as 7year "Loan" of $70 million at Market Rate

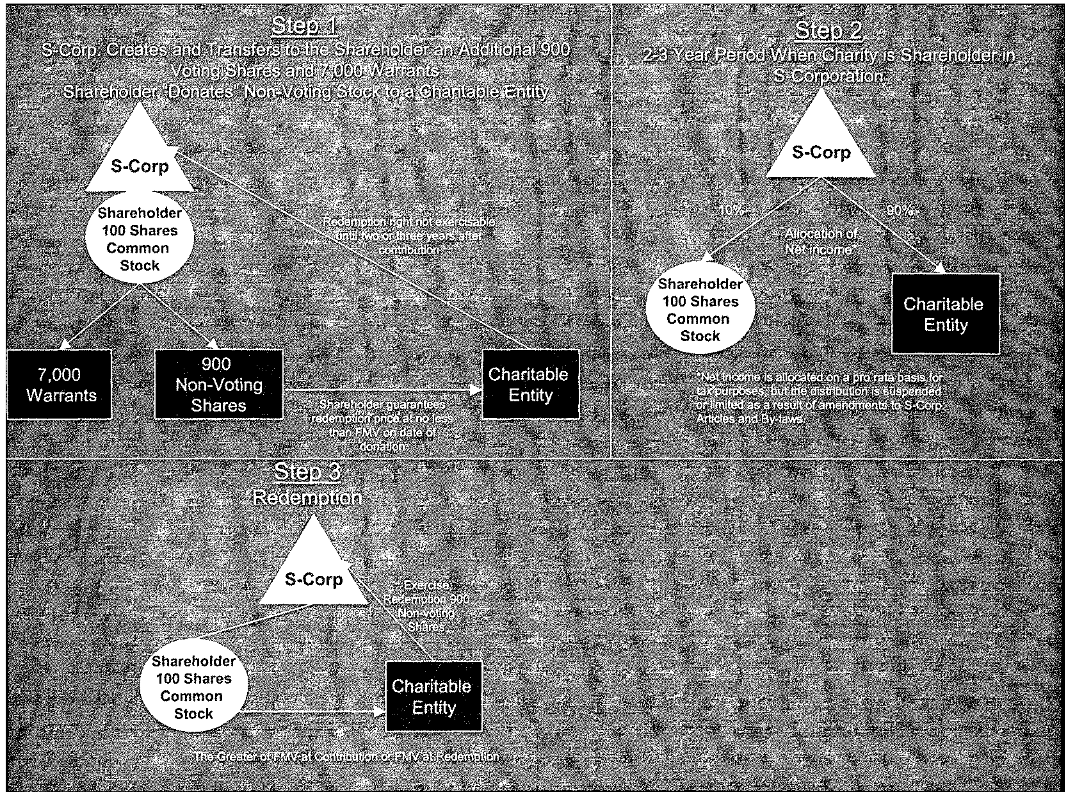

Investment "Scheme"
T
P
$1.4 million
LLC
P.G.
P.R.
$71.4 million
90%
Assignment of Loan Obligation
$15,556
1%
$140,000
9%
Face Value: $50 million
Premium: $20 million
7 yr "Loan" @ Above Market Rate 16%
SIF
$71.5 million
Wash Swap
Bank
LLC Now Repays as 7 year "Loan" of $70 million at Market Rate
Emerging Mkt. Currencies
(Foreign Currencies)
Stage I – 60 Days (Apparently Terminates)
Stage II – 120 Days
Stage III – 6.5 Years

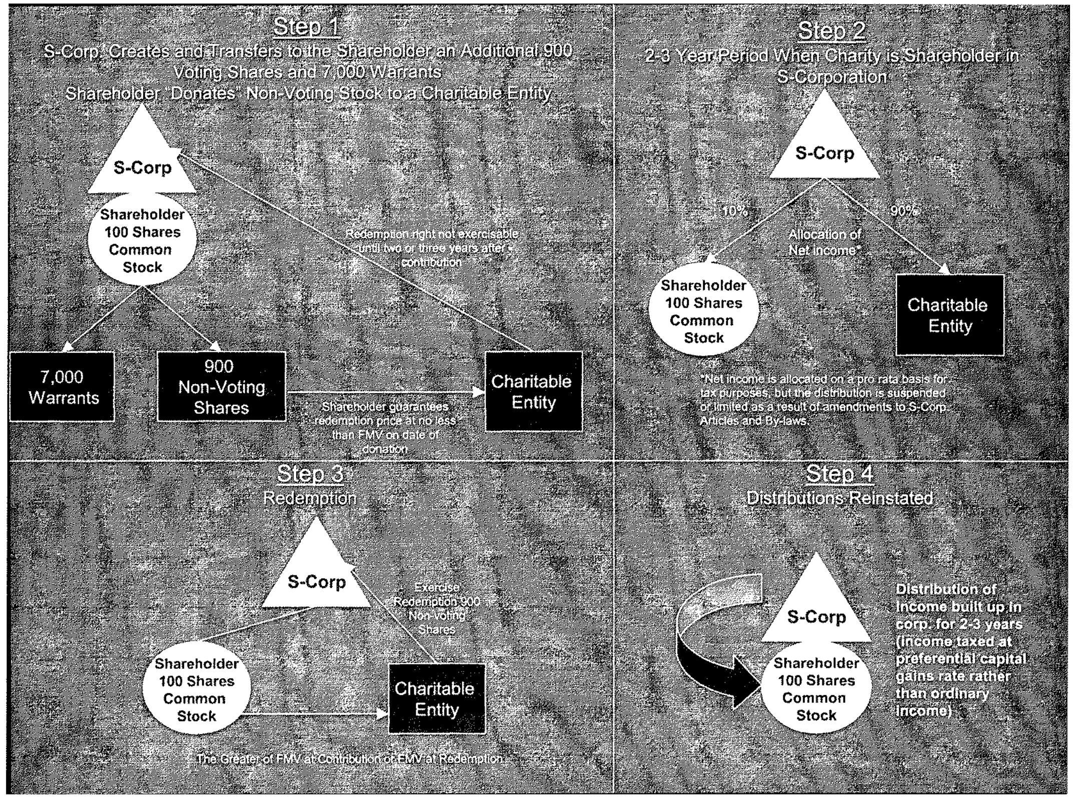

Unwind/Termination
T
P
P.G.
P.R.
LLC
(20 million
Basis)
Distribution if any
$
Distribution if any
$
SIF
$71.5 million
Repay Loan
$
Bank
$
Investment Program Terminated
(Usually at Stage I)
Emerging Mkt. Currencies
(Foreign Currencies)
Stage I – 60 Days (Apparently Terminates)
Stage II – 120 Days
Stage 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


SC²
Prepared by U.S. Senate Permanent
Subcommittee on Investigations,
Subcommittee Staff of Senator Carl Levin,
November 2003
Embargoed
Until Monday, November 17, 2003
Permanent Subcommittee on Investigations
EXHIBIT #1b


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
Redemption right not exercisable until two or three years after contribution
7,000 Warrants
900 Non-Voting Shares
Charitable Entity
Shareholder guarantees redemption price at no less than FMV on date of donation


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
Redemption right not exercisable until two or three years after contribution
7,000 Warrants
900 Non-Voting Shares
Charitable Entity
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
10%
Allocation of Net income*
90%
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 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
Redemption right not exercisable until two or three years after contribution
7,000 Warrants
900 Non-Voting Shares
Charitable Entity
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
10%
90%
Allocation of Net income*
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
Shareholder 100 Shares Common Stock
Redemption right not exercisable until two or three years after contribution
7,000 Warrants
900 Non-Voting Shares
Shareholder guarantees redemption price at no less than FMV on date of donation
Charitable Entity
Step 2
2-3 Year Period When Charity is Shareholder in S-Corporation
S-Corp
10%
90%
Allocation of Net Income*
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 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)

Permanent Subcommittee on Investigations
EXHIBIT #1c

Mass Marketing of Tax Shelters

"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."

-Internal KPMG email (2/22/01), Bates KPMG 0050822-23

"SELL, SELL, SELL!!"

-Internal KPMG email (2/18/00), Bates KPMG (049236

" 'We are dealing with ruthless execution- hand to hand combat-blocking and tackling.' Whatever the mixed metaphor, let's just do it."

-Internal KPMG email (2/3/00), Bates KPMG 0050888-90

Prepared by U.S. Senate Permanent Subcommittee on Investigations,
Subcommittee Staff of Carl Levin, November 2003

Knowledge of Counter Parties

"The principal design of this scheme is to generate significant capital losses for U.S. taxpayers which can then be used to offset capital gains which would otherwise be subject to tax."
–Undated internal UBS memo regarding FLIP, Bates UBS000006

"If a U.S. company/individual has a $100 million dollar capital gain… they are more willing to pay $2 to $4 million to generate a tax loss to offset the capital gain and corresponding taxes."
–Internal Quadra memo regarding FLIP (8/12/96), Bates UBS000002

"Target Customers: Capital Gain of $20 Million or more. Potential Benefits: Individual Capital Gain Elimination."
–Enhanced Investment Strategy Release from First Union (now Wachovia) regarding FLIP (2/2/99), Bates SEN-009397

"7% [is the] fee (equity) paid by investors for tax sheltering."
–Undated notes of HVB employee regarding BLIPS, Bates HVB000204

"It is imperative that the transaction be wound up...due to the fact that the [High Net Worth] individual will not receive his/her capital loss (or tax benefit) until the transaction is wound up."
–Undated internal Deutsche Bank memo regarding BLIPS, Bates DB BLIPS 01961

Prepared by the U.S. Senate Permanent Subcommittee on Investigations,
Subcommittee Staff of Carl Levin, November 2003

Permanent Subcommittee on Investigations
EXHIBIT #1d

kpmg Peat Marwick LLP

To Gregg Ritchie - KPMG, Los Angeles
Randy Bickham - KPMG, Palo Alto
John Harris - KPMG, Denver

Date February 23, 1998

From Robert D. Simon
KPMG Peat Marwick LLP

Steno lm
Ref p\users\moon\simon\memos\opis

I thought it might be useful to summarize some of my comments with respect to OPIS. You will undoubtedly recall that Larry DeLap charged us with the development of (i) a product that could be the subject of a more likely than not opinion and (ii) a product that was sufficiently different from the FLIP transaction that we could justify registering the current product (but not FLIP). I believe that in its current state, the product fails on both counts. I disagree on your conclusion. We believe we can write a more likely than not and expect DPP to agree. Furthermore, Presidio has offered to register the product in the event that we conclude this is necessary.

If OPIS is not exactly the FLIP product, it is, in the words of J. Harris, "son-of-FLIP." In my view, OPIS incorporates very few of the positive features of the LLC product previously submitted to Larry DeLap. The omission of these features is significant not only in a substantive sense, but because many were in direct response to concerns raised by L. DeLap and G. Bloom. Obviously, we are probably not going to have a product unless these concerns are addressed. All of the features in the LLC product were vetted and cleared with Bob Pfaff and J. Larson; indeed; B. Pfaff presented the revised product to a group of international tax leaders in December.

Proprietary Material
Confidentiality Requested

KPMG 0010729

Permanent Subcommittee on Investigations
EXHIBIT #2

I am not unmindful of the fact that many of the features of the LLC product had an economic cost to the investor, however, each also had an important tax benefit. Of course, given a choice, Presidio would rather not incorporate features that increase the cost of the deal to the investor, and it is to their credit if they can get us to agree. However, like it or not, we do have different considerations. We are the firm writing the opinions. Ultimately, if these deals fail in a technical sense, it is KPMG which will shoulder the blame. Agree.

The following are some of my general observations:

(1) The use of debt, possibly the most critical departure from FLIP, was an integral component of the LLC structure. To paraphrase Bob Pfaff's words, the use of debt strongly enhanced the deal from a tax perspective, because it guaranteed that our NRAs were truly at risk. In OPIS, the use of debt has apparently been jettisoned. If we can not structure a deal without at least some debt, it strikes me that all the investment banker's economic justification for the deal is smoke and mirrors. (By the way, we still haven't received Presidio's investment analysis showing the economic upside of the FLIP product). If 10-25% of U.S. investor's investment is in the form of debt, Presidio should be able to conclude that the debt will likely be repaid. We thoroughly explored the ability to use debt in this context. However, after extensive discussion, we could not get comfortable that we could get any assurance that it would be repaid in a sufficient amount and a significant number of times that we could credibly argue it was true debt. Without such expectation of repayment, the instrument would fail. The Swap idea was a creative alternative to the use of debt.

(2) In my discussions with John Harris, one thing that John and I feel strongly about is that the entire business purpose for the deal hinges upon Presidio's investment analysis. Indeed, the opinion states that investor has reviewed the investment analysis before undertaking the transactions. For this reason, we believe that the investment analysis must be reviewed by us (whatever the terms of the ultimate deal) before we can sign off on it. Obviously, the investment analysis should be attached to any opinion submitted to L. DeLap. I fully agree. We have communicated this both to Presidio and DPP. We have been told this analysis is in process and will be provided with input from DB and DMG.

(3) The only thing that really distinguishes OPIS (from FLIPS) from a tax perspective is the use of an instrument that is purported to be a swap. I agree that the use of a swap has some interesting possibilities. However, the instrument described in the opinion is not a swap under I.R.C. §446. Rick Solway does not share your opinion. Indeed, when coupled with the NRA's preferred return (which Randy mentioned) a fairly strong argument could be made that the U.S. investor has nothing more than a disguised partnership interest. While this is always an issue (similar to the RR 82-150 issue in version 1). Richard Smith did not consider this a large risk. By the way, Bob Pfaff has stated on several occasions that the NRAs would be truly at risk for their investments (and I understood that there would be no preferred return). Without true economic risk, the NRAs true characterization is probably that of a service provider or debt holder (or possibly a preferred shareholder). Obviously, any of these characterizations would lead to the conclusion that the U.S. investor is the equity holder (and the direct recipient of millions of dollars of income). Before OPIS can be implemented, Presidio has indicated that they must review the structure with their NRAs in

order to determine whether the strategy is acceptable to them. They believe that the NRAs will like the new structure and will agree to live with their added investment exposure.

(4) If, upon audit, the IRS were to challenge the transaction, the burden of proof will be on the investor. The investor will have to demonstrate, among other things, that the transaction was not consummated pursuant to a firm and fixed plan. Think about the prospect of having your client on the stand having to defend against such an argument. The client would have a difficult burden to overcome, especially if all the transactions were carried out between him and the bank (and Presidio). The failure to use an independent 3rd party in any of the transactions indicates that the deal is pre-wired. This issue was a significant concern of G. Bloom (in the FLIP transaction). Nevertheless, the OPIS structure drops the concept (contained in the LLC memo) of using unrelated third parties to carry out at least some of the transactions. OPIS does not summarily dismiss this idea. In fact, we know of certain clients who executed the long trades in the FLIP transaction through their own brokers. This is possible also in OPIS. The opinion letter does not presuppose who will execute each phase (except with reference to the redemption and out of the money option purchase, as we have previously discussed). However, a significant strength of OPIS is that it will be marketed as an integrated investment strategy as designed by Presidio, the investment advisor. Given the integrated structure of the overall investment plan and the commensurate benefits which could be realized by a US person (due to added leverage), it did seem actually counterproductive for Presidio to NOT have control over all aspects of execution. Such an investment plan would not be common without a coordinated execution strategy by the advisor.

kpmg Peat Marwick LLP

February 19, 1998
Page 5

(5) The concept of purchasing the long position several weeks before the establishment of the Cayman company (and the ensuing trades) was also eliminated without explanation. This was an important feature in that it put the holder at risk for at least several weeks. As a practical matter, there is already some lag time between the purchase of the long position and the other transactions. Indeed, Pfaff and Larson agreed to formalize a delay of several weeks. This is possible with the OPIS program (it is simply not addressed in the opinion). In fact, there is no objection from Presidio, KPMG, or the prospective clients. However, the client is actually at risk with respect to the long shares for the entire time that they own those shares. We cannot understand what possible benefit there may be from mismatching the timing of the purchase of the long shares from the indirect investment via the Cayman structure. Again, without a clear understanding of the benefit you hope to achieve, it seems counterproductive to structure this purchase in a way which would not be common in integrated market investment programs.

(6) There is no mention in the opinion of President Clinton's proposal prescribing regulatory authority on foreign built-in losses. The Administration is concerned that taxpayers are acquiring built-in losses incurred outside the U.S. taxing jurisdiction or are seeking to generate related income and loss in circumstances where the income is attributable to a foreign entity. Does this sound familiar? Any marketing of this transaction would have to directly address this proposal. Agreed. This is specifically one of the reasons why this product must get off the shelf and into clients hands. As you know, the proposal currently has an effective date which will correspond to the date of enactment.

(7) I have always wondered about the relevance of the discussion on the dividends - received deduction. Putting aside its theoretical relevance, it does not seem that we could include it without also citing similar risk of loss concepts contained in Notice 98-5. The Notice deals with transactions (including total return equity swap) in which foreign tax credits are effectively purchased by a U.S. taxpayer. If the risk of loss concepts of Notice 98-5 were applied to OPIS, I doubt that the investor's ownership interest would pass muster. I must defer on this issue to Randy/Pfaff. If this is a new issue, obviously we must ensure that it has been properly assessed. I do not recall your raising this issue in our conference call.

(8) Nothing was done to shore up the status of the Cayman Islands company. As you may recall, the lack of any substance (to the Cayman company) was the primary objection of an attorney from a prominent firm (who was reviewing the FLIP product for his client). The LLC memorandum to DeLap suggested some possibilities in this regard. As it stands now, the Cayman company remains extremely vulnerable to an argument that it is a sham. This is an area which we have talked about for some time, but have been unable to achieve a realistic solution. However, OPIS does make more sense in that its structure is primarily an offshore investment partnership between the US person and an NRA. As such, it would not be uncommon for such an entity to have no employees, directors, or assets (other than investment assets). There is still a desire to put some additional meat on the Cayman corp. however, that entity's purpose is to provide additional liability protection to the NRA, and to play the role of the manager of the LLC. In the US, such a structure for an investment portfolio (securities, real estate, etc) would not be uncommon without dedicated employees of the

entities. The Cayman entities will continue to have local directors with the appropriate legal responsibilities and control.

(8) I generally agree with the abandonment of a pre-establishing holding period, so long as the purpose for its abandonment is not to compress the transaction within an even shorter period. It should be recognized that transactions which span a short period of time are more vulnerable to a step-transaction analysis. Because there is one favorable case involving a 110 day holding period, the LLC product used such period as a benchmark. The abandonment of a daily holding period requirement was done NOT to allow for shorter transaction periods. It was done, again, to make the strategy conform to an investment strategy. No credible investment strategy would be designed around daily holding periods, they are dependent on price movements of the investment. This will be built into our investment modeling and will make sense given our expectation of profit.

(9) No further attempt has been made to quantify why I.R.C. §165 should not apply to deny the loss. Instead, the argument is again made that because the law is uncertain, we win. Recognize that the Tax Court position in Fox (which adopted a primary profit motive test) is based upon dicta of the U.S. Supreme Court in National Grocery. As we discussed in our conference call, there simply is nothing else to say on this topic. I believe John Harris agreed that, after his extensive review of this area, we could do no better. This however, is one element of why the strategy is only a "more-likely-than-not".

§7203 Criminal
Circular 230
Larry DeLap is adamant about not making this decision based solely on financial decisions.

KPMG Peat Marwick LLP

Financial Services

To Jeffrey N. Stein

Date May 26, 1998

From Gregg W. Ritchie
Los Angeles/Woodland Hills

Steno gwt

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cc Distribution List

OPIS Tax Shelter Registration

Attached is a memorandum from Jeff Zysik (Tax Innovation Center) concerning the potential financial consequences associated with failing to register a tax shelter under IRC section 6111. For purposes of this discussion, I will *assume* that we will conclude that the OPIS product meets the definition of a tax shelter under IRC section 6111(c).

Based on this assumption, the following are my conclusions and recommendation as to why KPMG should make the business/strategic decision not to register the OPIS product as a tax shelter. My conclusions and resulting recommendation are based upon the immediate negative impact on the Firm's strategic initiative to develop a sustainable tax products practice and the long-term implications of establishing a precedent in registering such a product.

First, the financial exposure to the Firm is minimal Based upon our analysis of the applicable penalty sections, we conclude that the penalties would be no greater than $14,000 per $100,000 in KPMG fees. Furthermore, as the size of the deal increases, our exposure to the penalties decreases as a percentage of our fees. For example, our average deal would result in KPMG fees of $360,000 with a maximum penalty exposure of only $31,000

This further assumes that KPMG would bear 100 percent of the penalty In fact, as explained in the attached memo, the penalty is *joint and several* with respect to anyone involved in the product who was required to register Given that, at a minimum, Presidio would also be required to register, our share of the penalties could be viewed as being only one-half of the amounts noted above. If other OPIS participants (e.g., Deutche Bank, Brown & Wood, etc.) were also found to be promoters subject to the registration requirements, KPMG's exposure would be further minimized. Finally, any ultimate exposure to the penalties are abatable if it can be shown that we had reasonable cause.

Second, the rules under section 6111(c) have not changed significantly since they were imposed in 1984. While there was an addition to section 6111 in the 1997 Tax Act, it only applies to products marketed to corporate investors under limited

KPMG 0034964

Proprietary Material
Confidentiality Requested

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KPMG Peat Marwick LLP

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circumstances. To my knowledge, the Firm has never registered a product under section 6111.

<u>**Third, the tax community at large continues to avoid registration of all products.**</u> Based on my knowledge, the representations made by Presidio and Quadra, and Larry DeLap's discussions with his counterparts at other Big 6 firms, *there are no tax products marketed to individuals by our competitors which are registered.* This includes income conversion strategies, loss generation techniques, and other related strategies.

Should KPMG decide to begin to register its tax products, I believe that it will position us with a severe competitive disadvantage in light of industry norms to such degree that we will not be able to compete in the tax advantaged products market

<u>**Fourth, there has been (and, apparently, continues to be) a lack of enthusiasm on the part of the Service to enforce section 6111.**</u> In speaking with KPMG individuals who were at the Service (e.g., Richard Smith), the Service has apparently *purposefully* ignored enforcement efforts related to section 6111. In informal discussions with individuals currently at the Service, WNT has confirmed that there are not many registration applications submitted and they do not have the resources to dedicate to this area

<u>**Finally, the guidance from Congress, the Treasury, and the Service is minimal, unclear, and extremely difficult to interpret when attempting to apply it to "tax planning" products.**</u> The Code section, regulations and related material were clearly written with a view toward the sale of "traditional" tax shelters That is, the rules anticipate that there will be the sale of a partnership interest by a promoter which purports to allow an investor to claim deductions significantly in excess of their investment. While the rules are written broadly enough to arguably include OPIS and other purely tax planning products, they are not easily applied to the marketing of an idea or strategy to a client which carries with it tax advantage

Although OPIS includes the purchase of securities by the investor, the tax results are driven simply by an interpretation of the application of Code section 302 and the regulations thereunder When coupled with the Service's apparent lack of enforcement effort, the lack of specific guidance is a further indication that the risk of noncompliance with the rules could be excused

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Based on the above arguments, it is my recommendation that KPMG does *not* register the OPIS product as a tax shelter. Any financial exposure that may be applicable can easily be dealt with by setting up a reserve against fees collected. Given the relatively nominal amount of such potential penalties, the Firm's financial results should not be affected by this decision.

In summary, I believe that the rewards of a successful marketing of the OPIS product (and the competitive disadvantages which may result from registration) far exceed the financial exposure to penalties that may arise. Once you have had an opportunity to review this information, I request that we have a conference with the persons on the distribution list (and any other relevant parties) to come to a conclusion with respect to my recommendation. As you know, we must immediately deal with this issue in order to proceed with the OPIS product.

Distribution List:

Mark Springer
Doug Ammerman
Walter Duer

KPMG Peat Marwick LLP

To Gregg Ritchie
Warner Center

Date May 26, 1998

From Jeffrey C. Zysik
Washington National Tax - Tax Innovation Center

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Registration

Issue: What is the financial consequence of failing to register a tax shelter, as required by section 6111 of the Internal Revenue Code (Code)?

Answer: Section 6111(a) requires a "tax shelter organizer" to register a tax shelter in the manner provided for by the Secretary not later than the first day on which the shelter is for sale. Failure to register a tax shelter as defined in sec. 6111(c) may result in a penalty equal to the greater of $500 or 1 percent of the "aggregate amount invested" in the tax shelter.[1] Sec 6707(a)(2). Pursuant to Temp. Regs. 301.6707-1T Q/A-1, "aggregate amount" is determined in the same manner as prescribed in temp. regs. 301.6111-1T Q/A-21. Q/A-21 defines "aggregate amount" as the amount "to be received from the sale of interests in the investment and includes all cash, the fair market value of all property contributed, and the principal amount of all indebtedness received in exchange for interest in the investment . . ."

There is no authority that treats the amount of the deduction allowable by reason of the investment as the "aggregate amount invested" for purposes of the sec 6707 penalty. Furthermore, because the amount of deductions potentially allowable by reason of an investment in a tax shelter is a key concept in determining if a tax shelter must be registered under sec. 6111(c) (it is used to calculate the tax shelter ratio, *see* sec. 6111(c)(2) and temp regs. 301.6111-1T Q/A-5&6), sec. 6707 could easily have referenced this amount as a factor in calculating the penalty. Since sec. 6707 does not reference the possible deductions allowable as a factor in determining the penalty, the amount of deductions generated appears to be irrelevant in calculating the penalty

Issue: Who bears the burden of the penalty?

Answer: The liability is joint and several among all persons who had a duty to register. Temp. Regs 301.6707-1T Q/A-9

Issue: Is there a reasonable cause exception to the penalty?

Answer: Yes., there is a reasonable cause exception to registration Sec 6707(a)(1), last sentence. Existence of reasonable cause is a factual question All representations known (or

[1] Contrast this penalty to that applicable to confidential corporate tax shelters Failure to register a confidential corporate tax shelter (defined at 6111(d)) may result in a penalty equal to the greater of $10,000 or 50 percent (75 percent if the failure is intentional) of the fees paid to all promoters Sec 6707(a)(3)

KPMG 0034967

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KPMG Peat Marwick LLP

Page ~~2~~3
Gregg Ritchie
Warner Center
May 28, 1998~~May 26, 1998~~

which should have been known) by a tax shelter organizer must be taken into account in determining if reasonable cause exists. A tax shelter organizer is deemed to know all representations known by sellers of the shelter. Temp. Regs. 301.6707-1T Q/A-4

Issue: Are there other penalties which could apply in this circumstance?

Answer: It is also possible that the sec. 6700 penalty for promotion of an "abuse tax shelter" would apply. This penalty is the lesser of $1,000 or 100 percent of the gross income derived (or to be derived) by the promoter for each activity related to the shelter. The statute does not define "activity" and no regulations have been issued under this section. Sec 6700(a).

Issue: Did the sec. 6111 registration requirements change as a result of 1997 legislation?

Answer: **Yes, but not with respect to the requirement to register a product which is marketed to individuals.** The definition of a sec. 6111 tax shelter was broadened **with respect to corporate taxpayers.** Pursuant to new sec. 6111(d), if an entity, plan, arrangement or transaction has a significant purpose of avoidance or evasion of federal income tax; is offered under terms of confidentiality; and the promoters may receive aggregate fees in excess of $100,000; the entity, plan, arrangement, or transaction must be registered This provision **does not** apply to a product which is marketed to individuals provided it is not also offered to corporate taxpayers. Further, even if offered to corporate taxpayers, 6111(d) registration is *not applicable* until regulations or other guidance is issued and, even then, would be applicable only if offered under conditions of confidentiality. No such guidance has yet been issued

KPMG 0034968

KPMG Peat Marwick LLP

To Gregg Ritchie
Warner Center

Date May 26, 1998

From Jeffrey C Zysik
Washington National Tax - Tax Innovation Center

Steno JCZ
Ref [illegible]

Registration

Issue: What is the financial consequence of failing to register a tax shelter, as required by section 6111 of the Internal Revenue Code (Code)?

Answer: Section 6111(a) requires a "tax shelter organizer" to register a tax shelter in the manner provided for by the Secretary not later than the first day on which the shelter is for sale Failure to register a tax shelter as defined in sec 6111(c) may result in a penalty equal to the greater of $500 or 1 percent of the "aggregate amount invested" in the tax shelter[1] Sec. 6707(a)(2). Pursuant to Temp Regs. 301.6707-1T Q/A-1, "aggregate amount" is determined in the same manner as prescribed in temp. regs. 301.6111-1T Q/A-21 Q/A-21 defines "aggregate amount" as the amount "to be received from the sale of interests in the investment and includes all cash, the fair market value of all property contributed, and the principal amount of all indebtedness received in exchange for interest in the investment "

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Issue: Who bears the burden of the penalty?

Answer: The liability is joint and several among all persons who had a duty to register Temp. Regs. 301.6707-1T Q/A-9.

Issue: Is there a reasonable cause exception to the penalty?

Answer: Yes,. there is a reasonable cause exception to registration. Sec 6707(a)(1), last sentence. Existence of reasonable cause is a factual question All representations known (or

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[1] Contrast this penalty to that applicable to confidential corporate tax shelters Failure to register a confidential corporate tax shelter (defined at 6111(d)) may result in a penalty equal to the greater of $10,000 or 50 percent (75 percent if the failure is intentional) of the fees paid to all promoters Sec 6707(a)(3)

which should have been known) by a tax shelter organizer must be taken into account in determining if reasonable cause exists. A tax shelter organizer is deemed to know all representations known by sellers of the shelter. Temp. Regs 301 6707-1T Q/A-4

Issue: Are there other penalties which could apply in this circumstance?

Answer: It is also possible that the sec 6700 penalty for promotion of an "abuse tax shelter" would apply. This penalty is the lesser of $1,000 or 100 percent of the gross income derived (or to be derived) by the promoter for each activity related to the shelter The statute does not define "activity" and no regulations have been issued under this section Sec 6700(a)

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Answer: **Yes, but not with respect to the requirement to register a product which is marketed to individuals.** The definition of a sec. 6111 tax shelter was broadened **with respect to corporate taxpayers** Pursuant to new sec. 6111(d), if an entity, plan, arrangement or transaction has a significant purpose of avoidance or evasion of federal income tax; is offered under terms of confidentiality; and the promoters may receive aggregate fees in excess of $100,000; the entity, plan, arrangement, or transaction must be registered. This provision **does not** apply to a product which is marketed to individuals provided it is not also offered to corporate taxpayers. Further, even if offered to corporate taxpayers, 6111(d) registration is *not applicable* until regulations or other guidance is issued and, even then, would be applicable only if offered under conditions of confidentiality No such guidance has yet been issued

March 3, 2000
C 50316-00002

PRIVILEGED AND CONFIDENTIAL

MEMORANDUM

TO: David M. Rivkin
KPMG LLP

FROM: Scott M. Knutson
Gibson, Dunn & Crutcher LLP

RE: BLIPS Tax Opinion

Set forth below are our comments and observations regarding the tax opinion (the "**KPMG Tax Opinion**") to be rendered by KPMG to our clients (referred to herein, in the singular, as "**Investor**") who participated in BLIPs transactions (the "**Transaction**"). We have been engaged by our clients to determine whether they could rely on the KPMG Tax Opinion for purposes of the penalty provisions under Section 6662 of the Internal Revenue Code of 1986, as amended (the "**Code**"). Our comments and observations set forth in sections B below are based upon the tax-advisor-reliance standards set forth in section A.

A. Standards for Reliance on Advice of Tax Advisor

The substantial understatement penalty under Code Section 6662 will not apply in the case of any item attributable to a tax shelter[1] if an individual taxpayer can establish that he or she reasonably believed that the tax treatment of such item by the taxpayer was more likely than not the proper tax treatment. A taxpayer can satisfy this standard if he or she reasonably relies on the opinion of a professional tax advisor. As to such reliance, the regulations provide as follows:

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[1] Our discussion herein assumes that the tax deduction anticipated from the proposed transaction is an item attributable to a tax shelter. A "tax shelter" is (i) a partnership or other entity, (ii) an investment plan or arrangement, or (iii) any other plan or arrangement, if a significant purpose of the partnership, entity, plan or arrangement is to avoid or evade federal income tax. I.R.C. § 6662(d)(2)(C)(iii). An item of income, gain, loss, deduction or credit is a "tax shelter item" if the item is directly or indirectly attributable to the principal purpose of a tax shelter to avoid or evade federal income tax. Treas. Reg. § 1.6662-4(g)(3).

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... a taxpayer is considered reasonably to believe that the tax treatment of an item is more likely than not the proper tax treatment if (without taking into account the possibility that a return will not be audited, that an issue will not be raised on audit, or that an issue will be settled) --

* * *

(B) The taxpayer reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities...and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service.[2]

The regulations further provide that in no event will a taxpayer be considered to have reasonably relied in good faith on the opinion of a professional tax advisor unless the following additional requirements are satisfied:

> **Requirement 1.** The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. This requirement will not be satisfied if the taxpayer fails to disclose a fact that he or she knows, or should know, to be relevant to the proper tax treatment of an item.[3]
>
> **Requirement 2.** The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption that the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner.[4]

The regulations go on to state that satisfaction of requirements 1 and 2 will not necessarily establish that the taxpayer reasonably relied on the opinion in good faith. As an example, the regulations provide that reliance may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of federal tax law.

B. Application of the Reliance Standards to the KPMG Tax Opinion

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2 Treas. Reg. § 1.6662-4(g)(4)(ii).

3 Treas. Reg. § 1.6664-4(c)(1)(i).

4 Treas. Reg. § 1.6664-4(c)(1)(ii).

Based on our review of the KPMG Tax Opinion, we have significant concerns that such opinion, as presently drafted, does not satisfy the tax opinion reliance standards set forth in the regulations discussed above. Our concerns are based on the following observations:

1. LLC-1 as the Initial Borrower of the Loan

The draft KPMG Tax Opinion considers and opines on a number of substantive legal issues. One very important issue is whether LLC-1 is the initial borrower of the non-recourse loan that is later assumed by LLC-2 (the **"Loan"**). The current draft of the KPMG Tax Opinion concludes, based on and subject to the facts, documentation, representations and assumptions set forth therein, that it is more likely than not that LLC-1 will be recognized as the initial borrower of the Loan for U.S. federal income tax purposes. We have serious doubts concerning the support for this conclusion in the current draft of the KPMG Tax Opinion and for the position that the current draft of the KPMG Tax Opinion satisfies the requirements of the regulations on the penalty question on this issue. These doubts arise because, in our view, the current draft of the KPMG Tax Opinion does not adequately address all of the pertinent facts necessary to render an opinion on this issue as required by the regulations. Our concerns are as follows:

- We have been unable to adequately determine a business purpose for the Loan as structured. From information derived from telephone conversations with Presidio and a written case study investment analysis drafted by Presidio, it appears that during the initial 60-day stage of the Transaction (i) the Loan proceeds may not be required for LLC-2 to enter into forward currency exchange transactions and (ii) most or all of the Loan proceeds held by LLC-2 may be invested in relatively risk-free money market securities. In other words, it seems quite possible that an investor could initially enter into forward currency exchange transactions identical to those currently contemplated for Stage I solely by contributing the cash used by the Investor to initially obtain the Loan. The draft KPMG Tax Opinion states that "Investor contributed the proceeds subject to the loan for the business purpose of leveraging its capital contribution. By leveraging its capital contribution outside the [Partnership] Investor was able to guarantee a minimum initial amount of financial leverage" (KPMG Tax Opinion page 15). This statement of fact is not specifically represented to by the Investor. Also, based on our review of the relevant documents and conversations with Presidio and KPMG, we have been unable to understand the relationship of the Loan to any currency transactions that might be undertaken by LLC-2. Thus, as to this point, we do not have a basis for concluding that the current draft of the KPMG Tax Opinion satisfies regulatory requirement 2 above since, in our view, it may be deemed to be based on a factual assumption that does not comport with the investments that actually may be made by LLC-2.

- The current draft of the KPMG Tax Opinion does not adequately address the purposes of structuring the Transaction as an initial loan to LLC-1 followed by an assumption by LLC-2, rather than having LLC-2 obtain the Loan directly from Bank. Regulatory requirement 1 discussed above requires that the Tax Opinions take into account the Investor's purposes (and the relative weight of such purposes) for structuring the Transaction "in a particular manner." During conversations with Presidio and KPMG, we asked why LLC-2 does not obtain the Loan directly from the Bank, rather than assume the Loan from LLC-1. We have been informed that this is a structural element of the Transaction required by

Presidio and that the Investor is not given any structural alternatives. We view this as an artificial structural requirement that, when weighed against the potential tax benefits of having LLC-1 treated as the initial borrower, raises a serious issue as to the compliance of the current draft of the KPMG Tax Opinion with regulatory requirement 1. The underlying business reasons, if any, for Presidio's insistence on this structural element should be discussed in the opinion.

The current draft of the KPMG Tax Opinion does not address the specific facts of the Loan transaction and its timing in relation to the Investor's agreement to invest in LLC-2 and have the Loan assumed by LLC-2. The conclusion in the draft KPMG Tax Opinion is substantially based on assumptions as to the form of the Loan transaction and the assumed fact that LLC-1 had unfettered control of the Loan proceeds (except for any restrictions imposed under the Loan agreement) for a 10-day period. The conclusion in the draft KPMG Tax Opinion that LLC-1 is the initial borrower of the Loan is, as clarified in a conversation with Randy Bickum of KPMG, based in part upon the factual finding that LLC-1 (or the Investor) does not have a binding obligation to invest in LLC-2 at the time the Loan is funded.

To reach such a conclusion, the current draft of the KPMG Tax Opinion does not, in our view, adequately delve into the specific detail and timing of the Loan transaction in relation to the Investor/LLC-1 agreeing to subscribe for the Class A interest in LLC-2, or the legal rights and obligations created under these agreements. The current draft of the KPMG Tax Opinion also fails to discuss and analyze the facts regarding the Bank's restrictions and limitations on the Investor's use of the Loan proceeds prior to their being contributed to LLC-2. Regulatory requirement 1 above requires that the KPMG Tax Opinion be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. To reach a reasoned conclusion on the issue of whether LLC-1 is the initial borrower and to satisfy regulatory requirement 1, the final KPMG Tax Opinion should address the specific order and time at which the documents are executed and the rights and obligations created by such documents. To satisfy some of our concerns, we can provide KPMG with a detailed factual time line as to the specific Transaction events for each of our clients.

Finally, to reach a more likely than not conclusion on this issue, the current draft of the KPMG Tax Opinion relies on a representation by the Bank that "[t]here is no plan or intention to require the Investor to convey the loan proceeds or assign the loan obligation to Partnership" (page 9 of the draft KPMG Tax Opinion; also, see our comments below regarding this representation). Given our understanding of the Transaction, we have serious doubts as to whether the Bank can make such representation and whether KPMG can rely on such representation to render the KPMG Tax Opinion. Regulatory requirement 2 above provides that the KPMG Tax Opinion must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person.

- The draft KPMG Tax Opinion does not consider the Investor's lack of involvement in negotiating the Loan. The Loan is arranged by Presidio and neither the Investor nor LLC-1 has any involvement in structuring or negotiating the terms of the Loan. Indeed, we were told by Presidio that changes in the Loan documents would <u>not</u> be made. The current draft of the KPMG Tax Opinion in a few instances favorably shades the facts regarding the Investor's involvement in such process. The current draft of the KPMG Tax Opinion makes the following statements: (i) "the Investment Advisor requires investors to *arrange* at least seven-year financing in order to cover the term of the program" (statement on page 4 of the KPMG Tax Opinion); (ii) "Investor *opted* to repay the loan at a [16] percent rate in return for a premium payment of [$60 million] percent per annum" (Presidio representation on page 5 of the KPMG Tax Opinion); and (iii) "Presidio *effectively allowed* an investor a choice of funding its participation in the Investment Fund on either a non-leveraged basis by contributing cash subject to an outstanding loan to the Investment Fund." (statement in footnote 6 of the KPMG Tax Opinion). For the final KPMG Tax Opinion to reach a reasoned conclusion as to whether LLC-1 is the true borrower, we believe that regulatory requirement 1 above requires KPMG to consider and discuss the Investor's/LLC-1's lack of involvement in structuring and negotiating the Loan and the fact that the terms of the Loan were fully negotiated by Presidio.

2. <u>Other Representations Contained in the KPMG Tax Opinion</u>

In addition to the representation regarding the reasonable potential for a pre-tax profit, the current drafts of the KPMG Tax Opinion relies on other representations that we are concerned about, which are as follows:

- The KPMG Tax Opinion requires the Investor to represent that the Investor's decision to exit the Transaction after the initial 60-day investment stage was dependent upon the investment performance of the program relative to alternative investments. In order to make such representation, the Investor's decision to exit must be based upon and supportable by one or more business or investment-related reasons, rather than solely motivated by the desire to generate a tax loss. We are not certain whether one or more of our client's can make this representation.

- The KPMG Tax Opinion requires the Investor to represent that he or she has provided KPMG with all facts and circumstances that the Investor knows, or has reason to know, are pertinent to the opinion letter and believes that all its assumptions and representations on which the KPMG Tax Opinion relies is reasonable. Our concern is that there are a number of facts not discussed in the KPMG Tax Opinion (*e.g.*, tax motives of the Investor) that KPMG is aware of but that are not identified in the opinion. This representation suggests that all the pertinent facts are in the opinion and any pertinent facts not set forth in the opinion were not disclosed. This representation should clearly cover all facts disclosed or understood by KPMG, whether or not expressly relied upon in the opinion.

- The KMPG Tax Opinion requires the Investor to represent that "...none of the parties involved held itself out to a third party as an agent of any of the others with respect to these transactions." Our clients are not in a position to know how the other parties in the Transaction conducted themselves. Since each party represents that it acted independently and at arm's length, perhaps this representation can be deleted.

- The KPMG Tax Opinion requires the Bank to represent that there was no plan or intention to require the Investor to convey the Loan proceeds or assign the Loan obligation to LLC-2. We are uncomfortable with this representation because the wording qualifies "plan" with "require," suggesting that there is no required plan, while at the same time leaving one with the impression that there is no general plan -- required or not. We do not believe that the Bank can represent that there is no general plan for LLC-1 to convey the Loan proceeds to LLC-2. Given the covenants contained in the Credit Agreement allows the Bank to call the Loan if the Investor ceases to own equity in LLC-2, its clear the Bank knew there was a structured plan to assign the Loan. Thus, the representation should either acknowledge the existence of a general plan, or eliminate any reference to plan and merely state that there is no binding obligation for LLC-1 to convey the Loan proceeds to LLC-2.

- Finally, many of the critical representations relied upon in the KPMG Tax Opinion are made by Presidio and the Bank. What recourse does an Investor have if such representations prove to be false? We have not seen the representation certificates that each party will sign. The certificates signed by Presidio and the Bank should clearly state the reason for the representations, that the Investor is relying on Presidio and the Bank to make accurate representations, and that the Investor could suffer adverse tax consequences if such representations prove to be false.

3. Investor's Purposes for Entering Into the Transaction

Regulatory requirement 1 above requires that the tax advisor take into account the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. The regulations apparently require KPMG to consider the Investor's tax purposes for entering into the Transaction and weigh those in relation to any stated business purposes. We have had discussions with certain individuals at KPMG's National Office regarding this regulatory requirement. KPMG is of the view that the final, written KPMG Tax Opinion does not need to separately address the Investor's tax motives for entering into the Transaction. The regulations are only 4 years old and there is no case law that has considered this regulatory requirement. We believe that the apparent intent of the regulation is to prevent a tax advisor from turning a blind eye towards tax motives that, in many cases, may be the only or predominate reason for the taxpayer entering into or structuring a particular transaction. Thus, we believe that the Tax Opinion (or other oral or written advice received from KPMG) should consider the tax motives of the Investor in order to minimize the risk that the substantial understatement penalty will be imposed.

To address our concerns regarding this issue, KPMG has sent us a letter stating that in preparing the current draft of the KPMG Tax Opinion they have taken into account the Investor's facts, documentation, and representations, including the Investor's purposes for entering into the transaction "as represented to us." To minimize the risk of penalties, we believe that it would be prudent for KPMG to deliver such a letter to the Investor after he or she has fully disclosed both the tax and business purposes for entering into the Transaction and that the letter provide some basis for the conclusion that the Investor is not motivated solely for tax reasons.

4. Notice 99-59

Notice 99-59 targets a specific transaction (the BOSS transaction), but also provides some fairly broad language. Specifically, the Notice states that "the arrangement described above (or *similar arrangements*) does not produce an allowable loss. Through a series of contrived steps, taxpayers claim tax losses for capital outlays that they have in fact recovered. Such artificial losses are not allowed for federal income tax purposes." The foregoing language appears to cover the BLIPS transaction. While we understand the Notice is not legal authority, it does set forth the government's position on these types of transactions and identifies certain bodies of law upon which it will rely to challenge such transactions. We believe that the KPMG Tax Opinion should address the Notice by comparing the BLIPS transaction with the BOSS transaction, state why the BLIPS transaction is distinguishable, and state the reasons the authorities discussed in the Notice do not apply and/or that the Notice considers authorities already addressed in the KPMG Tax Opinion and does not change any of the conclusions reached therein.

10229892_4.DOC

Unknown

From:	DeLap, Larry [ldelap@KPMG.COM]
Sent:	Wednesday, April 14, 1999 7:33 PM
To:	Zysik, Jeffrey C
Cc:	Eischeid, Jeffrey A; Bickham, Randall S; Lanning, John T; Lippman, Michael H; Ammerman, Douglas K; Watson, Mark T; Springer, Mark A; Wiesner, Philip J; Smith, Richard H; Elgin, Evelyn
Subject:	RE: BLIPS

BLP_ENG.DOC (40 KB)

<<BLIPS DPP RSB.DOC>> <<BLP_ENG.DOC>> <<BLIPS.PPT>>

Jeff -

Note that I have substituted engagement letter forwarded by Randy Bickham for the letter that was attached to your message.

1. The essential question is whether the investor is entitled to claim a deductible loss upon the disposition of the foreign currency received in the liquidating distribution. However, neither the "Summary of Opinion" nor the "Conclusion" opines on this issue. I'm not sure I understand the utility of an opinion that does not address the essential issue.

1a. The body of the opinion letter does include a section on "Foreign Currency Implications". The "Ordinary Version" thereof [it is not immediately clear why there is a "capital version" and an "ordinary version"] does state that it is MLTN that "taxable loss recognized upon subsequent disposition of nonfunctional currency assets will be characterized as ordinary loss". However, it does not explicitly state that it is MLTN the loss will be deductible. Moreover, the fourth paragraph of the letter states, "Our opinion is limited to the conclusions expressed below in the sections titled "Summary of Opinion" and "Conclusion". Accordingly, such statement in the "Ordinary Version" of "Foreign Currency Implications" is not part of our opinion in any event.

1b. PowerPoint slides state "Gain/Loss recognized by Investor is ordinary" and "Gain or loss on sale of assets by Investor may be either ordinary or capital", which would lead one to believe that we have concluded there is a deductible loss. But our opinion should be consistent with our slides (or vice versa).

2. The bank makes the loan to the investor for the purpose of investing in the partnership, with the knowledge that the proceeds and the liability will be immediately transferred to the partnership, and with the knowledge or expectation that the partnership will immediately thereafter into an interest rate swap with an affiliate of the bank. It seems to me that a threshold issue is "who is the borrower". I would think the IRS would advance the argument that the borrower is the partnership, and the investor's cash contribution to the partnership was $1.8 million, not $151.8 million. If that argument were successfully pursued, the rest of the analysis in the opinion letter would be academic. Why is the "who is the borrower" issue not addressed?

3. Please send me a copy of the "attached investment analysis" and "Analysis of Financing Alternatives" referenced in the opinion letter.

4. I believe we should not be making our own investment analysis and conclusions as part of the opinion letter. The "Overview of Investment Strategy" and "The Investment Structure" sections contain a number of declarative statements that one could interpret as representing our views. I think those sections should be rewritten to make it clear that those statements are those of Investment Advisor.

5. The last paragraph under "The Investment Structure" states, "The original intent of the parties was to participate in all three investment stages of the Investment Program". It seems to me that this a critical element of the entire analysis and should not be blithely

assumed as a "fact". If it is true, I think it should be one of the investor's representations. However, I would caution that if there were, say, 50 separate investors and all 50 bailed out at the completion of Stage I, such a representation would not seem credible.

6. There are several parenthetical references to Deutsche Bank. Will other banks be participating as lenders under similar terms? In either case, we need to get clearance from DPP-Assurance that Deutsche Bank's participation does not constitute an alliance or joint venture that would impact our independence with Deutsche Bank (which is a KPMG audit client). However, if only Deutsche Bank is participating as lender, I think we know what DPP-Assurance's reaction is likely to be.

7. With respect to the investor's second representation (no legally binding agreement), don't we need to look at the loan agreement to verify this is correct?

8. I don't think we should be giving the final opinion in the "Summary of Opinion" and "Conclusions" (namely, that "Investor has a business purpose and a profit motive"). That is a subjective determination that is in the mind of the investor. He can represent it to us, but I don't think we should be opining on it.

9. Who, in the Assurance department, wrote or reviewed the financial accounting discussions under "Debt Instruments - The General Rules"?

10. There are a lot of absolute statements sprinkled throughout the opinion letter (e.g., "the amount of the debt is [$100 million]". I think we need a general statement (see Eve Elgin for wording) that nothing in the letter is to be construed as implying a higher level of assurance than "more likely than not".

11. I question a statement in the last paragraph under "The Amount of the 'Liability' for Code Section 752 Purposes" that a position by the IRS that the amount of the liability is $150 million "would be inconsistent with the economics of the transaction". It is my understanding that any prepayment of the loan requires payment of a prepayment penalty, and that the amount of the prepayment penalty at any particular point in time would translate to an overall effective borrowing cost equal to 7% per annum on a $150 million base. Nowhere in the letter does there appear to be any mention of a prepayment penalty, other than peripherally in footnote 4. I would think that such a provision needs to be disclosed before one can talk about the "economics of the transaction".

12. In my view, footnote 34 is nonsensical. An obligation to repay proceeds of a borrowing, whether as principal or as "prepayment penalty", is not analogous to the receipt of payments under a long-term contract where there is no obligation to repay.

13. Footnote 4 and the penultimate paragraph under "Investor's Capital Contribution - The General Rules" refer to certain covenants in the loan agreement. Don't we need a representation from the investor that he was in compliance with those covenants prior to the transfer of the liability to the partnership?

14. I'm puzzled by the wording of the paragraph referenced in item 13:

With respect to a change in security, Treas. Reg. Section 1.1001-3(e)(4)(iv)(B) provides that a modification that releases, substitutes, adds or otherwise alters a substantial amount of collateral for , a guarantee on, or other form of credit enhancement for a nonrecourse debt instrument is a significant modification. The covenants contained in the loan agreement .... stipulate a collateral pool ... and provides [sic] the lender with the right to periodically review the collateral pool .... The loan covenants were not altered or amended upon the assumption of the loan by Partnership. Accordingly, there was no alteration made to the debt instrument that would constitute a ... change in security.... [Emphasis added.]

However, it seems to me that does not address the question of whether there was "a substitution of collateral" that would constitute a "significant modification". I see nothing in the letter that addresses the question of whether the investor provided collateral at all during the period he was the obligor, much less whether that collateral was "fungible or otherwise of a type where the particular units pledged are unimportant" with respect to the collateral provided by the partnership after the transfer.

15. In the third paragraph under "Activities Subject to the Code Section 465 Rules", the statement is made that "Investor invests directly in marketable securities and other financial instruments on its own account". But how do we know that? I see no such statement in the "facts" or the "representations".

16. Is the last sentence under "The Amount "At Risk" meant to indicate that any loss resulting from disposition of the foreign currency contracts is deductible only to the extent of the investor's income and gains from other investment activities?

17. According to the fourth paragraph under "Application of Anti-abuse Rules under Treas. Reg. Section 1.701-2", "the acquisition of the partnership interest is profit motivated; and, consequently as subsequently discussed, be [sic] respected as being bona fide and as having a business purpose". Even if it were established that the acquisition of the partnership interest (as opposed to participation in the investment program) were profit motivated, I don't understand how (and I see nothing in the subsequent discussion to establish how) one must necessarily conclude that therefore:

* The partnership is bona fide and each partnership transaction or series of related transactions is entered into for a substantial business purpose.
* The form of each partnership transaction must be respected under substance over form principles, and
* The tax consequences under the partnership provisions to each partner of partnership operations and of transactions between the partner and the partnership reflect the partner's economic agreement and clearly reflect the partner's income.

In the words of a Wendy's commercial from a long time ago, "Where's the beef". In my view, we need a lot more meat in this section to support the conclusion that the anti-abuse provisions of the partnership regulations are more likely than not to be inapplicable.

18. In the discussion of the Third Circuit decision in ACM under "Application of the Business Purpose/Economic Substance Doctrine", I'm a bit mystified as to the reason the emphasized sentences have been emphasized. It seems to me that the test of "objectively affecting the taxpayer's net economic position" is not met here.

19. I don't think it is correct to say "The most recent court case to address the business purpose doctrine is ACM Partnership". Leema Enterprises, T.C. Memo 1999-18 was decided subsequent to ACM. It's likely that other business purpose/economic substance cases has been decided after October 1998.

20. The statement that "ACM stands for the simple proposition that a transaction with no reasonable potential for pre-tax profit cannot be salvaged because the taxpayer also has unrelated profit-generating activity" is subject to voracious debate. I think it is preferable, if the statement is made at all, to preface it with "we believe that" or "it is our view that".

21. The first bullet in the paragraph that begins, "In summary, the case law applying the business purpose/economic substance doctrine consistently require the following requisites" is missing a few words ("the investor must be a reasonable potential").

22. The paragraph immediately following that referenced in item 21 makes declarative statements about the investment program. I think those statements should be avoided. (See item 4).

23. The paragraph just referenced includes the sentence, "Unlike the corporation disregarded in Gregory v. Helvering, Partnership was not a transitory entity that was formed, received contributed assets, and was liquidated within six days...." Do we really believe that a corporation in existence for six days is transitory, but a partnership in existence for sixty days is not? Also, it's not clear to me that the statement in the same paragraph that the "transactions entered into do not entail ... offsetting transactions with the same counterparty involving circular flows of funds with no net change in the taxpayer's economic position" is necessarily substantively accurate.

I'm starting to get concerned that my computer will soon lock up and I will lose everything written to this point. Accordingly, I am transmitting this message now, and.

will continue on another message.

Larry

> -----Original Message-----
> From: Zysik, Jeffrey C
> Sent: Wednesday, April 14, 1999 1:08 PM
> To: DeLap, Larry
> Cc: Eischeid, Jeffrey A; Bickham, Randall S; Lanning, John T; Lippman,
> Michael H; Ammerman, Douglas K; Watson, Mark T; Springer, Mark A;
> Wiesner, Philip J; Smith, Richard H; Elgin, Evelyn
> Subject: BLIPS
> Importance: High
>
> Larry,
>
> Please find attached the revised BLIPS opinion letter, the BLIPS power
> point presentation, and the BLIPS engagement letter for your review.
> Please note that the opinion letter has been revised to take into
> account the comments of each member of the BLIPS review team here at
> Washington National Tax.
>
> << File: BLIPS DPP RSB.DOC >> << File: BLP_ENG.DOC >> << File:
> BLIPS.PPT >>
>
> It is our understanding that you previously received a memo with
> respect to the sec. 6111(c) registration issue. If this is not the
> case, please let me know ASAP.
>
> We anxiously await your comments.
>
> Jeff

Message0002	
Subject:	FW: Product champions needed for S Corp strategy
From:	Manth, Larry E
Date:	2/18/2000 7:35:45 AM
To:	Schrier, John V
Message Body	

John, fyi.

-----Original Message-----
From: Peters, Marsha F
Sent: Friday, February 18, 2000 6:29 AM
To: Beakley, William D; Brasher, James J (US/Chicago AMP); Chopack, John J; Colley, Peter M; Crawford, Thomas W; Rosenthal, Richard P
Cc: Klein, Wendy (NSS-Tax); Manth, Larry E; Galbreath, Phillip L; DeLap, Larry; Springer, Mark A
Subject: Product champions needed for S Corp strategy

To Area Managing Partners-
The TIC needs your help in identifying an area product champion for a new product under development--S Corporation Charitable Contribution and Estate Planning Strategy. This strategy has been through an initial technical review (but not DPP review--Larry DeLap, this message is a heads up for you). The strategy involves an individual shareholder obtaining a deduction for contributing S Corporation stock to charity, followed by allocation of most of the S Corp earnings to the charitable organization. See attached documents more fully describing the strategy.

Larry Manth (Los Angeles) will be the National Product Champion. Larry recommends the following individuals as area champions for 3 of the areas:
Northeast: John Schrier, NY
West: Mark Hutchison, Warner Center
Southwest: Carol Warley, Houston

Please respond to me with the name of the person in your area who can serve in this role (or confirm one of the names above), after you have discussed it with him or her. Thanks.

Marsha Peters
KPMG Tax Innovation Center
(202) 533-3074
MailTo:mfpeters@kpmg.com

-----Original Message-----
From: Smith, Richard H (WNT)
Sent: Friday, February 18, 2000 8:16 AM
To: Peters, Marsha F
Cc: Manth, Larry E; Wiesner, Philip J; Kelliher, William B; Cvach, Gary Q
Subject: FW: S-CAEPS

Proprietary Material
Confidentiality Requested

Marsha,

Will you have the appropriate TIC person contact Larry Manth at (213) 630-8101 to assist him in getting S-CAEPS through the product development process. Larry is relatively new to the firm and will not know the procedures we have in place.

KPMG 0049235

Because this product has high potential for immediate revenue, please give it high priority.

Permanent Subcommittee on Investigations
EXHIBIT #6

Thanks,

Richard

-----Original Message-----
From: Rosenthal, Richard P
Sent: Friday, February 18, 2000 2:34 AM
To: Kelliher, William B; Manth, Larry E
Cc: Smith, Richard H (WNT); Stein, Jeff (US/Vice Chairman); Klein, Wendy (NSS-Tax); Peters, Marsha F; Springer, Mark A
Subject: RE: S-CAEPS

I want to personally thank everyone for their efforts during the approval process of this strategy. It was completed very quickly and everyone demonstrated true teamwork. Thank you! Now lets SELL, SELL, SELL!! I will contact Wendy Klein and the TIC to get area champions appointed, etc...

Rick
-----Original Message-----
From: Kelliher, William B
Sent: Thursday, February 17, 2000 8:46 AM
To: Manth, Larry E
Cc: Smith, Richard H (WNT); Rosenthal, Richard P
Subject: S-CAEPS

Larry:

Per the conference call this morning, here is the list of key factors that Richard Smith mentioned.
<< File: Factors Needed To Support.doc >>
Bill Kelliher
KPMG/ Washington National Tax
(202) 467-3885

Attachment
S_Corp_Strategy.doc

Attachment
tic-submissionform.doc

Outlook Header Information

Conversation Topic: S-CAEPS
Subject: FW: Product champions needed for S Corp strategy
From: Manth, Larry E
Sender Name: Manth, Larry E
To: Schrier, John V
Received By: Schrier, John V
Delivery Time: 2/18/2000 7:35:45 AM
Creation Time: 2/18/2000 7:35:17 AM
Modification Time: 2/18/2000 7:35:48 AM
Submit Time: 2/18/2000 7:35:37 AM
Importance: 2/1
Priority: 2/0
Sensitivity: 2/0

Flags: 2/17
Size: 2/226825

Sequential

From: Wiesner, Philip J [pwiesner@KPMG.com]
Sent: Thursday, February 24, 2000 10:33 AM
To: Stein, Jeff (Deputy Chairman & COO); DeLap, Larry
Cc: Brockway, David H; Elgin, Evelyn; Ammerman, Douglas K; Lanning, John T; Watson, Mark T
Subject: RE: BLIPS/OPIS

Jeff: As the person with ultimate responsibility last year for approving the more likely than not opinion for BLIPS I (It was pre Brockway), let me add a couple of footnotes to Larry's e-mail. I have taken another look at the engagement letter and the draft tax opinion. I continue to believe that we can issue a more likely than not (just a bit more than 50%) tax opinion based on the representations made by the client and Presidio. However, the sooner we get them out the door the better since the law - especially the primary profit motive test - is evolving daily and not in a taxpayer friendly manner. I absolutely agree that we need to move on the tax opinions asap and WNT is ready to do its part as reviewer as soon as we receive them from the field.

I also want to raise the issue of the 18 BLIPS transactions that were "grandfathered" in 1999 where the transaction will not be entered into until this year and the level of tax opinion we will be able to get to on these deals. If we still continue to pursue them, consider that the current engagement letter contemplates a tax opinion sometime in 2001. Given where the IRS (See BOSS) and the courts are going, we well may not be able to be more likely than not, even based on the representations presented. We need to consider at a minimum modifying the engagement letter so that we do not promise a more likely than not level of opinion or even consider not doing the tax opinions at all.

Lastly, an issue that I am somewhat reluctant to raise but I believe is very important going forward concerns the representations that we are relying on in order to render our tax opinion in BLIPS I. In each of the 66 or more deals that were done at last year, our clients represented that they "independently" reviewed the economics of the transaction and had a reasonable opportunity to earn a pretax profit. Also, that they had no "agreement" to complete the transaction in any predetermined manner, ie, close out the deal on 12/31 and trigger the embedded tax loss. As I understand the facts, all 66 closed out by year-end and triggered the tax loss. Thus, while I continue to believe that we can issue the tax opinions on the BLIPS I deals, the issue going forward is can we continue to rely on the representations in any subsequent deals if we go down that road? Combined with the risk of evolving adverse case law, we need to consider making a business call of whether now is the time to terminate our involvement in the BLIPS transaction. My recommendation is that we deliver the tax opinions in BLIPS I and close the book on BLIPS and spend our best efforts on alternative transactions.

Phil

> -----Original Message-----
> From: Stein, Jeff (US/Vice Chairman)
> Sent: Wednesday, February 23, 2000 10:23 PM
> To: DeLap, Larry
> Cc: Brockway, David H; Wiesner, Philip J; Elgin, Evelyn; Ammerman,
> Douglas K; Lanning, John T; Watson, Mark T
> Subject: RE: BLIPS/OPIS
>
> Thanks for the prompt response. I agree.
>
> -----Original Message-----
> From: DeLap, Larry

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>     Sent: Wednesday, February 23, 2000 10:22 PM
>     To:   Stein, Jeff (US/Vice Chairman)
>     Cc:   Brockway, David H; Wiesner, Philip J; Elgin, Evelyn;
> Ammerman, Douglas K; Lanning, John T; Watson, Mark T
>     Subject:    RE: BLIPS/OPIS
>
>     Assuming that, under the facts and the relevant authorities, we are
> in a position to issue an opinion now, I think we should do so. I would
> not defer issuance of an opinion just because the client extends the due
> date of his tax return.
>
>     I do think we need to stick with the position that the opinions are
> to be signed off by Washington National Tax prior to issuance, but would
> be okay if David were able to make other WNT partners available to assist
> in the preissuance review.
>
>     Larry
>
>           -----Original Message-----
>           From:       Stein, Jeff (US/Vice Chairman)
>           Sent: Wednesday, February 23, 2000 9:52 PM
>           To:   Jeff: Ammerman, Douglas K; Lanning, John T; Lippman,
> Michael H; Brockway, David H; Wells, Robert - MONTVALE; Beakley, William
> D; Brasher, James J (US/Chicago AMP); Chopack, John J; Colley, Peter M;
> Crawford, Thomas W; Rosenthal, Richard P; Rivotto, Brian; Branan, Carolyn
> B; Zaudtke, David P; Ito, Dennis A; Wright, Glen A; Duty, James V;
> Eischeid, Jeffrey A; Watson, Mark T; Tendler, Neil J; Wolfson, Neil E;
> Pedersen, Robert A; Perez, Robert L; Henderson, Tracie K; Goldberg,
> William J
>           Cc:   DeLap, Larry
>           Subject:    RE: BLIPS/OPIS
>
>           3 questions:
>
>           1 - Given that PwC has refunded all fees to their clients
> that signed on for BOSS, what do we gain by working with representatives
> from PwC?  If I were them I would do everything O could to drive a
> conclusion that we should do the same so they are not the only firm with
> egg on their face.
>
>           2 - I don't understnad the penalty protection issue of
> delaying the issuance of opinions coincident with the filing of tax
> returns.  Does that mean if they are on extension through October 15, we
> would delay the issuance until that point.  Larry/David - Can you help me
> out with that point.
>
>           3 - Do I assume from what is stated below that all opinion
> letters are completed and awaiting the review of Mark Watson?  Is there
> anybody else we could get involved so that all of this doesn't fall solely
> on Mark's shoulders?
>
>           Thanks - I appreciate the effort everyone is putting in on
> bringing all of this to a favorable conclusion.
>
>                 -----Original Message-----
>                 From:       Ammerman, Douglas K
>                 Sent: Wednesday, February 23, 2000 8:14 PM
>                 To:   Lanning, John T; Stein, Jeff (US/Vice
> Chairman); Lippman, Michael H; Brockway, David H; Wells, Robert -
> MONTVALE; Beakley, William D; Brasher, James J (US/Chicago AMP); Chopack,
> John J; Colley, Peter M; Crawford, Thomas W; Rosenthal, Richard P; Brian
> Rivotto; Carolyn Branan; David Zaudtke; Dennis Ito; Glen Wright; James
> Duty; Jeffrey Eischeid; Mark Watson; Neil Tendler; Neil Wolfson; Robert
> Pedersen; Robert Perez; Tracie Henderson; William Goldberg
>                 Subject:    BLIPS/OPIS
>
>                 This message is a summary of yesterday's meeting and
```

> the significant impact on the PFP practice.
>
> BLIPS 2000. Despite considerable technical review, this strategy has not yet been approved by WNT and the ultimate outcome remains uncertain. The focus of concern centers around issues that include profit motive and economic substance.
>
> Action Plan: We are diligently working with Presidio in developing a comprehensive economic analysis to enhance this transaction. We expect them to resubmit this analysis to WNT next week. Failure to arrive a MLTN opinion will present major obstacles to the PFP practice in sustaining our record levels of profitability.
>
> OPIS (Prior Transactions). WNT is concerned that recent regulatory changes adversely impact our ability to issue a MLTN opinion. Specifically, the new fast-pay stock regulations (1.7701(1)) . While everyone agrees that this provision was not intended to apply to OPIS, there is fear that literal reading of the new regulations could be problematic. I cannot underscore the significant adverse impact of such interpretation. First of all, we would be unable to issue MLTN opinions on approximately 25 OPIS transactions that were consummated in 1999. Furthermore, the collateral damage with clients would be devastating. In addition to approximately $10MM in fees that could be refundable, we would be at risk relative to significant client relationships, underpayment penalties, outside fees and expenses.
>
> Action Plan: We are working with Presidio, Quadra, Brown & Woods and representatives at PwC to determine how other professional service firms are responding to this issue. We hope to have such supporting positions this week.
>
> Issuance of Opinion Letters. There appears to be some confusion regarding the issuance of opinion letters on various PFP strategies. It has always been our intention to issue such opinion letters concurrent with the filing of the related tax returns. This protection was adopted to provide the most penalty protection for our clients. From a practical standpoint, most of these transactions "closed" late December and were arguably impacted by pending legislation. Secondly, due to recent concerns of WNT over OPIS, we are currently precluded from issuing such opinion letters until such concerns have been favorably resolved.
>
> Notwithstanding the above, all pending OPIS and BLIPS opinion letters have been substantially completed by managers in Atlanta and are awaiting final approval by Mark Watson (Jeff Stein, this unfortunately does not represent a substantial chargeable project for underutilized PFP professionals).
>
> In short, we are at a critical period in our practice. Significant individual clients are now in the process of finalizing their 1999 tax returns. The above issues need to be resolved as quickly as possible. Until we reach such resolution, I will continue to provide you with additional updates.
>
> Thanks,
>
> Doug Ammerman
> Personal Financial Planning
> KPMG LLP
> Orange County Office
> (714) 850-4455
> Fax (714) 850-4410
> dammerman@KPMG.com
>

Sequential

From:	Watson, Mark T [mwatson@KPMG.com]
Sent:	Thursday, February 24, 2000 9:58 AM
To:	Stein, Jeff (Deputy Chairman & COO); DeLap, Larry
Cc:	Brockway, David H; Wiesner, Philip J; Ammerman, Douglas K; Lanning, John T; Lippman, Michael H; Eischeid, Jeffrey A
Subject:	RE: BLIPS/OPIS

Gentlemen, let me try to clarify why the BLIPS opinion letters have not yet been issued and where we are in the process. The primary reason we issue a more-likely-than-not (MLTN) opinion letter for a BLIPS transaction (and other similar transactions) is to provide those clients who enter into such a transaction with some protection from a substantial understatement penalty. However, in order for a client to avoid a substantial understatement penalty under these circumstances, he or she generally must reasonably believe at the time the relevant tax return is filed that claiming the loss generated by the BLIPS transaction is MLTN the proper tax treatment. See Treas. Reg. Sec. 1.6662-4(g)(1)(i). In other words, in order for our opinion letter to be of any value to the client, it must be based on the law existing at the time the client files his or her tax return in which the loss is reported. Thus, we always intended to issue the BLIPS opinion letters in March or April of this year (for transactions that were closed in 1999), and we are on schedule to do just that.

As for where we are in the opinion writing process, I have reviewed the opinion letter template, and Jeff Eicheid's group in Atlanta is currently preparing the opinion letters based on this template. As they finish the opinion letters, they will send them back to me for a final review and then they will send them to the clients. We hope to have most (if not all) of the opinion letters issued by the end of March.

> -----Original Message-----
> From: Stein, Jeff (US/Vice Chairman)
> Sent: Wednesday, February 23, 2000 10:23 PM
> To: DeLap, Larry
> Cc: Brockway, David H; Wiesner, Philip J; Elgin, Evelyn; Ammerman,
> Douglas K; Lanning, John T; Watson, Mark T
> Subject: RE: BLIPS/OPIS
>
> Thanks for the prompt response. I agree.
>
> -----Original Message-----
> From: DeLap, Larry
> Sent: Wednesday, February 23, 2000 10:22 PM
> To: Stein, Jeff (US/Vice Chairman)
> Cc: Brockway, David H; Wiesner, Philip J; Elgin, Evelyn;
> Ammerman, Douglas K; Lanning, John T; Watson, Mark T
> Subject: RE: BLIPS/OPIS
>
> Assuming that, under the facts and the relevant authorities, we are
> in a position to issue an opinion now, I think we should do so. I would
> not defer issuance of an opinion just because the client extends the due
> date of his tax return.
>
> I do think we need to stick with the position that the opinions are
> to be signed off by Washington National Tax prior to issuance, but would
> be okay if David were able to make other WNT partners available to assist
> in the preissuance review.
>
> Larry
>
> -----Original Message-----
> From: Stein, Jeff (US/Vice Chairman)

> Sent: Wednesday, February 23, 2000 9:52 PM
> To: Ammerman, Douglas K; Lanning, John T; Lippman,
> Michael H; Brockway, David H; Wells, Robert - MONTVALE; Beakley, William
> D; Brasher, James J (US/Chicago AMP); Chopack, John J; Colley, Peter M;
> Crawford, Thomas W; Rosenthal, Richard P; Rivotto, Brian; Branan, Carolyn
> B; Zaudtke, David P; Ito, Dennis A; Wright, Glen A; Duty, James V;
> Eischeid, Jeffrey A; Watson, Mark T; Tendler, Neil J; Wolfson, Neil E;
> Pedersen, Robert A; Perez, Robert L; Henderson, Tracie K; Goldberg,
> William J
> Cc: DeLap, Larry
> Subject: RE: BLIPS/OPIS
>
> 3 questions:
>
> 1 - Given that PwC has refunded all fees to their clients
> that signed on for BOSS, what do we gain by working with representatives
> from PwC? If I were them I would do everything O could to drive a
> conclusion that we should do the same so they are not the only firm with
> egg on their face.
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> delaying the issuance of opinions coincident with the filing of tax
> returns. Does that mean if they are on extension through October 15, we
> would delay the issuance until that point. Larry/David - Can you help me
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> 3 - Do I assume from what is stated below that all opinion
> letters are completed and awaiting the review of Mark Watson? Is there
> anybody else we could get involved so that all of this doesn't fall solely
> on Mark's shoulders?
>
> Thanks - I appreciate the effort everyone is putting in on
> bringing all of this to a favorable conclusion.
>
> -----Original Message-----
> From: Ammerman, Douglas K
> Sent: Wednesday, February 23, 2000 8:14 PM
> To: Lanning, John T; Stein, Jeff (US/Vice
> Chairman); Lippman, Michael H; Brockway, David H; Wells, Robert -
> MONTVALE; Beakley, William D; Brasher, James J (US/Chicago AMP); Chopack,
> John J; Colley, Peter M; Crawford, Thomas W; Rosenthal, Richard P; Brian
> Rivotto; Carolyn Branan; David Zaudtke; Dennis Ito; Glen Wright; James
> Duty; Jeffrey Eischeid; Mark Watson; Neil Tendler; Neil Wolfson; Robert
> Pedersen; Robert Perez; Tracie Henderson; William Goldberg
> Subject: BLIPS/OPIS
>
> This message is a summary of yesterday's meeting and
> the significant impact on the PFP practice.
>
> BLIPS 2000. Despite considerable technical review,
> this strategy has not yet been approved by WNT and the ultimate outcome
> remains uncertain. The focus of concern centers around issues that
> include profit motive and economic substance.
>
> Action Plan: We are diligently working with
> Presidio in developing a comprehensive economic analysis to enhance this
> transaction. We expect them to resubmit this analysis to WNT next week.
> Failure to arrive a MLTN opinion will present major obstacles to the PFP
> practice in sustaining our record levels of profitability.
>
> OPIS (Prior Transactions). WNT is concerned that
> recent regulatory changes adversely impact our ability to issue a MLTN
> opinion. Specifically, the new fast-pay stock regulations (1.7701(1)).
> While everyone agrees that this provision was not intended to apply to
> OPIS, there is fear that literal reading of the new regulations could be
> problematic. I cannot underscore the significant adverse impact of such
> interpretation. First of all, we would be unable to issue MLTN opinions

> on approximately 25 OPIS transactions that were consummated in 1999.
> Furthermore, the collateral damage with clients would be devastating. In
> addition to approximately $10MM in fees that could be refundable, we would
> be at risk relative to significant client relationships, underpayment
> penalties, outside fees and expenses.
>
> Action Plan: We are working with Presidio, Quadra,
> Brown & Woods and representatives at PwC to determine how other
> professional service firms are responding to this issue. We hope to have
> such supporting positions this week.
>
> Issuance of Opinion Letters. There appears to be
> some confusion regarding the issuance of opinion letters on various PFP
> strategies. It has always been our intention to issue such opinion
> letters concurrent with the filing of the related tax returns. This
> protection was adopted to provide the most penalty protection for our
> clients. From a practical standpoint, most of these transactions "closed"
> late December and were arguably impacted by pending legislation.
> Secondly, due to recent concerns of WNT over OPIS, we are currently
> precluded from issuing such opinion letters until such concerns have been
> favorably resolved.
>
> Notwithstanding the above, all pending OPIS and
> BLIPS opinion letters have been substantially completed by managers in
> Atlanta and are awaiting final approval by Mark Watson (Jeff Stein, this
> unfortunately does not represent a substantial chargeable project for
> underutilized PFP professionals).
>
> In short, we are at a critical period in our
> practice. Significant individual clients are now in the process of
> finalizing their 1999 tax returns. The above issues need to be resolved
> as quickly as possible. Until we reach such resolution, I will continue
> to provide you with additional updates.
>
> Thanks,
>
> Doug Ammerman
> Personal Financial Planning
> KPMG LLP
> Orange County Office
> (714) 850-4455
> Fax (714) 850-4410
> dammerman@KPMG.com
>

Sequential

From: DeLap, Larry [ldelap@KPMG.COM]
Sent: Wednesday, February 23, 2000 10:22 PM
To: Stein, Jeff (US/Vice Chairman)
Cc: Brockway, David H; Wiesner, Philip J; Elgin, Evelyn; Ammerman, Douglas K; Lanning, John T; Watson, Mark T
Subject: RE: BLIPS/OPIS

Assuming that, under the facts and the relevant authorities, we are in a position to issue an opinion now, I think we should do so. I would not defer issuance of an opinion just because the client extends the due date of his tax return.

I do think we need to stick with the position that the opinions are to be signed off by Washington National Tax prior to issuance, but would be okay if David were able to make other WNT partners available to assist in the preissuance review.

Larry

> -----Original Message-----
> From: ' Stein, Jeff (US/Vice Chairman)
> Sent: Wednesday, February 23, 2000 9:52 PM
> To: Ammerman, Douglas K; Lanning, John T; Lippman, Michael H; Brockway,
> David H; Wells, Robert - MONTVALE; Beakley, William D; Brasher, James J
> (US/Chicago AMP); Chopack, John J; Colley, Peter M; Crawford, Thomas W;
> Rosenthal, Richard P; Rivotto, Brian; Branan, Carolyn B; Zaudtke, David P;
> Ito, Dennis A; Wright, Glen A; Duty, James V; Eischeid, Jeffrey A; Watson,
> Mark T; Tendler, Neil J; Wolfson, Neil E; Pedersen, Robert A; Perez,
> Robert L; Henderson, Tracie K; Goldberg, William J
> Cc: DeLap, Larry
> Subject: RE: BLIPS/OPIS
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> for BOSS, what do we gain by working with representatives from PwC? If I
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>
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> this to a favorable conclusion.
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>   -----Original Message-----
>   From: Ammerman, Douglas K
>   Sent: Wednesday, February 23, 2000 8:14 PM
>   To: Lanning, John T; Stein, Jeff (US/Vice Chairman); Lippman,
> Michael H; Brockway, David H; Wells, Robert - MONTVALE; Beakley, William
> D; Brasher, James J (US/Chicago AMP); Chopack, John J; Colley, Peter M;
> Crawford, Thomas W; Rosenthal, Richard P; Brian Rivotto; Carolyn Branan;
> David Zaudtke; Dennis Ito; Glen Wright; James Duty; Jeffrey Eischeid; Mark
> Watson; Neil Tendler; Neil Wolfson; Robert Pedersen; Robert Perez; Tracie

> Henderson; William Goldberg
> Subject: BLIPS/OPIS
>
> This message is a summary of yesterday's meeting and the significant impact on the PFP practice.
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> In short, we are at a critical period in our practice. Significant individual clients are now in the process of finalizing their 1999 tax returns. The above issues need to be resolved as quickly as possible. Until we reach such resolution, I will continue to provide you with additional updates.
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> Thanks,
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> Doug Ammerman
> Personal Financial Planning
> KPMG LLP
> Orange County Office
> (714) 850-4455
> Fax (714) 850-4410
> dammerman@KPMG.com
>

Message0021	
Subject:	**SC2 Solution--New Development**
From:	Leak, Councill
Date:	2/22/2001 4:52:26 PM
To:	Avent, Thomas W; Bornstein, Howard R; Branan, Carolyn B; Brawley, David F; Butler, Charles P; Cates, Bernard V; Chomiak, Leon W; Currie Jr, Arthur D; Dunn II, Wallace; Eischeid, Jeffrey A; Elker, Stephen P; Engel, James C; Fouts, Patricia A; Fowler, Jamie B; Gerrits, Dianne; Gillis, Timothy H; Giroux, Peter J; Glenn, Neil; Harmon, Atlee O; Heinz, James A; Henderson, Tracie K; Huber II, Frank E; Igarashi, Mie; Johnson, Peder R; Kay, Sheldon-ATLANTA M; Kelly, Timothy M; Leak, Councill; Leone, Steven P; Lopez, Rolando; Lusk, Gary; Mcgarr, Samuel H; Mcintosh, Betty W; Mcleighton, Steven W; Medford, Mark A; Messing, Steven G; Miller, David-TAMPA; Pace, Katherine A; Propst, Tamara C; Rich Jr, Donald E; Ritchie, Lewis R; Sanabria, Edgardo; Saron, Carole B; Satalino, Frank P; Sheridan-moore, Catherine M; Suarez, Oscar J; Tuley, Patrick A; Turner, G.Chris; Weil, Jerry M; Weld, Gary E; Williams, Patrick A; Zukowski, Philip M; Anderson, Mark E; Corrigan Jr, J Eustis; Smith, Gregory L; Ellis, William E; Horan, James L; Larsen, Cheryl A (US\Charlotte); Jones, James R; Lawter, Robert
CC:	Colley, Peter M; Smith, Jerry N; Gray, Mike - RALEIGH; Manth, Larry E; Atkın, Andrew S; Parker, Paul C
Message Body	

Quick Snapshot--We are now offering a modified SC2 solution. S Corp shareholders can use the structure to direct significant gifts to 501(c)(3) tax exempts of their choice. Net tax benefit is less than original SC2...shareholder "feel good" factor is higher. We need targets and ICV's.

More Detail Than You Really Want:

KPMG 0050822

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

Those of you who have gone on SC2 ICV's with Mike Gray or me know that one of the difficult issues to overcome in closing an SC2 transaction is finding a tax exempt entity that can absorb S Corporation income without incurring any unrelated business income tax (UBIT). Typically these are 501(c)(3) entities with UBIT net operating losses or other tax exempt entities that are not subject to UBIT at all. Currently we have five or six tax exempts that have reviewed the transaction, are comfortable they are not subject to UBIT and are eager to receive gifts of S Corp stock. These organizations are well established, solid organizations, but generally aren't organizations our clients and targets have made gifts to in the past. This point hit painfully home when, just before signing our engagement letter for an SC2 transaction with a $3 million fee, an Atlanta target got cold feet.

New SC2 Solution Development: **Proprietary Material Confidentiality Requested**

As a result of the Atlanta target experience, I asked WNT and the SC2 solution developers from the West to expedite the technical review of a modified SC2 structure. The modification was approved for Beta Test use by WNT last week. The modification will allow S Corp shareholders to make a gift of non-voting stock that will ultimately benefit a 501(c)(3) entity of the shareholder's choosing (i.e. church, synagogue, university, etc...). We have discussed the modified structure with the Atlanta target and have received very positive reaction. They have committed to a full shareholder meeting in mid-March and we are confident they are going to move forward. The trade-off for having the ability to direct the gift to any 501(c)(3) entity is that some level of UBIT will likely be incurred. The shareholder must therefore make additional cash contributions to make the tax exempt whole. We

Permanent Subcommittee on Investigations
EXHIBIT #8

have created an economic model for the modified structure. As a general rule, the modified SC2 benefit will be between 55% and 65% of the benefit expected in the original SC2 structure.

Why Should You Care?:

In the last 12 months the original SC2 structure has produced $1.25 million in signed engagements for the SE. Three or four large SC2 transactions failed to move to implementation due in large part, I think, to the shareholders being nervous about gifting stock to a tax exempt they aren't familiar with. Some of you probably knew of S Corps in your area that you were reluctant to contact due to this fact. The 501(c)(3) modification opens up the door to get back in front of these targets with a solid solution that produces a compelling tax benefit, while at the same time fulfilling a shareholder's personal charitable objectives. Because the benefit is a bit smaller, we need to target S Corps with at least $5 million of annual taxable income for the modified solution. Pricing is set at 75% of the original SC2 price, with a minimum fee of $500,000. The original solution still works (we just finished our second SE implementation on 2/1/01). The modified solution just gives us something that may appeal to some of the more conservative SE targets we are pursuing.

Look at the last partner scorecard. Unlike golf, a low number is not a good thing... A lot of us need to put more revenue on the board before June 30. SC2 can do it for you. Think about targets in your area and call me.

Councill

J. Councill Leak
Partner, Federal Tax Services/Stratecon Practice
kpmg LLP, Charlotte, NC
Direct: 704.371.8135
Fax: 704.335.5377
Cell: 704.906.4520
e-mail: cleak@KPMG.com

Outlook Header Information

Conversation Topic: SC2 Solution--New Development
Subject: SC2 Solution--New Development
From: Leak, Councill
Sender Name: Leak, Councill
To: Avent, Thomas W; Bornstein, Howard R; Branan, Carolyn B; Brawley, David F; Butler, Charles P; Cates, Bernard V; Chomiak, Leon W; Currie Jr, Arthur D; Dunn II, Wallace; Eischeid, Jeffrey A; Elker, Stephen P; Engel, James C; Fouts, Patricia A; Fowler, Jamie B; Gerrits, Dianne; Gillis, Timothy H; Giroux, Peter J; Glenn, Neil; Harmon, Atlee O; Heinz, James A; Henderson, Tracie K; Huber II, Frank E; Igarashi, Mie; Johnson, Peder R; Kay, Sheldon-ATLANTA M; Kelly, Timothy M; Leak, Councill; Leone, Steven P; Lopez, Rolando; Lusk, Gary; Mcgarr, Samuel H; Mcintosh, Betty W; Mcleighton, Steven W; Medford, Mark A; Messing, Steven G; Miller, David-TAMPA; Pace, Katherine A; Propst, Tamara C; Rich Jr, Donald E; Ritchie, Lewis R; Sanabria, Edgardo; Saron, Carole B; Satalino, Frank P; Sheridan-moore, Catherine M; Suarez, Oscar J; Tuley, Patrick A; Turner, G.Chris; Weil, Jerry M; Weld, Gary E; Williams, Patrick A; Zukowski, Philip M; Anderson, Mark E; Corrigan Jr, J Eustis; Smith, Gregory L; Ellis, William E; Horan, James L; Larsen, Cheryl A (US\Charlotte); Jones, James R; Lawter, Robert
CC: Colley, Peter M; Smith, Jerry N; Gray, Mike - RALEIGH; Manth, Larry E; Atkin, Andrew S; Parker, Paul C
Delivery Time: 2/22/2001 4:52:26 PM
Creation Time: 2/22/2001 4:52:24 PM
Modification Time: 2/22/2001 4:52:26 PM
Submit Time: 2/22/2001 4:52:26 PM
Importance: 2/2
Priority: 2/1
Sensitivity: 2/0
Flags: 2/1

KPMG 0050823

Proprietary Material
Confidentiality Requested

Size: 2/35572

Message0006	
Subject:	**FW: Revised SC2 Script**
From:	Stein, Jeff (US/Vice Chairman)
Date:	6/8/2000 2:09:17 PM
To:	Klein, Wendy (NSS-Tax)

Message Body

-----Original Message-----
From: Rosenthal, Richard P
Sent: Thursday, June 08, 2000 12:10 PM
To: Stein, Jeff (US/Vice Chairman)
Subject: RE: Revised SC2 Script

This looks good as it relates to SC2. However, with a few additional questions, we can get information to determine if CREWP applies. I don't know what those questions should be, other than if they answer that they are a C Corp, we should ask a set of CREWP questions. If they answer that they are an S Corp. then we ask the SC2 questions.

Manth and Wiseberg should sign off on the questions....

Rick

-----Original Message-----
From: Stein, Jeff (US/Vice Chairman)
Sent: Thursday, June 08, 2000 4:57 AM
To: Rosenthal, Richard P
Subject: FW: Revised SC2 Script
Importance: High

Thoughts?

-----Original Message-----
From: Klein, Wendy (NSS-Tax)
Sent: Thursday, June 08, 2000 7:40 AM
To: Stein, Jeff (US/Vice Chairman)
Subject: Revised SC2 Script
Importance: High

Proprietary Material
Confidentiality Requested

I understand that Larry Manth, National Champion for SC2, believes that the PDCs may help qualify prospects for SC2. Given the current environment I wanted to be sure that there were no pitfalls in following the line of questioning included below. I have inserted an excerpt from the talk points the PDCs would use below (however the full conversation guide is included in the word file). Can we discuss?

Owner/CFO Opening:

Hello, ___________? This is ___________ with KPMG's Tax Practice. We have an innovative tax strategy that could potentially benefit closely-held companies like ___________, but I have a couple of questions to make sure we have a good fit with your company's situation. Could you answer a few/handful of questions for me?

1.) Are you an "S," or a "C" corporation?

KPMG 0049114

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2.) How many stockholders do you have?

3.) Do you anticipate that your corporation will have net income of at least $3.3 million annually for the next 2-4 years? "Yes," go to Appointment Close. "No," go to Non-appointment Close.

<< File: SC2Script.doc >>

Outlook Header Information
Conversation Topic: Revised SC2 Script Subject: FW: Revised SC2 Script From: Stein, Jeff (US/Vice Chairman) Sender Name: Stein, Jeff (US/Vice Chairman) To: Klein, Wendy (NSS-Tax) Received By: Klein, Wendy (NSS-Tax) Delivery Time: 6/8/2000 2:09:17 PM Creation Time: 6/8/2000 2:08:24 PM Modification Time: 6/8/2000 10:00:51 PM Submit Time: 6/8/2000 2:09:17 PM Importance: 6/1 Priority: 6/0 Sensitivity: 6/0 Flags: 6/1 Size: 6/5912

From /O=KPMG/OU=US/CN=RECIPIENTS/CN=9905
From: /O=KPMG/OU=US/CN=RECIPIENTS/CN=9905
To: /O=KPMG/OU=US/CN=RECIPIENTS/CN=20499
Subject: FW: Grantor trust memo
Sent: 1998-09-10 13:45:42.133
Date: 1998-09-10 13:45:42.226
X-Folder: Grantor Trust

Jeff -

My preference would be to provide all necessary detail to the grantor: date purchased, date sold, cost and proceeds on an attachment that's included in the 1041. The summary page would show the net. That way, we have given the taxpayer what he requires to file an accurate return. Accordingly, any netting is "really" done at the 1040 level. But, we have a better argument for doing the netting that we would if we had no grantor trust.

Tracie

-----Original Message-----
From: Eischeid, Jeffrey A
Sent: Tuesday, September 08, 1998 9:14 AM
To: Henderson, Tracie K
Subject: FW: FW: Grantor trust memo

-----Original Message-----
From: Watson, Mark T
Sent: Thursday, September 03, 1998 1:50 PM
To: Eischeid, Jeffrey A
Cc: Gardner, John H
Subject: RE: FW: Grantor trust memo

Jeff, yes, there are several reasons I disagree with the memo's logic. Specifically, section 671, Reg. section 671-1, -2, and -3, several court cases, Rev. Rul. 85-13, and numerous private letter rulings make it very clear that if a grantor or another person is treated as the owner of a trust, "he [or she] takes into account in computing his [or her] income tax liability all items of income, deduction, and credit . . . to which he [or she] would have been entitled had the trust not been in existence during the period he is treated as the owner." See Reg. section 1.671-3(a)(1). In other words, the grantor is treated as if he or she owned the trust's assets. Clearly, if the grantor directly sold one stock that generated a long-term capital gain, and, in the same year, directly sold another stock that generated a short-term capital loss, the grantor could not net the short-term loss against the long-term gain and report only the net gain or loss on his or her tax return. Rather, he or she would have to report each transaction separately on Schedule D.

Why then, when the above mentioned authority makes it clear that a grantor who is treated as the owner of a trust is treated as if he or she owned the trust's assets, would we reach a conclusion that we can net gains and losses at the grantor trust level? The "grantor trust memo" answers this question basically by stating "there is nothing that explicitly says we can't net." However, I argue that Treasury did not need to specifically address this matter because it is abundantly clear -- a grantor who is treated as the owner of a trust is deemed to own the trust's assets, and if he or she is deemed to own the trust assets, then reportable transactions related to those assets must be reported in the same manner as they would if grantor actually did own the assets (i.e., no netting).

Further, to my knowledge, KPMG (and I suspect every other accounting firm) has never netted on grantor trust returns. In fact, as the memo points out, you can get the wrong tax liability by netting on a grantor trust return. Thus, in response your second question, we cannot adopt netting on a broad-based basis because we would not be giving our clients sufficient information to prepare an accurate tax return if we did.

All the relevant evidence (e.g., the Code, regulations, case law, IRS rulings, partnership rules, S corporation rules, etc.) leads to the rational conclusion that you cannot net on a grantor trust return. Thus, I disagree with the conclusion reached in the memo.

-----Original Message-----
From: Eischeid, Jeffrey A
Sent: Wednesday, September 02, 1998 7:34 PM
To: Watson, Mark T
Subject: RE: FW: Grantor trust memo

Is there a particular reason you disagree with the memo's logic? I don't want our people reporting in an inappropriate manner.

If we were to adopt the approach on a broad-based, go-forward basis are you more comfortable? In other words, what if we use the netting approach w/r/t trusts that didn't have an OPIS transaction in them as well as those that did?

Jeff

-----Original Message-----
From: Watson, Mark T
Sent: Wednesday, September 02, 1998 7:24 PM
To: Gardner, John H; Eischeid, Jeffrey A
Cc: Henderson, Tracie K; Elgin, Evelyn ; 'Randall S Bickham at KPMG_Silicon_Valley2'; Perez, Robert L
Subject: RE: FW: Grantor trust memo

Notwithstanding the conclusion reached in the "grantor trust memo," I don't think netting at the grantor trust level is a proper reporting position. Further, we have never prepared grantor trust returns in this manner. What will our explanation be when the Service and/or courts ask why we suddenly changed the way we prepared grantor trust returns/statements only for certain clients? When you put the OPIS transaction together with this "stealth" reporting approach, the whole thing stinks.

-----Original Message-----
From: Gardner, John H
Sent: Wednesday, September 02, 1998 4:19 PM
To: Eischeid, Jeffrey A
Cc: Henderson, Tracie K; Watson, Mark T; Elgin, Evelyn ; Randall S Bickham at KPMG_Silicon_Valley2
Subject: RE: FW: Grantor trust memo

Jeff:

Carl Hasting told me that an attorney he was dealing with just raised an issue with 6501(e) and the possibility that the netting could create a 6-year statute. I would argue that Reg. sec. 301.6501(e)-1(a)(1)(i) states the general rule that applies if the taxpayer omits from the gross income stated in the return of a tax imposed by subtitle A of the Code AN AMOUNT PROPERLY INCLUDIBLE THEREIN (emphasis added) which is in excess of 25 percent of the gross income so stated . . . The amount properly includible on Schedule D, lines 5 and 12, is the net short-term or long-term gain or loss from a trust's K-1. The grantor trust attachment that is filed pursuant to Reg. sec. 1.671-4(a) is essentially a substitute K-1, thus the net amount from the trust's K-1 would be the amount properly includible on the return.

What do you think? For less aggressive taxpayers, note that 6501(e)(1)(A)(ii) provides an exclusion for amounts omitted from gross income stated in the return if such amount is disclosed in the return, or a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item. Since a six year statute for this transaction is not a good answer, we may want to consider some way of providing the details in an understated way.

John

______________________________ Reply Separator ______________________________
Subject: FW: Grantor trust memo
Author: Jeffrey A Eischeid at KPMG_US
Date: 9/1/1998 7:45 PM

-----Original Message-----
From: Henderson, Tracie K
Sent: Tuesday, September 01, 1998 1:38 PM
I think this is great and I agree with the analysis and conclusions. Are you comfortable mentioning this on tomorrow's conference call and posting it on the KMan workgroup in the OPIS toolkit? People are trying to get their tax returns out the door, as well as plan '98 transactions.

Jeff

To: Eischeid, Jeffrey A
Subject: FW: Grantor trust memo

fyi

-----Original Message-----
From: Gardner, John H
Sent: Monday, August 31, 1998 7:40 AM
To: Henderson, Tracie K
Subject: Grantor trust memo

Tracie:

I sent this to Gregg a while ago with the understanding that he would circulate it among the CaTS team for comments. I believe this is the latest version.

John

From /O=KPMG/OU=US/CN=RECIPIENTS/CN=15833
From: /O=KPMG/OU=US/CN=RECIPIENTS/CN=15833
To: /O=KPMG/OU=US/CN=RECIPIENTS/CN=20499
Subject: FW: Grantor trust memo
Sent: 1998-09-06 17:04:00.000
Date: 1998-09-06 17:07:02.915
X-Folder: Grantor Trust

For the record, the purpose of the "grantor trust memo" was to evaluate the risks from a filing standpoint associated with netting the gains at the grantor trust level. It was not intended to be the basis of a more likely than not opinion.

The risks identified in the memo are penalties under section 6722 and section 6662. Of particular importance is the intentional disregard provision of section 6722(c) and the potential imposition of a penalty of 10% of the aggregate amount of the items required to be reported correctly without the application of the 6722(a) limitation of $100,000. A client who is fully informed of these risks and chooses to accept these risks and report in this fashion may have a fight with the IRS and may lose that fight. If a client is not willing to accept that risk, he or she should not enter into this transaction.

________________ Reply Separator ________________
Subject: RE: FW: Grantor trust memo
Author: Mark T Watson at KPMG_US
Date: 9/3/1998 1:49 PM

Jeff, yes, there are several reasons I disagree with the memo's logic. Specifically, section 671, Reg. section 671-1, -2, and -3, several court cases, Rev. Rul. 85-13, and numerous private letter rulings make it very clear that if a grantor or another person is treated as the owner of a trust, "he [or she] takes into account in computing his [or her] income tax liability all items of income, deduction, and credit . . . to which he [or she] would have been entitled had the trust not been in existence during the period he is treated as the owner." See Reg. section 1.671-3(a)(1). In other words, the grantor is treated as if he or she owned the trust's assets. Clearly, if the grantor directly sold one stock that generated a long-term capital gain, and, in the same year, directly sold another stock that generated a short-term capital loss, the grantor could not net the short-term loss against the long-term gain and report only the net gain or loss on his or her tax return. Rather, he or she would have to report each transaction separately on Schedule D.

Why then, when the above mentioned authority makes it clear that a grantor who is treated as the owner of a trust is treated as if he or she owned the trust's assets, would we reach a conclusion that we can net gains and losses at the grantor trust level? The "grantor trust memo" answers this question basically by stating "there is nothing that explicitly says we can't net." However, I argue that Treasury did not need to specifically address this matter because it is abundantly clear -- a grantor who is treated as the owner of a trust is deemed to own the trust's assets, and if he or she is deemed to own the trust assets, then reportable transactions related to those assets must be reported in the same manner as they would if grantor actually did own the assets (i.e., no netting).

Further, to my knowledge, KPMG (and I suspect every other accounting firm) has never netted on grantor trust returns. In fact, as the memo points out, you can get the wrong tax liability by netting on a grantor trust return. Thus, in response your second question, we cannot adopt netting on a broad-based basis because we would not be giving our clients sufficient information to prepare an accurate tax return if we did.

All the relevant evidence (e.g., the Code, regulations, case law, IRS rulings, partnership rules, S corporation rules, etc.) leads to the rational conclusion that you cannot net on a grantor trust return. Thus, I disagree with the conclusion reached in the memo.

-----Original Message-----
From: Eischeid, Jeffrey A
Sent: Wednesday, September 02, 1998 7:34 PM
To: Watson, Mark T
Subject: RE: FW: Grantor trust memo

Is there a particular reason you disagree with the memo's logic? I don't want our people reporting in an inappropriate manner.

If we were to adopt the approach on a broad-based, go-forward basis are you more comfortable? In other words, what if we use the netting approach w/r/t trusts that didn't have an OPIS transaction in them as well as those that did?

Jeff

-----Original Message-----
From: Watson, Mark T
Sent: Wednesday, September 02, 1998 7:24 PM
To: Gardner, John H; Eischeid, Jeffrey A
Cc: Henderson, Tracie K; Elgin, Evelyn ; 'Randall S Bickham at KPMG_Silicon_Valley2'; Perez, Robert L
Subject: RE: FW: Grantor trust memo

Notwithstanding the conclusion reached in the "grantor trust memo," I don't think netting at the grantor trust level is a proper reporting position. Further, we have never prepared grantor trust returns in this manner. What will our explanation be when the Service and/or courts ask why we suddenly changed the way we prepared grantor trust returns/statements only for certain clients? When you put the OPIS transaction together with this "stealth" reporting approach, the whole thing stinks.

-----Original Message-----
From: Gardner, John H
Sent: Wednesday, September 02, 1998 4:19 PM
To: Eischeid, Jeffrey A
Cc: Henderson, Tracie K; Watson, Mark T; Elgin, Evelyn ; Randall S Bickham at KPMG_Silicon_Valley2
Subject: RE: FW: Grantor trust memo

Jeff:

Carl Hasting told me that an attorney he was dealing with just raised an issue with 6501(e) and the possibility that the netting could create a 6-year statute. I would argue that Reg. sec.

301.6501(e)-1(a)(1)(i) states the general rule that applies if the taxpayer omits from the gross income stated in the return of a tax imposed by subtitle A of the Code AN AMOUNT PROPERLY INCLUDIBLE THEREIN (emphasis added) which is in excess of 25 percent of the gross income so stated . . . The amount properly includible on Schedule D, lines 5 and 12, is the net short-term or long-term gain or loss from a trust's K-1. The grantor trust attachment that is filed pursuant to Reg. sec. 1.671-4(a) is essentially a substitute K-1, thus the net amount from the trust's K-1 would be the amount properly includible on the return.

What do you think? For less aggressive taxpayers, note that 6501(e)(1)(A)(ii) provides an exclusion for amounts omitted from gross income stated in the return if such amount is disclosed in the return, or a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item. Since a six year statute for this transaction is not a good answer, we may want to consider some way of providing the details in an understated way.

John

______________________________ Reply Separator ______________________________
Subject: FW: Grantor trust memo
Author: Jeffrey A Eischeid at KPMG_US
Date: 9/1/1998 7:45 PM

-----Original Message-----
From: Henderson, Tracie K
Sent: Tuesday, September 01, 1998 1:38 PM
I think this is great and I agree with the analysis and conclusions. Are you comfortable mentioning this on tomorrow's conference call and posting it on the KMan workgroup in the OPIS toolkit? People are trying to get their tax returns out the door, as well as plan '98 transactions.

Jeff

To: Eischeid, Jeffrey A
Subject: FW: Grantor trust memo

fyi

-----Original Message-----
From: Gardner, John H
Sent: Monday, August 31, 1998 7:40 AM
To: Henderson, Tracie K
Subject: Grantor trust memo

Tracie:

I sent this to Gregg a while ago with the understanding that he would circulate it among the CaTS team for comments. I believe this is the latest version.

From /O=KPMG/OU=US/CN=RECIPIENTS/CN=21552
From: /O=KPMG/OU=US/CN=RECIPIENTS/CN=21552
To: /O=KPMG/OU=US/CN=RECIPIENTS/CN=20499
Subject: Grantor Trust Netting
Sent: 1998-09-08 11:46:41.109
Date: 1998-09-08 11:45:46.617
X-Folder: Grantor Trust

Carl, I agree with your concern. I don't think netting at the grantor trust level is a proper reporting method, and I seriously doubt the IRS and/or the courts will deem netting to be adequate disclosure. If you take this reporting position, I recommend that you advise your clients that they will likely be subject to a 6-year statute of limitations.

-----Original Message-----
From: Hasting, Carl D
Sent: Sunday, September 06, 1998 2:07 PM
To: Eischeid, Jeffrey A; Watson, Mark T; Gardner, John H; Randall S Bickham at KPMG_Silicon_Valley2
Subject: Grantor Trust Netting

Guys:

I am gravely concerned about the possibility that through our netting of gains and losses for Opis within grantor trusts we might be buying our clients a 6-year statute of limitations under Section 6501(e). Gardner and I have discussed the issue, but I think we should invest whatever time is necessary to resolve this. I have looked at a number of cases and have the following initial observations:

First, it is well settled that capital losses are not included in the definition of "gross income" under 6501(e). See, for example, Green, 7 TC 263 (1946) and DiLeo, 96 TC 858 (1991).

Roschuni, 44 TC 80 (1965) is also informative. The taxpayer reported a net capital loss of $34,190 from an S corp pass-through without disclosing the gross gains and losses separately. The taxpayer won on the issue because he had "adequate disclosure" by typing in "See -- Golbert Hotel, Inc. (Schedule D, Form 1120-S) ($34,190)." But implicitly the court said that without that disclosure, the 6-year statute would have applied.

In Corrigan, 155 F.2d 164, 6th Cir. (1946), a trust beneficiary reported net K-1 income on her personal return. The trust filed its own return and improperly deducted expenses attributable to tax exempt income. The IRS asserted that the 6-year statute applied because gross income was understated by more than 25%. Taxpayer argued that income had changed by adding back deductions, not increasing items of gross income. The court said that in adding back the deductions, "gross income" for purposes of the 6-year statute application increased by more than 25%; therefore, the 25% rule applied. This case is very troubling to me.

Let me know what you think. I really feel we should immediately resolve this.

Carl

DeLap, Larry

From: Eischeid, Jeffrey A
Sent: Friday, January 22, 1999 8:30 AM
To: Hasting, Carl D
Cc: Ito, Dennis A; DeLap, Larry; Ammerman, Douglas K
Subject: RE: Grantor trust reporting

Carl -

I'd be happy to discuss this with you on the phone. I presume you weren't able to make yesterday's CaTS conference call either. On that call, we concluded that each partner must review the WNT memo and decide for themselves what position to take on their returns - after discussing the various pros and cons with their clients.

Jeff

-----Original Message-----
From: Hasting, Carl D
Sent: Thursday, January 21, 1999 4:18 PM
To: Eischeid, Jeffrey A
Cc: Ito, Dennis A
Subject: FW: Grantor trust reporting

Jeff:

This "debate" between Watson and Gardner affects me in a significant way in that a number of my deals were sold giving the client the option of netting (and living with a 6-year statute) or not netting. Therefore, if they ask me to net, I feel obligated to do so. These sales were before Watson went on record with his position and after the memo had been outstanding for some time.

What is our position as a group? Watson told me he believes it is a hazardous professional practice issue. Given that none of us wants to face such an issue, I need some guidance.

Help???

Carl

-----Original Message-----
From: Watson, Mark T
Sent: Thursday, January 21, 1999 12:05 PM
To: Eischeid, Jeffrey A; Baumann, Dale R; Bickham, Randall S; Bloom, Richard J; Branan, Carolyn B; Carbo, Deke G; Fergus, Terrence P; Gardner, John H; Hasting, Carl D; Henderson, Tracie K; Jordan, Robert M; Liston, Shannon L; Nuckolls, John M; Pace, Katherine A; Paule, Robin M; Pedersen, Robert A; Poage, Ray M; Rivkin, David; Slattery, Daniel M; Speiss, Timothy P; Spitz, William L; Tendler, Neil J; Watkins, B M; Wissel, Kyle; Zaudtke, David P; Zysik, Jeffrey C
Subject: RE: Grantor trust reporting

You should all know that I do not agree with the conclusion reached in the attached memo that capital gains can be netted at the trust level. I believe we are filing misleading, and perhaps false, returns by taking this reporting position.

-----Original Message-----
From: Eischeid, Jeffrey A
Sent: Thursday, January 21, 1999 2:12 PM
To: Baumann, Dale; Bickham, Randall; Bloom, Richard; Branan, Carolyn; Carbo, Deke; Eischeid, Jeffrey; Fergus, Terrence; Gardner, John; Hasting, Carl; Henderson, Tracie; Jordan, Robert; Liston, Shannon; Nuckolls, John; Pace, Katherine; Paule, Robin; Pedersen, Robert; Poage, Ray; Rivkin, David; Slattery, Daniel; Speiss, Timothy; Spitz, William; Tendler, Neil; Watkins, B; Watson, Mark; Wissel, Kyle; Zaudtke, David; Zysik, Jeffrey
Subject: Grantor trust reporting

I believe this is the latest version. Don't forget the statute of limitations issue Tracie raised.

Jeff

KPMG

DRAFT

MEMORANDUM OF TELEPHONE CALL

Client:

Caller : Carl Hastings

Date: May 24, 2000

Received by: Kevin A. Pace

Transcribed by:

Ref: [illegible]

Kevin, Carl Hastings. Its five minutes after three on Monday, the 22[nd], returning your call.

The short answer to your inquiry is, up in the Northeast, at least, there is quite a bit of activity in the trust area where they used to not audit many of these kinds of trusts. They are now auditing quite a number of them because they have figured out that trusts are a common element in some of these shelter deals. So our best intelligence is that you are increasing your odds of being audited, not decreasing your odds by filing that Grantor Trust return. So we have discontinued doing that.

You may want to call either Carol Worley in Dallas or Tracy Henderson in Atlanta. I forget which one of them was tracking the activity up in the Northeast. I think it was Carol, but give her a call. If its not her, she will know who it was and get the most recent intelligence. But again, the short answer is we are not doing that anymore, cause we think it increases the risk instead of decreasing it.

Thanks, Bye.

Unknown

From: Eischeid, Jeffrey A
Sent: Friday, October 20, 2000 6:20 PM
To: Mccrimlisk, George H
Subject: FLIP

Did you have your "netting" discussions with and ? I need copies of the memos of oral advice.

Thanks,

Jeff

REDACTED

new

From: Jeff Stein
Sent: Saturday, March 14, 1998 6:56 AM
To: Gregg W. Ritchie; Douglas J. Green; Robert J. Wells; John T. Lanning; Larry DeLap
Subject: Simon Says

By the way - anybody who does not have a copy of the Pfaff letter, let me know and I will fax it over to you. In addition in case you want a copy of the November 6, 1997 memo detailing the proposed LLC strucutre written by Simon to "The Working Group" which included Ritchie, Pfaff, Larson, Bickahm and R.J. Ruble of the law firm of Brown & Wood let me know and I will fax it over to you as well. As I said below, the OPIS strategy is a stripped dwon version of the LLC structure.

Incidentally, I failed to mention that the research on the most troublesome issues with respect to this product was done in large measure by Simon, Harris and Margaret Lukes (also IS). Those issues included:

a - Whether U.S. investor's interest in the Cayman entity was disguised equity.

b - The application of the at-risk rules and,

c - The basis of the shares held by the U.S. investor.

Frankly Doug - if you are the ultimate arbiter in this matter, I think you have all the facts you need at your disposal to make your decision. I will have a conversation if you and Greg feel it is necessary but that discussion would only result in a debate over the facts as presented below and Simon and Harris would need to be prresent on that call to represent what they have told me concerning their involvement in this product.

Guys - Have a terrific weekend.

________________ Forward Header ________________

Subject: Simon Says
Author: Jeff Stein at KPMG_NYO_Tax2
Date: 3/14/98 9:46 AM

Bob/John/Larry - I've copied each of you on this because of your involvement up to this point, especially with regard to the technical issues that have arisen, on managing those rare personality flare ups and in coding discussions. I feel (not fear) the end is near.

After some - but not exhaustive - due diligence on my part over the last few days, here is what I was able to come up with as regards the involvement of IS in the OPIS strategy (son of FLIP). They are to be contrated with Opie and Flipper, two TV characters from the 60's. Obviously reasonable men can differ on both the facts and conclusions but I thought I'd take a stab at laying out at least my understanding which perhaps can serve as a working document for any discussions next week. I invite any of you to please reply and let me know where I am off base on any of this. I have tried to be as honest and accurate as I can be and have toned down my normal pronation (not just a foot and running term Doug) towards exaggeration but have tried to at least add some humor.

1

Proprietary Material
Confidentiality Requested

KPMG 0034380

Permanent Subcommittee on Investigations
EXHIBIT #11

First of all, in terms of involvement you should all have a copy of an unsolicited letter to me from Bob Pfaff extolling the virtues of Bob Simon and which indicates how integrally involved Bob has been in the development of this strategy. From my law school days, I was always told to lead with strength and if you could get a third party to say how great your client was rather than having your client say that he was great - it would better serve you. Thus, Pfaff is my first character witness who may later be called to the stand to discuss specific factual allegations in this case. I believe that letter states that "Bob (Simon) contributed significantly to making it (the basis shift strategy) a better product with less risk for all concerned." So that's Exhibit A.

Just as a matter of background, in September or October of last year Bob Simon and Bob Pfaff began to have discussions on a successor to the FLIP transaction which was being marketed. These discussions took on an air of urgency when Larry Delap determined that KPMG should discontinue marketing the existing product. Simon and Pfaff met in late October and throughout November to tweak or redesign if necessary the old strategy - focusing on the Cayman partnership and adding features designed to lessen any Subpart F or other risks. They determined that whatever the new product, it needed a greater economic risk attached to it and should probably include a debt or convertible debt feature. During those 6 plus weeks, there were daily phone calls between Pfaff and Simon and numerous meetings. The involvement was significant and depending upon which IRS test we want to apply, Simon was big-time involved. Now to the heart of the discussion.

OPIS at it's core (pardon the use of core - it is not a coding term of art) is really just an updated version of the basis shift strategy developed by IS and Pfaff. It is now - and don't take this the wrong way - a watered down version (OBJECTION - OVERRULED) of what Pfaff and Simon came up with in November and which was presented to the IS leadership team by Pfaff in early December for their review and comments. It was Simon who wrote up the product for distribution to the leadership team and for circulation to Larry.

The use of a Cayman partnership instead of a Cayman corp came about through meetings Simon held with Pfaff. Although Pfaff had actually floated that idea back in July when he was still with KPMG, nobody ever pursued it. When FLIP was tabled, Simon brought it back on the table and showed Pfaff how we could achieve an even better structure with a Cayman LLC or partnership. By the way - you guys should feel free to call Pfaff to the stand and ask him to confirm or deny any of what I am saying as well as Simon's involvement.

As you may know, the Cayman entity (in both FLIP and OPIS) is nominally owned by an NRA (nonresident alien). Under the FLIP structure, there was a real question as to whether an NRA was truly an equity holder. In particular, the NRA received a preferred return, was protected from risk, and in most respects looked like a service provider or debt holder. If that were true, either of those characterizations would have lead to a tax disaster. Simon was the one who suggested buttressing the NRA's position as an equity holder and although some of Simon's suggested improvements did not make their way into the ultimate OPIS product, others did. I assume the same could be said of other team members who worked on this product. For example, I know that from discussions with Pfaff, the NRA will now have real economic risk and no longer has a preferred return. In addition, the NRA will hold both equity and debt.

In the FLIP structure, the U.S. investor bought a warrant to purchase 90% of the stock of a Cayman company for a price designed to include all the fees of the participants in the transaction. It was essential that the warrant be treated as an option to acquire stock in the Cayman company (for Section 302 purposes), without being treated as actual stock. Simon was the one who pointed out the weakness in having the U.S. investor purchase a warrant for a ridiculously high amount of money - well in excess of the strike price - which in no event would be exercised (since the investor also had a cash-settled option which would enable him to gain any upside in the Cayman company without paying the strike price of exercise). It was clear, we needed the option to be treated as an option for Section 302 purposes, and yet in truth the option was really illusory and stood out more like a sore thumb since no one in his right mind would pay such an exorbitant price for such a warrant. Pfaff and Simon discussed alternatives and came up with the idea of having the U.S. investor purchase convertiable debt since the investor could be expected to pay at or near the principal amount for convertible debt. Eventually this was changed to a swap (in OPIS) but the idea was the same - to get a bunch (technical term) of money into Cayman corp in a manner which would have some economic substance without itself being equity.

There have been other changes to the strategy as well based on conversations that Simon has had with Pfaff but since Simon was effectively cut out of the loop in mid-December he has not been privy to everything that has transpired.

The FLIP strategy included a loan from a foreign bank to the Cayman company. The Cayman company then turned around and purchased shares in the same bank. Later, the shares were redeemed and magically, at the same moment, the U.S. investor (related to Cayman through the warrant) would buy an option for the equivalent amount of the shares from the Bank. In kicking the tires on FLIP (perhaps too hard for the likes of certain people) Simon discovered that there was a delayed settlement of the loan which then raised the issue of whether the shares could even be deemed to be issued to the Cayman company. Naturally without the shares being issued, they could not later be redeemed. Under OPIS, the same simultaneous redemption is present, but settlement of the loan documents will occur immediately, i.e., no delayed settlement. Clearly Simon was very vocal in his concern over the delayed settlement issue and played the key role in eliminating it from the new and improved strategy.

Simon was also the one who suggested and prepared investor's representation letters which dealt primarily with the investor's economic expectations heading into the deal. Prior to that we had some 20 or so representations buried in a 50 page opinion. Because the investor himself was not making the representations, they were of dubious validity. Representation letters will now be issued on all OPIS deals and wherever possible in the old FLIP deals.

Additionally, all of the time spent by John Harris on this project (and it is considerable) has been run through international services contracts. A very significant issue in OPIS is whether the partnership anti-abuse regulations apply. John is the author of that entire section, which was used word for word in the OPIS draft. Incidentally, although admittedly not entirely relevant is the praise that WNT had for that particular section. Indeed, the OPIS draft that Randy Bickham circulated was primarily taken from an earlier draft of a partnership structure that John Harris had worked on with Bob Pfaff before Bob left the Firm.

Finally, and although this may be considered by Greg as an admission against interest, it was Greg who stated in writing to I believe Bob Simon that the "the OPIS product was developed in response to your and DPP tax's concerns over the FLIP strategy. We listened to your input regarding technical concerns with respect to the FLIP product and attempted to work solutions into the new product". I assume Greg does not mean that he worked those technical solutions into the product himself or with just Mr. Birkham. I will leave the discussion on Mr Birkham and the evaluation of his international technical skills made independently by two senior IS partners to another discussion.

In conclusion - The development of the OPIS strategy was a team effort with the primary technical thrust for the improved product coming from IS. Given the similarity of this product to FLIP and the extensive involvement of Simon and Harris working alongside Pfaff, I do not believe there is any credible claim that PFP invented a new strategy or product called OPIS and it would take an absolute disregard of the facts to reach such a conclusion. A I said above, FLIP is a watered down version of what Simon and Pfaff presented to the IS leadership team in December. I believe that all that has been accomplished over the past two months since Simon has been cut out is that as many of the expensive modifications that could be taken out of OPIS have been and one change has been made, that being the swap rather than the debt instrument (which adds nothing of substance). I also believe that some of the features that gave this product more economic substance have also been eliminated but I will obviously defer to Larry who is the one who should opine on the relevant technical impact of the modifications and eliminations to the product.

What I thought we were trying to achieve here was bringing the best minds we had in this Firm together in order to design the best product to go to market with. That we did and for the five or so months that Simon and Harris have been involved working with Pfaff, not once did anybody ask, including Sandy Smith who is ultimately responsbile for the financial results in that geopgraphy, who is going to pay IS for the time and effort being spent by the IS group in Denver. That was the same path we went down when Pfaff and Larson worked on the original FLIP strategy. To now say that the hundreds of hours that IS spent in designing this strategy was either nominal or does not rise to the level of substantial is not only offensive but I can guarantee you will not result in a greater sense of teamwork going forward as we attempt to better leverage ourselves with the FCS group.

What I thought we were trying to accomplish in creating that group was not having independent pockets of professionals spending time developing independent strategies that were not nearly as powerful as what we could accomplish working together as a team. That should be what we're trying to accomplish rather than this "mine is bigger than yours" thing that we seem to be experimenting with. Somebody tell me what we're doing here by suggesting a reward system that is based on anything but team. Truth be told on this one, IS has probably been responsible for 90% of the OPIS idea when you examine the final product and compare it to FLIP, along with what led to OPIS, who suggested the key modifications to the FLIP strategy, and the key product characteristics of OPIS. Let's just stay with our 50 50 deal and forget about the Ides of March.

Author: Larry DeLap at KPMG_Silicon_Valley2
Date: 3/16/98 2:05 PM
Priority: Normal
TO: Gregg W. Ritchie at KPMG_Warner_Center
TO: Douglas J. Green at KPMG_NSS_Park
TO: Robert J. Wells at KPMG_EO_Montvale4
TO: John T. Lanning at KPMG_NSS_Park
TO: Jeff Stein at KPMG_NYO_Tax2
Subject: Re: Simon Says

------------------------------------ Message Contents ------------------------------------

Jeff -

I think you know this, but just to make it clear - the marketing of OPIS has not been approved by DPP-Tax. Neither has it been disapproved. We are awaiting additional information from Gregg, including an economic analysis of the pre-tax profit opportunity and a beefed-up analysis of the partnership issue (i.e., whether the swap transaction could cause the U.S. investor to be considered a partner in the foreign partnership).

I am in New York at 55 East 52nd this week. Could you have the two items noted in the first paragraph below sent over to me.

Larry

______________________ Reply Separator ______________________

Subject: Simon Says
Author: Jeff Stein at KPMG_NYO_Tax2
Date: 3/14/98 9:56 AM

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OPIS at it's core (pardon the use of core - it is not a coding term of art) is really just an updated version of the basis shift strategy developed by IS and Pfaff. It is now - and don't take this the wrong way - a watered down version (OBJECTION - OVERRULED) of what Pfaff and Simon came up with in November and which was presented to the IS leadership team by Pfaff in early December for their review and comments. It was Simon who wrote up the product for distribution to the leadership team and for circulation to Larry.

The use of a Cayman partnership instead of a Cayman corp came about through meetings Simon held with Pfaff. Although Pfaff had actually floated that idea back in July when he was still with KPMG, nobody ever pursued it. When FLIP was tabled, Simon brought it back on the table and showed Pfaff how we could achieve an even better structure with a Cayman LLC or partnership. By the way - you guys should feel free to call Pfaff to the stand and ask him to confirm or deny any of what I am saying as well as Simon's involvement.

As you may know, the Cayman entity (in both FLIP and OPIS) is nominally owned by an NRA (nonresident alien). Under the FLIP structure, there was a real question as to whether an NRA was truly an equity holder. In particular, the NRA received a preferred return, was protected from risk, and in most respects looked like a service provider or debt holder. If that were true, either of those characterizations would have lead to a tax disaster. Simon was the one who suggested buttressing the NRA's position as an equity holder and although some of Simon's suggested improvements did not make their way into the ultimate OPIS product, others did. I assume the same could be said of other team members who worked on this product. For example, I know that from discussions with Pfaff, the NRA will now have real economic risk and no longer has a preferred return. In addition, the NRA will hold both equity and debt.

In the FLIP structure, the U.S. investor bought a warrant to purchase 90% of the stock of a Cayman company for a price designed to include all the fees of the participants in the transaction. It was essential that the warrant be treated as an option to acquire stock in the Cayman company (for Section 302 purposes), without being treated as actual stock. Simon was the one who pointed out the weakness in having the U.S. investor purchase a warrant for a ridiculously high amount of money - well in excess of the strike price - which in no event would be exercised (since the investor also had a cash-settled option which would enable him to gain any upside in the Cayman company without paying the strike price of exercise). It was clear, we needed the option to be treated as an option for Section 302 purposes, and yet in truth the option was really illusory and stood out more like a sore thumb since no one in his right mind would pay such an exorbitant price for such a warrant. Pfaff and Simon discussed alternatives and came up with the idea of having the U.S. investor purchase convertiable debt since the investor could be expected to pay at or near the principal amount for convertible debt. Eventually this was changed to a swap (in OPIS) but the idea was the same - to get a bunch (technical term) of money into Cayman corp in a manner which would have some economic substance without itself being equity.

There have been other changes to the strategy as well based on conversations that Simon has had with Pfaff but since Simon was effectively cut out of the loop in mid-December he has not been privy to everything that has transpired.

The FLIP strategy included a loan from a foreign bank to the Cayman company. The Cayman company then turned around and purchased shares in the same bank. Later, the shares were redeemed and magically, at the same moment, the U.S. investor (related to Cayman through the warrant) would buy an option for the equivalent amount of the shares from the Bank. In kicking the tires on FLIP (perhaps too hard for the likes of certain people) Simon discovered that there was a delayed settlement of the loan which then raised the issue of whether the shares could even be deemed to be issued to the Cayman company. Naturally without the shares being issued, they could not later be redeemed. Under OPIS, the same simultaneous redemption is present, but settlement of the loan documents will occur immediately, i.e., no delayed settlement. Clearly Simon was very vocal in his concern over the delayed settlement issue and played the key role in eliminating it from the new and improved strategy.

Simon was also the one who suggested and prepared investor's representation letters which dealt primarily with the investor's economic expectations heading into the deal. Prior to that we had some 20 or so representations buried in a 50 page opinion. Because the investor himself was not making the representations, they were of dubious validity. Representation letters will now be issued on all OPIS deals and wherever possible in the old FLIP deals.

Additionally, all of the time spent by John Harris on this project (and it is considerable) has been run through international services contracts. A very significant issue in OPIS is whether the partnership anti-abuse regulations apply. John is the author of that entire section, which was used word for word in the OPIS draft. Incidentally, although admittedly not entirely relevant is the praise that WNT had for that particular section. Indeed, the OPIS draft that Randy Bickham circulated was primarily taken from an earlier draft of a partnership structure that John Harris had worked on with Bob Pfaff before Bob left the Firm.

Finally, and although this may be considered by Greg as an admission against interest, it was Greg who stated in writing to I believe Bob Simon that the "the OPIS product was developed in response to your and DPP tax's concerns over the FLIP strategy. We listened to your input regarding technical concerns with respect to the FLIP product and attempted to work solutions into the new product". I assume Greg does not mean that he worked those technical solutions into the product himself or with just Mr. Bickham. I will leave the discussion on Mr Bickham and the evaluation of his international technical skills made independently by two senior IS partners to another discussion.

In conclusion - The development of the OPIS strategy was a team effort with the primary technical thrust for the improved product coming from IS. Given the similarity of this product to FLIP and the extensive involvement of Simon and Harris working alongside Pfaff, I do not believe there is any credible claim that PFP invented a new strategy or product called OPIS and it would take an absolute disregard of the facts to reach such a conclusion. A I said above, FLIP is a watered down version of what Simon and Pfaff presented to the IS leadership team in December. I believe that all that has been accomplished over the past two months since Simon has been cut out is that as many of the expensive modifications that could be taken out of OPIS have been and one change has been made, that being the swap rather than the debt instrument (which adds nothing of substance). I also believe that some of the features that gave this product more economic substance have also been eliminated but I will obviously defer to Larry who is the one who should opine on the relevant technical impact of the modifications and eliminations to the product.

What I thought we were trying to achieve here was bringing the best minds we had in this Firm together in order to design the best product to go to market with. That we did and for the five or so months that Simon and Harris have been involved working with Pfaff, not once did anybody ask, including Sandy Smith who is ultimately responsabile for the financial results in that geopgraphy, who is going to pay IS for the time and effort being spent by the IS group in Denver. That was the same path we went down when Pfaff and Larson worked on the original FLIP strategy. To now say that the hundreds of hours that IS spent in designing this strategy was either nominal or does not rise to the level of substantial is not only offensive but I can guarantee you will not result in a greater sense of teamwork going forward as we attempt to better leverage ourselves with the FCS group.

What I thought we were trying to accomplish in creating that group was not having independent pockets of professionals spending time developing independant strategies that were not nearly as powerful as what we could accomplish working together as a team. That should be what we're trying to accomplish rather than this "mine is bigger than yours" thing that we seem to be experimenting with. Somebody tell me what we're doing here by suggesting a reward system that is based on anything but team. Truth be told on this one, IS has probably been responsible for 80% of the OPIS idea when you examine the final product and compare it to FLIP, along with what led to OPIS, who suggested the key modifications to the FLIP strategy, and the key product characteristics of OPIS. Let's just stay with our 50/50 deal and forget about the Ides of March.

Rosenthal, Steven M

From:	Rosenthal, Steven M
Sent:	Sunday, May 09, 1999 11:56 AM
To:	Smith, Richard H (WNT)
Cc:	Springer, Mark A; Watson, Mark T; Wiesner, Philip J
Subject:	RE: Who is the Borrower in the BLIPS transaction

Yes.

-----Original Message-----
From: Smith, Richard H (WNT)
Sent: Sunday, May 09, 1999 11:32 AM
To: Rosenthal, Steven M
Cc: Springer, Mark A; Watson, Mark T; Wiesner, Philip J
Subject: RE: Who is the Borrower in the BLIPS transaction

Steve,

Based on your analysis below, do you conclude that the tax results sought by the Investor are NOT "more likely than not" to be realized?

Thanks,

Richard

-----Original Message-----
From: Rosenthal, Steven M
Sent: Friday, May 07, 1999 4:48 PM
To: Wiesner, Philip J
Cc: Springer, Mark A; Smith, Richard H (WNT); Watson, Mark T
Subject: Who is the Borrower in the BLIPS transaction

Phil,

As a follow-up to our meeting this morning, I wanted to outline my concerns on the "Who is the Borrower" issuer. My research suggests that this question turns on economic substance--and a "facts and circumstances" determination. My largest concern is that the BLIPS facts suggest that, in economic substance, the partnership, rather than the individual investor is the true borrower (assuming there is a debt). I believe the following facts are problematic: the investor is nominally the borrower for only a transitory period (7-10 days); the loan is non-recourse (the investor never assumes any personal liability); the investor does not control the proceeds (the proceeds are left in the bank) and the investor apparently has little investment discretion while it holds the funds; the investor presumably will earn a negative spread while it holds the proceeds; the bank--and all of the other parties to the transaction-- will look to the partnership, and not the investor, to repay the loan; the non-tax business reason for the investor to borrow the proceeds and convey the loan is not substantial (the purported reason, leverage, can be accomplished in or out of the partnership).

The case law (Plantation Patterns, NIPSCO, Aiken) emphasizes that the substance (which requires a non-tax business purpose), and not the form, of an arrangement is critical to answering the question of "Who is the Borrower." Thus, in NIPSCO, a back-to-back finance arrangement that provided the intermediary with dominion and control of the funds and a positive interest rate spread was upheld, but, in Aiken, an intermediary that earned no profit was not respected.

The S-corporation cases appear of limited value. In these cases, the individual actually borrows and enters into another loan agreement (and thereby remains liable on the original loan). In our case, the individual borrows and then conveys the assumed loan to the partnership (without a substantial change in its economic position). In addition, in these S corporation cases, the bank typically was unaware (and did not care) that the loan proceeds were relent (see, e.g., Bolding). In BLIPS, the bank (and the other parties) contemplate that the partnership, and not the investor, will repay the loan. Likewise, in Rev. Rul. 80-240, in a structure very similar to BLIPs (but, with a corporation and not a partnership, assuming a loan borrowed by an individual), the IRS determined that the individual would be ignored for federal income tax purposes because the individual was merely an intermediate agent (and there was no plan or intention for the individual either to own the property acquired with the loan proceeds or repay the loan proceeds).

Even if we could surmount these first two issues (i.e., a non-tax business purpose and the requirement that the parties look to the investor as the borrower), there are further hurdles to relying on these S-corporation cases. In Bergman v. U.S. (decided last month by the 8th Cir.), the court emphasized that "[l]oan transactions, like all transactions, must have independent economic substance to confer tax benefits on the parties [citations omitted]. The tax benefits of creating indebtedness thus may be set aside if the taxpayer's economic situation has not actually changed [citations omitted]. Actual indebtedness is created only where there is an economically significant

Permanent Subcommittee on Investigations
EXHIBIT #12

Rosenthal, Steven M

From: Wiesner, Philip J
Sent: Monday, May 10, 1999 8:52 AM
To: Rosenthal, Steven M
Cc: Springer, Mark A; Smith, Richard H (WNT); Watson, Mark T; Lippman, Michael H
Subject: RE: Who is the Borrower in the BLIPS transaction

Gentlemen: Please help me on this. Over the weekend while thinking about WNT involvement in BLIPS I was under the impression that we had sent the transaction forward to DPP Tax on the basis that everyone had signed off on their respective technical issue(s) and that I had signed off on the overall more likely than not opinion. If this impression is correct, why are we revisiting the opinion other than to beef up the technical discussion and further refine the representations on which the conclusions are based. I am very troubled that at this late date the issue is apparently being revisited and if I understand correctly, a prior decision changed on this technical issue?! Richard, in particular, jog my memory on this matter since I based my overall opinion on the fact that everyone had signed off on their respective areas?
Phil

-----Original Message-----
From: Rosenthal, Steven M
Sent: Friday, May 07, 1999 4:48 PM
To: Wiesner, Philip J
Cc: Springer, Mark A; Smith, Richard H (WNT); Watson, Mark T
Subject: Who is the Borrower in the BLIPS transaction

Phil,

As a follow-up to our meeting this morning, I wanted to outline my concerns on the "Who is the Borrower" issuer. My research suggests that this question turns on economic substance--and a "facts and circumstances" determination. My largest concern is that the BLIPS facts suggest that, in economic substance, the partnership, rather than the individual investor is the true borrower (assuming there is a debt). I believe the following facts are problematic: the investor is nominally the borrower for only a transitory period (7-10 days); the loan is non-recourse (the investor never assumes any personal liability); the investor does not control the proceeds (the proceeds are left in the bank) and the investor apparently has little investment discretion while it holds the funds; the investor presumably will earn a negative spread while it holds the proceeds; the bank--and all of the other parties to the transaction-- will look to the partnership, and not the investor, to repay the loan; the non-tax business reason for the investor to borrow the proceeds and convey the loan is not substantial (the purported reason, leverage, can be accomplished in or out of the partnership).

The case law (Plantation Patterns, NIPSCO, Aiken) emphasizes that the substance (which requires a non-tax business purpose), and not the form, of an arrangement is critical to answering the question of "Who is the Borrower." Thus, in NIPSCO, a back-to-back finance arrangement that provided the intermediary with dominion and control of the funds and a positive interest rate spread was upheld, but, in Aiken, an intermediary that earned no profit was not respected.

The S-corporation cases appear of limited value. In these cases, the individual actually borrows and enters into another loan agreement (and thereby remains liable on the original loan). In our case, the individual borrows and then conveys the assumed loan to the partnership (without a substantial change in its economic position). In addition, in these S corporation cases, the bank typically was unaware (and did not care) that the loan proceeds were relent (see, e.g., Bolding). In BLIPS, the bank (and the other parties) contemplate that the partnership, and not the investor, will repay the loan. Likewise, in Rev. Rul. 80-240, in a structure very similar to BLIPs (but, with a corporation and not a partnership, assuming a loan borrowed by an individual), the IRS determined that the individual would be ignored for federal income tax purposes because the individual was merely an intermediate agent (and there was no plan or intention for the individual either to own the property acquired with the loan proceeds or repay the loan proceeds).

Even if we could surmount these first two issues (i.e., a non-tax business purpose and the requirement that the parties look to the investor as the borrower), there are further hurdles to relying on these S-corporation cases. In Bergman v. U.S. (decided last month by the 8th Cir.), the court emphasized that "[l]oan transactions, like all transactions, must have independent economic substance to confer tax benefits on the parties [citations omitted]. The tax benefits of creating indebtedness thus may be set aside if the taxpayer's economic situation has not actually changed [citations omitted]. Actual indebtedness is created only where there is an economically significant change in the taxpayer's wealth; in other words, there must be an actual economic outlay that leaves the taxpayer poorer in a material sense [citations omitted]." In a non-recourse situation, like BLIPS, the investor appears no poorer, or at more risk, by serving as an intermediary, as compared to his exposure if the partnership had borrowed the proceeds directly.

Steve

Rosenthal, Steven M

From: Rosenthal, Steven M
Sent: Wednesday, August 04, 1999 9:44 AM
To: Watson, Mark T; Brockway, David H; Springer, Mark A; Ammerman, Douglas K
Subject: RE: BLIPS

Mark,

I share your concerns. We are almost finished with our technical review of the documents that you gave us, and will recommend some clarifications to address these technical concerns. We are not, however, assessing the economic substance of the transaction (i.e., is there a debt? who is the borrower? what is the amount of the liability? is there a reasonable expectation of profit?) I continue to be seriously troubled by these issues, but I defer to Phil Wiesner and Richard Smith to assess them.

Steve

-----Original Message-----
From: Watson, Mark T
Sent: Wednesday, August 04, 1999 9:25 AM
To: Brockway, David H; Springer, Mark A; Ammerman, Douglas K
Subject: BLIPS

Gentlemen, we are almost finished with our second review of the loan documents and LLC agreement related to BLIPS, and I anticipate that we will submit our final comments on these documents by the end of business today. The PFP practice will then begin implementing the BLIPS transaction, and we anticipate that approximately 80 transactions will be implemented before 12/31/99.

However, before engagement letters are signed and revenue is collected, I feel it is important to again note that I and several other WNT partners remain skeptical that the tax results purportedly generated by a BLIPS transaction would actually be sustained by a court if challenged by the IRS. We are particularly concerned about the economic substance of the BLIPS transaction, and our review of the BLIPS loan documents has increased our level of concern.

Nonetheless, since Richard Smith and Phil Wiesner -- the WNT partners assigned with the responsibility of addressing the economic substance issues associated with BLIPS -- have concluded that they think BLIPS is a "more-likely-than-not" strategy, I am prepared to release the strategy once we complete our second review of the loan documents and LLC agreement and our comments thereon (if any) have been incorporated.

Permanent Subcommittee on Investigations
EXHIBIT #13

Author: Mark A. Springer at KPMG_Dallas
Date: 5/26/98 10:27 PM
Priority: Normal
TO: Jeff Stein at KPMG_NYO_Tax2
TO: Walter M. Duer at KPMG_Houston
TO: Douglas K. Ammerman at KPMG_Orange_County
TO: Gregg W. Ritchie at KPMG_Warner_Center
Subject: Re: OPIS Tax Shelter Registration
------------------------------- Message Contents -------------------------------

Although some recent events may suggest a more focused attention on the part of the IRS/Congress with respect to what are perceived as abusive tax-oriented transactions (comments at public forum (don't remember the exact conference) by IRS executive re development by accounting firms of "tax products"; introduction of bipartisan legislation today to shut down the REIT liquidation strategy), I would still concur with Gregg's recommendation re registration under the old rules. If for some reason the IRS decides to "get tough" with someone vis-à-vis the old rules, I suspect it could easily pick on ANY of the Big 6, or for that matter any number of law firms/promoters -- I don't think we want to create a competitive DISADVANTAGE, nor do we want to lead with our chin.

Mark

______________________________ Reply Separator ______________________________
Subject: OPIS Tax Shelter Registration
Author: Gregg W. Ritchie at KPMG_WARNER_CENTER
Date: 5/26/98 3:55 PM

Please review the attached memoranda as soon as possible. It is imperative that we come to a collective decision immediately. I look forward to your response.

From /O=KPMG/OU=US/CN=RECIPIENTS/CN=18293
From: /O=KPMG/OU=US/CN=RECIPIENTS/CN=18293
To: /O=KPMG/OU=US/CN=RECIPIENTS/CN=20499
Subject: OPIS
Sent: 1998-12-07 23:39:17.649
Date: 1998-12-07 23:39:20.631
X-Folder: OPIS

To confirm my understanding of our phone discussion:

1. There will be no further proactive marketing of OPIS.

2. Through December 31, 1998, there can be reactive marketing of OPIS (i.e., if a client or target approaches us for ideas relating to reduction in capital gains taxes, we can discuss OPIS as a possible strategy).

3. After December 31, 1998, there will be no marketing of OPIS in any circumstances.

4. To the extent a client or target has been introduced to, and has expressed interest in, OPIS prior to January 1, 1999, we can assist with implementation of an OPIS strategy for that particular client or target during 1999. In order to monitor this grandfather rule, Jeff should obtain an inventory of all clients and targets who are said to have expressed in interest in OPIS prior to January 1, 1999.

All references to "OPIS" include the similar product for which Quadra is the investment adviser.

Larry

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #15

KPMG 0025730

Unknown

From:	Eischeid, Jeffrey A
Sent:	Wednesday, July 21, 1999 6:10 AM
To:	Comer, Michael S
Cc:	Ammerman, Douglas K; Green, Douglas J
Subject:	FW: National Accounts Database

The following is a draft "product pitch" similar to the one you forwarded me last month. Note that this product has received tentative DPP-Tax approval. It is still subject to Washington National Tax review of the underlying documentation to insure the documentation comports with various representations. That review is currently in process and should be completed some time this week or next week. To be conservative, you should probably wait for formal approval before distributing your email to National Account TSPs.

I'd like to talk to you about more specific targeting within the National Accounts list. This effort is going to be somewhat difficult given the breath of application of the BLIPS product.

Finally, I am not sure how to integrate the BLIPS product announcement with the broader PFP issue we discussed on the 14th. Specifically, if the priority of the TSPs is to enhance KPMG's relationships with the "C class", they should introduce their local PFP partner and the broad services that the PFP practice offers, e.g., tax return preparation, estate planning, stock option planning, retirement planning, etc. Innovative Strategies (formerly CaTS) is an integral part of that broad practice and is something like the icing on the cake. If the notion of a broad PFP relationship doesn't sell in a particular situation, we can at least offer key executives an introduction to Innovative Strategies. Innovative Strategies is a portfolio of value-added products that are designed to mitigate an individual's income tax as well as estate and gift tax burdens. BLIPS is just one of the products in the Innovative Strategies portfolio.

Jeff

********************** ACTION REQUIRED **********************

PRODUCT: BLIPS

CRITERIA: Individuals with:

- significant (> $20 million) capital gain income, e.g., sale of company stock, or
- significant (> $20 million) ordinary income, e.g., exercise of nonqualified options.

VALUE PROPOSITION: Reduce Federal and state tax liabilities by making tax advantaged investments in emerging markets currencies. Aside from trading profits, a key objective is for the tax loss associated with the investment structure to offset/shelter the taxpayer's other, unrelated, economic profits. This is a turnkey investment program that integrates the services of various parties including the investment advisor, legal/drafting, banking, and KPMG tax opinion. The all-in cost of the program, assuming a complete loss of investment principal, is 7% of the targeted tax loss (pre-tax). The tax benefit of the investment program, which ranges from 20% to 45% of the targeted tax loss, will depend on the taxpayer's effective tax rates.

FEE: BLIPS is priced on a fixed fee basis which should approximate 1.25% of the tax loss. Note that this fee is included in the 7% described above.

CONTACT:
Jeff Eischeid -Personal Financial Planning - Atlanta- 404/222-3180

KPMG 0006664

Permanent Subcommittee on Investigations
EXHIBIT #16

-----Original Message-----
From: Comer, Michael S
Sent: Tuesday, July 20, 1999 10:12 AM
To: Eischeid, Jeffrey A
Subject: National Accounts Database

<< File: NA720.xls >>
Jeff,

Attached is the current listing of National Accounts for the PFP analysis. It's not substantially different than the June 2 listing. Let me know if you need any other information.

Michael
212 872 6039

From /O=KPMG/OU=US/CN=RECIPIENTS/CN=11847
From: /O=KPMG/OU=US/CN=RECIPIENTS/CN=11847
To: /O=KPMG/OU=US/CN=RECIPIENTS/CN=20499
Subject: BLIPs
Sent: 1999-08-05 16:43:47.648
Date: 1999-08-05 16:43:48.435
X-Folder: Sales Assistance

FYI
Bill Goldberg

KPMG
700 Louisiana St, Suite. 3000
Houston, TX 77002
Telephone: 713-319-2143
Facsimile: 713-319-2040
e-mail: wgoldberg@kpmg.com

-----Original Message-----
From: Kearns, Paul M
Sent: Thursday, August 05, 1999 11:32 AM
To: Goldberg, William J
Cc: Beakley, William D
Subject: RE: BLIPs

Just so we are clear, I personally view it no greater than 15%

-----Original Message-----
From: Goldberg, William J
Sent: Thursday, August 05, 1999 10:37 AM
To: Kearns, Paul M
Cc: Beakley, William D
Subject: RE: BLIPs

Paul,

It is, for this firm, an aggressive strategy. Of course, there are other people approaching our clients with even more aggressive strategies. I see this as the client's decision with full disclosure on our part as to how aggressive they want to be. I wouldn't want to misjudge the client's risk tolerance to then find out they instead went to PwC or DLJ and don't understand why we didn't present any ideas to them.

Close call or not, this firm will still give a more likely than not opinion; I have no problem telling a client that we regard this as a 51% strategy and not a 52% strategy and let them decide where to go from there.

Bill Goldberg

KPMG
700 Louisiana St, Suite. 3000
Houston, TX 77002
Telephone: 713-319-2143
Facsimile: 713-319-2040
e-mail: wgoldberg@kpmg.com

Proprietary Material
Confidentiality Requested

KPMG 0028162

Permanent Subcommittee on Investigations
EXHIBIT #17

-----Original Message-----
From: Kearns, Paul M
Sent: Thursday, August 05, 1999 11:01 AM
To: Goldberg, William J
Cc: Beakley, William D
Subject: RE: BLIPs

Bill G:

"a close call" to get to "more likely than not" is not good enough for me to sell to a client

Paul

-----Original Message-----
From: Goldberg, William J
Sent: Thursday, August 05, 1999 10:01 AM
To: Kearns, Paul M
Subject: FW: BLIPs

FYI. This summarizes some of the BLIPS professional practice issues.
Bill Goldberg

KPMG
700 Louisiana St, Suite. 3000
Houston, TX 77002
Telephone: 713-319-2143
Facsimile: 713-319-2040
e-mail: wgoldberg@kpmg.com

-----Original Message-----
From: Carbo, Deke G
Sent: Thursday, August 05, 1999 8:06 AM
To: Goldberg, William J; Poage, Ray M
Subject: FW: BLIPs

Bill and Ray:

FYI

Deke

-----Original Message-----
From: Eischeid, Jeffrey A
Sent: Thursday, August 05, 1999 6:37 AM
To: Baumann, Dale; Belcher, Gregory; Bickham, Randall; Bloom, Richard; Carbo, Deke; Desany, Edmond; Eischeid, Jeffrey; Gray-RALEIGH, Mike; Hasting, Carl; Henderson, Tracie; Jordan, Robert; Lipschultz, Brent; Liston, Shannon; Mccrimlisk, George; Nuckolls, John; Pace, Katherine; Paule, Robin; Perez, Robert; Remo, DeeAnn; Rivkin, David; Shatzman, Janice; Slattery, Daniel; Smolin, Jay; Speiss, Timothy; Spitz, William; Warley, Carol; Watkins, B; Watson, Mark; Weems, Pamela; Zaudtke, David; Zysik, Jeffrey

Subject: FW: BLIPs

FYI

-----Original Message-----
From: Wiesner, Philip J
Sent: Wednesday, August 04, 1999 8:07 PM
To: Ammerman, Douglas K; DeLap, Larry; Springer, Mark A; Watson, Mark T; Eischeid, Jeffrey A; Smith, Richard H (WNT); Bickham, Randall S
Cc: Lanning, John T; Stein, Jeff; Lippman, Michael H; Wiesner, Philip J
Subject: BLIPs

The WNT team reviewing BLIPs has completed our review of the loan documents and LLC agreement related to BLIPs. If a BLIPs transaction is executed using these documents (with revisions provided to Randy Bickham) and the actual facts of the transaction comport with those in the fact and representation sections of the opinion, we believe that, while it is a close call, a "more-likely-than-not" federal tax opinion with respect to the transaction is, on balance, appropriate.

As we discussed, we anticipate that the PFP team will assure that the actual facts of each transaction are in accord with the facts and representations provided for in the opinion (for example, the client believes that there is a reasonable opportunity to earn a reasonable pre-tax profit in excess of transaction costs). Also, we expect that the following conditions established by Larry DeLap in his message dated May 18, 1999, approving the marketing of BLIPs will be satisfied:

1. BLIPS is to be marketed only to individuals. This includes a pass-through entity in which all the persons to whom attributes are passed through are individuals.

2. BLIPS is not to be marketed to corporations, nor to any pass-through entity that includes a corporation (other than an S corporation not subject to corporate tax on recognized built in gains or excess net passive income) as a member, partner, etc.

3. A member of the PFP Innovative Strategies group, or another person specifically designated by Doug Ammerman, is to be present at all presentations to prospective BLIPS clients.

4. A determination is to be made that a prospective BLIPS client has a high tolerance for investment risk and tax risk before presenting an engagement letter to the prospective client.

5. The attached memorandum on penalty issues is to be provided to a prospective BLIPS client prior to providing the prospective client an engagement letter.

6. The attached standard engagement letter is to be used on all BLIPS engagements. Minor revisions to the standard letter may be approved by the applicable Professional Practice Partner - Tax. Significant revisions require the approval of DPP-Tax.

7. Our prospective client evaluation process is to be followed for each BLIPS client who is not an existing KPMG client. Where a pass through entity is involved, this includes each member, partner, etc,. of the pass through entity.

8. Before the first BLIPS engagement letter is issued, Mark Watson and other relevant Washington National Tax personnel are to receive, review, and approve the intended language of the documents to be used. [This message satisfies this condition]

9. Mark Watson, or his designee, is to be involved in each BLIPS transaction to the extent necessary to determine that the underlying documentation and transactions are such that the contemplated opinion letter(s) can later be issued.

10. Mark Watson, or his designee, is to review and approve each opinion letter issued to a BLIPS client.

11. There will be an overall limit on the number of BLIPS engagements that can be sold. That overall limit is not being established at this time, but will be the subject of periodic discussions among Doug Ammerman, Jeff Eischeid, Mark Watson, and me [Larry DeLap].

12. Third parties (e.g., First Union) are not to be used a referral source or otherwise in connection with marketing of BLIPS without express advance permission of DPP-Tax.

13. If there is an intention to use Business Development Managers in connection with the marketing of BLIPS, the intended script and other aspects of the BDMs participation are to be approved in advance by DPP-Tax.

If there are other conditions that we have agreed to, or should agree to, that are not included in the above list, please let me [Larry DeLap] know.

Best regards,

Phil

From /O=KPMG/OU=US/CN=RECIPIENTS/CN=20499
From: /O=KPMG/OU=US/CN=RECIPIENTS/CN=20499
To: /O=KPMG/OU=US/CN=RECIPIENTS/CN=20499
Subject: BLIPS 2000
Sent: 1999-09-25 14:32:22.296
Date: 1999-09-25 14:32:22.375
X-Folder: BLIPS

A number of people are looking at doing BLIPS transactions to generate Y2K losses. We currently have bank capacity to have $1 billion of loans outstanding at 12/31/99. This translates into approximately $400 million of premium. This tranche will be implemented on a first-come, first-served basis until we fill capacity. Get your signed engagement letters in!!

This limitation does not apply to transactions implemented in 2000. However, at this point, we have not made decisions as to how many new Y2K deals (if any) that we will do. We are working hard on developing alternative or replacement products. Call or email me if you have any questions.

Jeff

Proprietary Material
:onfidentiality Requested

KPMG 0025828

Permanent Subcommittee on Investigations
EXHIBIT #18

Message0269	
Subject:	**FW: Hot Tax Products (5 Month Mission)**
From:	Wiesner, Philip J
Date:	2/3/2000 1:20:37 PM
To:	US-WNT Tax Partners
Message Body	

. Listed below are the tax products indentified by the functional teams as having significant revenue potential over the next few months. The list includes two additional items added since the original list. NOTE: PLEASE READ THE FOLLOW-UP MESSAGE AFTER THE PRODUCT LIST.

PRODUCT FUNCTIONAL TEAM

Tax Accounting Strategies (TAS) Tax Accounting

Contingent Liability Acceleration Strategy (CLAS) Tax Accounting

Credit Card Deferral Strategies (CARDS) Tax Accounting/FCS

Cash Flow Enhancement Strategies (CFES) Tax Accounting/Comp & Benefits

ACRA/SubACRA Tax Accounting/M&A

TEMPEST M&A

CREW - P M&A/Pass-throughs

Canadian Debt Opportunities (CANDO) M&A/ICS

CAMPUS M&A/ICS

301(b)(2) Dividend Reducer FCS

301(b)(2) Loss Generator FCS

KPMG 0050888

Permanent Subcommittee on Investigations
EXHIBIT #19

LADD FCS

ZEUS FCS

FLIP FCS/Pass-throughs

Corporate Partner Liquidation Strategy (CPLS) Pass-throughs

TAARP Mark Ely

RESTART (Employment Tax Refunds) SALT

Advantageous Compensation for Expatriates (ACE) Comp & Benefits/IES

InsureCo Insurance

WarrentyCo (WITS) Insurance

Reacquisition Charitable Remainder Trust (REACT) PFP

Global Leasing for Expatriate Employees (GLEE) IES

The list is in the process of being reviewed by Mark Springer and the Product Leaders to make sure that the proper items are on the list. When this is completed, the functional teams will need to WNT champions to work with the National Product champions to maximize the revenue generated from the respective products. Also, this list does not include any Tax Service Idea Bank initiatives. I know from working with the pass-throughs team that there are plenty of revenue generators that are currently in the Tax Service Idea Bank that need to be recharged. As of today I have only been copied on one functional team's plan with respect to the team plans to move our involvement forward.

In terms of the importance of WNT's efforts over the next 5 months, I would only point you to Jeff Stein's MUST READ memo of today on what we all must do to meet plan this year. You should note that WNT is specifically mentioned not only with respect to the list of strategies that have the greatest revenue potential, but also with respect to Tax Service Idea Bank initiatives and that all partners should temporarily defer non-revenue producing activities. To quote from Jeff's memo, "This is true of partners in Washington National tax as well as those in operating offices." We must work together to not only identify the best revenue generating initiatives, but also work on formulating the best way to get these intitiatives, in particular, many of the tax service idea bank items that from what I can ascertain curently get lost in the shuffle, in the hands of the right people. In many cases, we know who these people are from the course of our dealings around the firm. We can really make a difference as far as helping to increase the leverage of these initiatives!

Thanks for help in this critically important matter. As Jeff said, "We are dealing with ruthless execution - hand to hand combat - blocking and tackling." Whatever the mixed metaphor, let's just do it.

Outlook Header Information
Conversation Topic: Hot Tax Products (5 Month Mission) Subject: FW: Hot Tax Products (5 Month Mission) From: Wiesner, Philip J Sender Name: Wiesner, Philip J To: US-WNT Tax Partners Received By: Wiesner, Philip J Delivery Time: 2/3/2000 1:20:37 PM Creation Time: 2/3/2000 1:20:36 PM Modification Time: 2/14/2000 12:40:17 PM Submit Time: 2/3/2000 1:20:36 PM Importance: 2/1 Priority: 2/0 Sensitivity: 2/0 Flags: 2/33 Size: 2/9784

Message0005	
From:	Terracina, Michael P
Date:	4/21/2000 9:36:59 AM
To:	Choate, Gary M; Johnston, Michael L

Message Body

Here is the list as I know it. Please update often and forward to me.

I will have the relevant info input into the SC2 Outlook folder. Please make sure you can access that folder, because the toolkit info is being updated often.

Gary - I don't know if you were on Larry Manth's call today, but Rosenthal led the initial discussion. There have been several successes - the West and South Florida with many ICV's in other parts of the country. We are behind.

This is THE STRATEGY that they expect significant value added fees by June 30.

The heat is on.....

Mike

Attachment

SC2TARGETS.xls

Outlook Header Information

From: Terracina, Michael P
Sender Name: Terracina, Michael P
To: Choate, Gary M; Johnston, Michael L
Delivery Time: 4/21/2000 9:36:59 AM
Creation Time: 4/21/2000 9:36:58 AM
Modification Time: 4/21/2000 11:47:19 AM
Submit Time: 4/21/2000 9:37:01 AM
Importance: 4/1
Priority: 4/0
Sensitivity: 4/0
Flags: 4/17
Size: 4/32057

<u>SC^2 – Meeting Agenda June 19^{th}, 2000</u>

I. Introduction

Team_Members.doc

II. Overview of SC^2

SC2_Internal_Awarene ss_Present...

III. New Developme

IV. Feasibility/Implementation

Implementation.doc Workplan.xls FMV Valuation Model.xls

V. Exempt Organizations

TEOs.doc

VI. KPMG Coordination

SC2_coordination.doc

VII. Marketing

VIII. Frequently Asked Questions and Sticking Points

Frequently Asked Questions by ... sticking points.doc

IX. Status Update

X. Questions

XI. Challenge

<u>Permanent Subcommittee on Investigations</u>
EXHIBIT #21

SC² Team Members

Northeast

John Schrier (NY)	(212) 872-5906
Tim Speiss (NY)	(215) 299-5053

Midatlantic

Jim Duty (Richmond)	(804) 697-4210
Larry Silver (Philadelphia)	(215) 299-3119

Southeast

Mike Gray (Raleigh)	(919) 664-7130
Councill Leak (Charlotte)	(704) 371-8135

Midwest

David Cohen (Chicago)	(312) 665-5292
Craig Pichette (Chicago)	(312) 665-5267

Southwest

Mike Terracina (Houston)	(713) 319-2293
Carol Warley (Houston)	(713) 319-2180

West

Mark Hutchison (Warner-Center)	(818) 227-6904
Richard Wise (Sacramento)	(916) 554-1135

National

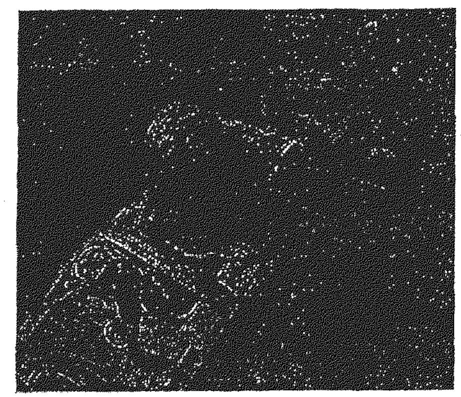
Andrew Atkin (Los Angeles)	(213) 955-8830
Doug Duncan (Los Angeles)	(213) 630-5376
Robert Huber (Los Angeles)	(213) 630-5378
Larry Manth (Los Angeles)	(213) 630-8101

WNT

Phillip Galbreath	(202) 533-4162
Bill Kelliher	(202) 533-3090

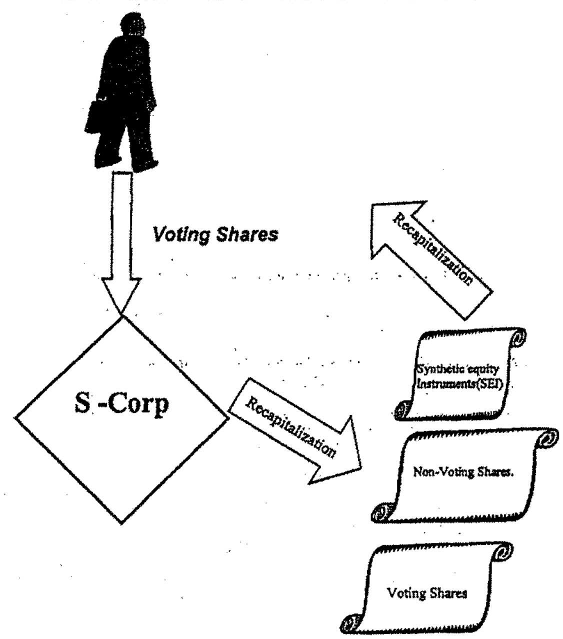
KPMG

S - Corporation Charitable Contribution Strategy (SC²)



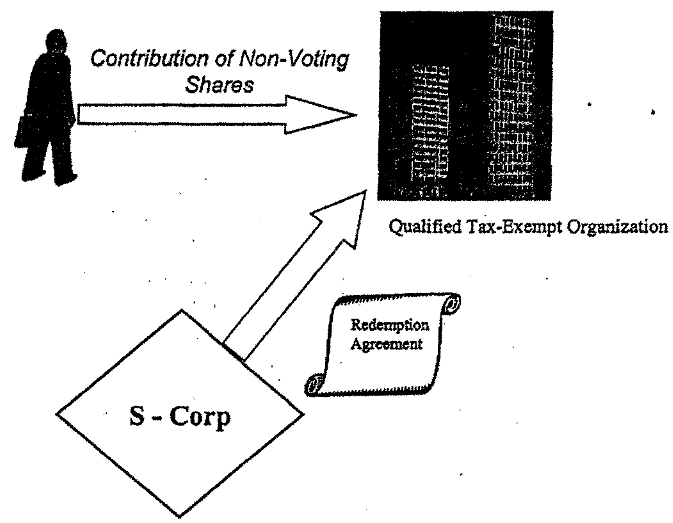
For Internal Use Only

SC^2 : *Illustration*



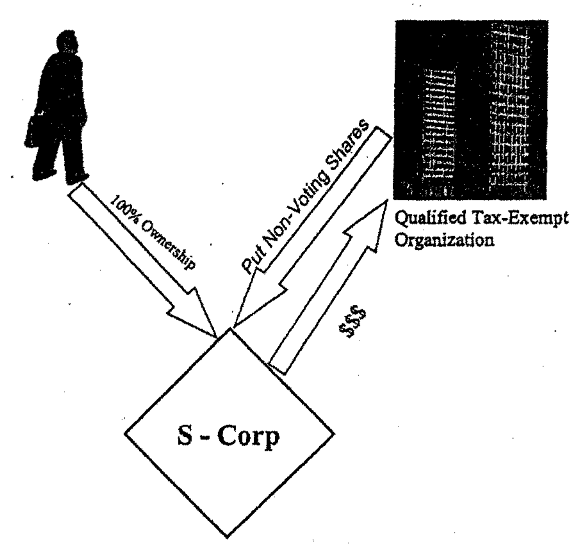
KPMG

SC² : Illustration



KPMG

SC² : *Illustration*



KPMG

KPMG 0013380

SC² - Implementation

- Taxpayer is a 100 percent owner of the common stock of S-corporation.
- S-corporation undergoes a recapitalization and issues non-voting stock (with the same liquidation and distribution rights as voting stock) and synthetic equity interests ("SEI") to the shareholder. The SEIs are not considered a second class of stock.
- After the recapitalization the taxpayer owns voting stock, non-voting stock, and SEIs.
- Taxpayer gifts the non-voting shares of stock to a qualified tax-exempt organization and receives a charitable contribution deduction.

KPMG

SC^2 - Implementation (cont)

- S-corporation and exempt organization enter into a stock redemption agreement whereby the exempt organization can demand that S-corporation re-acquire the non-voting shares at FMV (measured at time of contribution or at redemption).
  - *The exempt organization is prohibited from demanding redemption for a two year time period from the date that the agreement is executed. (Alternatively, a put option can be attached to the non-voting shares).*
- After the contribution, the exempt-organization is allocated a disproportionate amount of S-corporation profits with remaining profits allocated to shareholder.

SC^2 - *Implementation (cont)*

- For valid business purposes, the S-corporation will decrease its cash distributions during the tax-exempt shareholder's stock ownership.

- Later, the exempt organization decides to sell back the non-voting stock to the S-corporation at fair market value pursuant to the redemption agreement.

KPMG

SC^2 : Benefits

- Shareholder(s) can fulfill their charitable objective(s) and receive the tax benefits attributable to such donation
- Allows for the accumulation of tax-deferred earnings resulting from S-corporation operations for a short-time horizon
- Future distributions to shareholder(s) from the S-corporation (attributable to business operations) in excess of adjusted basis in stock generally taxed at capital gain rates and not at ordinary income rates
- Provides an excellent strategy to transfer wealth to younger generations

SC2 IMPLEMENTATION PROCESS

I. DUE DILLIGENCE/FEASIBILITY

a. **Determine Ownership structure.**
   i. How many shares are outstanding? Does the company already have nonvoting stock? Who owns the shares and in what amounts?
   ii. If any of the shares are owned by a trust, we need to review the trust agreement to make sure the non-voting stock can be contributed to the tax-exempt entity.
   iii. We will generally propose that 9 new shares be issued for each share outstanding to achieve our 90%/10% allocation.

b. **Benefit Analysis.**
   i. See "Assumptions" on first page of each workbook. These assumptions have been built into the model. Proceed with caution if any of these assumptions are not followed. Currently, the $500,000 minimum fee is not factored into the analysis' in Outlook if taxable income is less than $5 million per year.
   ii. This benefit analysis is meant to be an approximation of the expected benefit (e.g. it is impossible for KPMG to know the exact rate of return a client will return on its excess cash).

c. **Corporate issues** – we need to review copies of Articles of Incorporation, By Laws and any shareholder agreements. Make sure that there are no provisions in any corporate documents:
   i. requiring the Corporation to make dividends (e.g. to pay taxes);
   ii. allowing the corporation or other shareholders to redeem stock; or
   iii. giving shareholders indemnification for any actions;
      If any of these provisions exist, we will probably need to delete or alter them before the contribution.

d. **State law issues**
   i. Are the distributions proper under state law? Generally, certain financial tests must be met before distributions can be made. Generally not an issue because we are issuing additional securities, not assets of the company.
   ii. Does the state follow federal tax rules on S Corps?
      1. Is the tax-exempt a permissible shareholder?
      2. Same standards as federal for 2nd class of stock analysis?
   iii. Minority rights issues.

II. VALUATION

a. Valuation firm determines enterprise value of the company.
    i. Discounts to be used (lack of control, and lack of marketability)
b. We work with valuation firm to determine number and terms of the warrants to issue.
c. Valuation firm values the block of nonvoting stock that will be contributed.
d. Valuation firm also needs to value the warrants and voting stock separately, for purposes of basis allocation under Section 307. However, these values do not need to be a part of their report.

III. LEGAL DOCUMENTS

a. We supply draft legal documents to company's counsel for counsel to use in drafting the legal documents.
b. State securities law issues / filings. Certain filings may be necessary, including filing the amendments to the articles of incorp.

IV. TRANSFER OF STOCK

a. After all legal documents have been signed and finalized, the share certificates must be transferred to the tax-exempt. KPMG generally makes the delivery.
b. The tax-exempt will generally sign: 1) an acknowledgment of the gift; 2) the redemption agreement; and 3) give a representation as to its tax-exempt status.
c. The tax-exempt will return the stock certificates it received to the company's attorney for issuance of new certificates in the tax-exempt's name.

V. POST TRANSACTION

a. Issuance of opinion letters
b. Determine charitable contribution amount and whether shareholders will claim it.
c. Section 751 issues. If the company is a cash basis taxpayer or has significant income from long-term contracts, there may be significant reductions to the contribution amount.
d. Form 8283 must be signed by valuation firm and tax-exempt if shareholder will claim the deduction.

Tax-Exempt Organizations

I. KPMG's Role.

a. Work with the company owners to find a qualifying tax-exempt organization that will accept the donated stock
   i. This should be presented to the company owners as a process.
   ii. Most traditional tax-exempts that the owners have given to in the past will probably not work
b. Work with the company and its outside counsel to present the stock to the tax-exempt.
   i. Redemption agreement
   ii. Form 8283
   iii. Acknowledgement of acceptance

II. Pre-Screening.

a. If you are close to a signed deal, please contact me so that we can begin to search for a qualified tax-exempt.
b. KPMG processes. At this point we also perform our internal processes with respect to conflicts and independence issues (e.g. we coordinate on a national basis with the applicable KPMG tax-exempt professionals).
c. TEO's Outside Legal Counsel.

III. Contacting the Tax-Exempt.

a. Upon signing of the engagement letter
   i. Why do we wait until the engagement letter is signed?
      1. It is difficult to find qualifying tax exempts
      2. Of those that qualify only a few end up being interested and only a few of those will accept donations
      3. We need to be able to go to the tax-exempt with what we are going to give them to get them interested. It is very difficult to ask them to accept a donation that we are not sure of, i.e. open-ended.
      4. The tax-exempts must expend considerable time and resources they are not used to spending such as:
         a. Outside legal counsel (usually a written opinion)
         b. Internal review and support
         c. Possible Board and Subcommittee review and approval
b. Prior dealings. If the tax-exempt has already accepted stock in this transaction, we can contact the TE earlier in the process.

IV. Miscellaneous.

a. Non-resident TEOs
b. Problem states

SC² Coordination, Marketing, and Revenue Sharing Guidelines

With respect to our teleconference on May 31, the following is a list of guidelines to be followed for SC²:

1) **Previously identified opportunities.** All pre-ICVs and subsequent stage opportunities as of May 31, 2000 are the responsibility of the pre-June 1st team to complete. For example, if an initial discussion took place with Craig Pichette in the Midwest and a PFP partner in St. Louis regarding a PFP client, Craig will be responsible for the opportunity.

2) **PFP partners.** The PFP partners of the SC² team will be responsible for the following:
   a) Discussing SC² with all PFP partners and management group members within your applicable region.
   b) Identifying existing PFP relationships where SC² may be applicable.
   c) Coordinating new SC² leads with existing SC² product champions. There should be a joint effort to ensure that new leads are pursued in a coordinated effort. For example, in the West, Mark Hutchison and Richard Wise may agree that all new leads in Northern California, Oregon, Washington, and Montana are handled by Richard, and all others are handled by Mark.
   d) ICVs. At least the first two ICVs of the newly appointed PFP partner should be jointly attended by the existing regional product champion (or Larry Manth).

3) **Federal Tax Partners.** As mentioned above, Federal Tax partners will continue to be responsible for all pre-ICV and subsequent stage opportunities as of May 31, 2000. All new opportunities should be coordinated as discussed in 2 above.

4) **Rules for Implementation.**
   a) All projects will be implemented by Federal Tax.
   b) The first two projects sold in each region must be implemented in coordination with Los Angeles. Depending on the extent of involvement by Los Angeles, Los Angeles will receive time and expense or time and expense plus 33% of the premium.

5) **PFP Sales.** Opportunities identified and sold by PFP partners (beginning June 1, 2000) will be split as follows:
   PFP – 66% of the Premium.
   Federal Tax – Standard time and expense for implementation + 33% of the Premium.
   Example. Tim Speiss (PFP partner – Northeast) sells an SC² for $1 million. John Schrier and his team in New York implements the project with total time and expense of $100,000. PFP will be allocated $600,000 ($1 million less $100,000 time and expense, times 66%). Federal tax will be allocated $400,000 ($100,000 time and expense for implementation + 33% of the premium).

SC² – Appropriate Answers for Frequently Asked Shareholder Questions

Q1: What happens if the tax-exempt ("TE") does not want to redeem the stock to the S-corp?

A1: First, the longer the TE owns the stock, the more benefit the comr ny will receive (assuming the company continues to make money). Secondly, the TI . ɔuld have no reason not to sell the stock back, since the company is really its onl ce of liquidity (nobody will want the stock). Third, the only reason for the TE to the stock is to get cash. Also, the TE knows the deal prior to accepting the stock s a redemption agreement that discloses the warrants as well as the fact that no di ıs are required to be made.

However, if we assume the TE gets a new board, and the board wants to hold the company "hostage," the shareholders can exercise their warrants that can dilute the TE to less than 10%.

Q2: That's fine, but I need complete assurance that the TE will redeem.

A2: To guarantee 100% assurance, we can have the company issue an option to purchase the non-voting stock simultaneously with the issuance of the non-voting stock and warrants. However, the options must be either gifted or sold to an independent third party, not under the control of the shareholder(s). Since a private foundation has its own self-dealing rules, it should qualify to own the options.

The exercise price of the option must be at least 125% of the FMV of the underlying stock and the term must not overlap the put agreement with the TE. For example, if the put agreement is for 2 years, the option may be exerciseable in 4 years.

Keep in mind that an outstanding option will have the effect of lowering the likelihood of success of the transaction. However, if we abide by the above pricing and term, we should still get to a more likely than not opinion.

Q3: Wonder if my competitor discovers that the TE owns stock in my company and offers to purchase the stock at a substantial premium?

A3: First of all, it would be very difficult for your competitor to discover this information. Although certain states, such as Florida, has a public record law that could provide access to your competitor. Also, if your competitor purchased the stock, unless they had significant net operating loss carryforwards or did not care about cash, the liability associated with the stock ownership would be so substantial that the likelihood of such an event would be minimal.

However, if there is a concern, we recommend changing the legal name of the corporation (can also reincorporate or establish a holding company structure). We also would recommend a right of first refusal provision in the bylaws and stock certificates.

Finally, if the client is still concerned, have the corporation issue an option as discussed above.

Q4: What information do I need to send to the TE shareholder, e.g. financial statements, notice of shareholder meetings?

A4: Generally, depending on the particular state, the S-corp must send financial statements, tax information, and notice of shareholder meetings to the TE. However, under some circumstances, and depending on the state, the S-corporation could incorporate certain provisions in its bylaws which could restrict certain information to the TE.

Q5: What happens if we want to sell the business or go public?

A5: Although this strategy could work to absorb the gain on an asset sale, we do not recommend that you go forward if you have plans to sell the company. We also do not recommend that you implement this if you plan on going public.

Q6: What happens if we receive an exceptional offer to sell the business? Will the amount that the TE receive go up significantly?

A6: The SEI's ("Synthetic Equity Instruments") will receive most of the value, but obviously if the company were to receive an offer of,say, 4 times its original valuation, the TE's stock should be entitled to that increase as well. Our understanding, based on discussions with valuation professionals, is that if the proceeds of the sale are invested in marketable securities inside the S-corp, there will still be significant valuation discounts, so the non-voting stock should maintain its low value.

From a corporate law perspective, however, in certain states non-voting shareholders can vote on a major corporate transaction.

Q7: What types of tax-exempts have you used, and is there a local charity I can give to?

A7a: (Trusted clients) Due to confidentiality purposes, we cannot disclose the name of the charities. However, out of the greater than 200,000 tax-exempts in the U.S., less than 100 would be eligible and not all of those will consider owning S corp stock. The reason is that S-corporation income by definition is UBTI and therefore most tax-exempt entities will pay tax on S-corp holdings. There are some TEs, however, that are able to absorb UBTI for one reason or another. For example, 501(c)(3)'s with NOLs or some entities which are somehow related to a city or state government. The latter are typically not thought of as charities and will probably not be a charity that you have given to in the past.

At the appropriate time (after you are comfortable with the transaction), we can begin the discussion of applicable charities.

A7b: (Non-trusted clients and non-clients). Due to confidentiality purposes, we cannot disclose the name of the charities. However, out of the greater than 200,000 tax-exempts in the U.S., less than 100 would be eligible and not all of those will consider owning S corp stock. The reason is that S-corporation income by definition is UBTI and therefore most tax-exempt entities will pay tax on S-corp holdings. There are some TEs, however, that are able to absorb UBTI for one reason or another. For example, 501(c)(3)'s with NOLs. These entities will have deductions that can offset S-corp income, such as losses from other business enterprises. You may or may not have heard of them, but we can assure you that these entities are very substantial and very sophisticated.

At the appropriate time (after you are comfortable with the transaction), we can begin discussions of applicable charities.

Q8: Do you think I can give to my college, XYZ University?

A8: Most likely not, since colleges and universities are specifically subject to UBIT pursuant to the Internal Revenue Code.

Q9: Can you talk to our attorney about this?

A9: KPMG would be willing to meet with your outside counsel if you are seriously considering the transaction. However, we need to be assured that your attorney will not discuss this transaction with other outside parties. We obviously don't want this transaction publicized in some law journal. It is in your best interest to keep this low profile, i.e. this is not cocktail party banter.

Q10: Can I have my CPA review this?

A10: If your CPA does not work for a competitor (competitor includes Big 5, Moss Adams, and Grant Thornton) and will not communicate the strategy to one of our competitors, we can discuss this transaction with him or her. (see above explanation with outside counsel as well)

Q11: How many clients have you done this for?

A11: We have implemented 8 transactions and have several more in process.

Q12: What is my tax risk?

A12: The IRS may put forth a couple of arguments. First, the Service could argue that the warrants and/or non-voting stock represent a second class of stock. KPMG issues its strongest opinion with respect to second class of stock issues ("Should"), so we highly doubt that the Service would be successful in that argument. The second argument the Service could put forth is that the TE was never really the beneficial owner of the non-voting stock and therefore allocate all of the income back to the original shareholders.

The original shareholders would then pay tax (as they would have if they did not do this transaction) plus interest (presumably the use of the money exceeds the interest cost). The shareholders would then be out of pocket the cash paid to the TE plus transaction costs (both of which should be tax deductible).

Q13: Wonder if the IRS were to tax the TE, could the TE demand distributions from us to pay for the tax?

A13: First of all, this would probably go to court and the S-corp would be long gone. Also, the TE will receive an outside legal and tax opinion with respect to UBIT and other issues arising from holding the S-corp stock. However, if additional comfort is necessary, we suggest that client's counsel review the applicable state law. We can also protect against this by removing any language from the articles of incorporation and bylaws which require distributions to pay tax liabilities. The TE would have to prove that they were being discriminated against and were damaged by this discrimination. This risk should be minor and can be managed by proper due diligence in selecting the TE. This is one of the reasons all discussion with a TE are to go through the Los Angeles Office.

Q14: Will this transaction increase my risk of being audited, since last year I showed $5 million of taxable income and this year I will show $1 million of taxable income?

A14: This should not lead to an increased audit risk. Income is always subject to fluctuation, especially in recent years. Additionally, from an S-corporation perspective, there will not be a large schedule M item which could prompt an audit. The charitable deduction, depending on the amount, may be a large percentage of income that could possibly attract some attention. If there is a concern, one suggestion is to either forgo the deduction or aggressively apply section 751 to reduce the deduction.

Also, this transaction is very stealth. We are not generating losses or other highly visible items on the S-corp return. All income of the S-corp is allocated to the shareholders, it just so happens that one shareholder will not pay tax.

Q15: What do I get from KPMG?

A15: KPMG will issue four opinions (delivered in three opinion letters) with respect to the transaction. Two opinions are the highest level given by KPMG – Should, and opine with respect to second class of stock issues and that the TE is a qualified S-corporation shareholder. The other two opinions are more likely than not and are with respect to the charitable deduction and the allocation of income to the TE.

Q16: How do the new tax shelter regulations effect this transaction?

A16: We believe that the new regulations are not applicable and WNT is in the process of providing a written opinion to support this assumption. However, we cannot guarantee that subsequent regulations will not be written that effect this transaction.

Q17: How does 90% of outstanding stock represent less than 10% of the value of the company?

A17: There are two major reasons for this. First, since the company is privately held and closely held, the non-voting stock will receive significant discounts, such as lack of marketability, lack of control, and lack of voting rights. Secondly, the synthetic equities are deemed exercised and therefore are outstanding for valuation purposes, so the non-voting stock is valued on a fully diluted basis.

Q18: What are the costs?

A18: If the expected taxable income is in excess of $10 million, we can quote the transaction costs at 10% of first year's expected taxable income, all inclusive. If the expected taxable income is less than $10 million, we can quote the transaction costs as 10% of first years taxable income, plus valuation fees, plus outside legal fees.

Q19: How did you arrive at the 10% fee?

A19: The fee was determined by our WNT economists and takes into account the R&D effort (not only on this transaction but others that have not made it through the approval process), average costs per deal, expected busted deals, dry holes, KPMG risks, and many other factors. Additionally, KPMG will cap this transaction after completing a certain number of transactions.

Q20: Can we be subject to penalties?

A20: The opinion letters that we issue should get you out of any penalties. However, the Service could try to argue that KPMG is the promoter of the strategy and therefore the opinions are biased and try and assert penalties. We believe there is very low risk of this result. If you desire additional assurance, there is at least one outside law firm in NYC that will issue a co-opinion. The cost ranges between $25k - $40k.

<u>SC² – Sticking Points and Problems: Suggested Solutions.</u>

<u>1) "Too Good to be true."</u> -- Some people believe that if it sounds too good to be true, it's a sham. Some suggestions for this response are the following:

a) This transaction has been through KPMG's WNT practice and reviewed by at least 5 specialty groups (Pass-through, M&A, PFP, Tax-exempt, Employee Benefits, Valuation). Many of the specialists are ex-IRS employees.

b) Many sophisticated clients have implemented the strategy in conjunction with their outside counsel.

c) At least one outside law firm will give a co-opinion on the transaction.

d) Another transaction with some similar aspects which dealt with an ESOP was discovered by the Service and Congress. To attack the transaction, Congress has proposed some legislation on a prospective basis.

e) Absolutely last resort – At least 3 insurance companies have stated that they will insure the tax benefits of the transaction for a small premium. This should never be mentioned in an initial meeting and Larry Manth should be consulted for all insurance conversations to ensure consistency and independence on the transaction.

<u>2) "I Need to Think About it."</u> Many clients are extremely busy and need some time to think about the transaction. We obviously do not want to seem too desperate but at the same time we need to keep this moving along. Some suggestions:

a) "Get Even" Approach. Perhaps a good time to revisit the strategy is at or near estimated tax payment time when the shareholder is making or has made a large estimated tax payment and is extremely irritated for having done so. For a client, there should be another reason to call the shareholder (e.g. reminding them or asking them about the ES payment). For a non-client, you could update them with respect to the strategy (e.g. explain some of the new variations, like the insurance or call options – if you think these will help).

b) Beenie Baby Approach. This approach can be used to see if the shareholder is serious. We call the client and say that the firm has decided to cap the strategy (if we had not already said this at the ICV or subsequent meeting) and the cap is quickly filling up. "Should I put you on the list as a potential?" This is obviously a more aggressive approach, but will tell you if the client is serious about the deal.

c) "Break-up" Approach. This is a risky approach and should only be used in a limited number of cases. This approach entails us calling the client and conveying to them that they should no longer consider SC2 for a reason solely related to KPMG, such as the cap has been reached with respect to our city or region or we have been so successful with this strategy and the demand has been so great that the firm is shutting it down. This approach is used as a psychological tool to elicit an immediate response from the client. Use it cautiously...

3) Valuation Problems. Some attorneys have raised a concern over the valuation. The typical arguments are 1) the non-voting stock is valued incorrectly and/or 2) the warrants are valued incorrectly. Some responses:

a) Standard valuation procedures mandate that stock options and/or warrants are taken into account in valuing a company's equity. Therefore, the valuation of the non-voting stock is computed on a fully diluted basis. For S-corporation purposes, since the warrants are issued at least equal to 90% of FMV, they are not considered outstanding stock. If the attorney or CPA is not satisfied with this response, we can have them speak with a valuation professional.

b) To establish an exercise price of at least 90% of FMV, the company is valued (including discounts) and the warrant price is determined based on this value. Some attorneys have expressed a discomfort with respect to the warrant exercise price, saying that the price should reflect the deemed exercise of the warrants, so not to dilute the VALUE of the outstanding stock. This is a misconception of synthetic equities. Any existence of an option or warrant to purchase stock at below FMV will have a dilutive effect on both the value and ownership percentage of outstanding stock. If there is no dilutive effect on the value of the outstanding stock, options or warrants can never truly be issued to purchase stock at below fair market value, it is mathematically impossible!!!

4) The shareholders are thinking about selling the company. Recommend a gain mitigation strategy such as the newly approved short option strategy or HILO.

5) John F Brown Syndrome. This is named after an infamous attorney who could not get comfortable with anything about the strategy. We have had a number of clients with stubborn outside counsel with respect to the strategy itself, the engagement letter, or other aspects of the transaction. Here are some approaches:

a. If we have dealt with this particular attorney before and we know he will not approve of the transaction we should tell this to the client and either walk or convince the client not to use the attorney or law firm for this deal.

b. We have wasted a number of hours on the phone with stubborn attorneys on the technical aspects of the transaction. If we do not see the conversation progressing and start to get into a confrontational situation, we can politely excuse ourselves and ask the attorneys to address their concerns in writing and we will respond. This format will allow for the client to see (if they desire) both sides of the argument, rather than having a heated discussion that goes nowhere. We should already have most technical issues addressed and be able to respond fairly quickly (we have the competitive advantage here and should use this approach whenever possible).

c. If the fee is substantial, and the attorney is the critical factor in approving the strategy, the last resort is to summarize a transaction with all the possible bells and whistles to make the deal as risk-free as possible. For example: The client does SC2 with the following elements: 1) option to reacquire stock from TE, 2) insurance covering the tax benefits plus penalties (with number 1, not sure what the insurance would cover), and 3) outside opinion from an independent law firm. If the attorney is still uncomfortable, we need to convey this to the client and they can decide.

From: Jeff Stein (Vice Chair Tax)
Sent: Friday, July 14, 2000 11:59 AM
Subject: Distance Learning Sales Training

Date: July 14, 2000

To: Tax Partners and Tax Management Group

From: Jeff Stein - NSS/345 Park Avenue

Subject: ***Selling with Confidence: Skills for Successful Selling -- "Positioning"***
August 8th, 2000, 2:00 to 4:30 p.m. EDT

We have made a commitment to provide our tax partners and management group with a regimen of training to build, enhance, and accelerate the skills needed to excel in today's marketplace.

The latest phase of this training is the ***Selling with Confidence: Skills for Successful Selling*** distance learning series, which focuses on critical communications skills essential for success in the marketplace. The fourth session, ***Positioning***, will be held on **Tuesday, August 8th, from 2:00 to 4:30 p.m. EDT**. The session will focus on how to position your services and capabilities to meet client needs. The program will be interactive, and include opportunities to practice these skills using exercises and role-plays.

Our tax practice cannot grow at the pace we expect if our tax professionals do not possess the necessary knowledge and skills and model the behavior necessary for success in the marketplace.

I strongly encourage full participation for the August 8 session.

Registration Details

Please contact the Distance Learning Registrar at (888) ONE-HRSC (follow prompts to training menu, and then choose option 3, option 1 for Distance Learning) or e-mail the following information to: "*Distance Learning Registrar.*"

- Name
- 7 digit KPMG ID #
- Phone Number
- Home Office
- Name and Date of Class: *Selling with Confidence, Skills for Successful Selling*

Permanent Subcommittee on Investigations
EXHIBIT #22

XX-000017

- Session dates and times: *Positioning* - August 8th, 2000 2:00 - 4:30 (EDT)
- Site at which you will participate (see link to list of sites below)

Your registration will be confirmed via e-mail. Registrations received within 24 hours of the scheduled broadcast will not be confirmed.

Participate at the KPMG Distance Learning site most convenient for you.

A complete list of sites can be found at:
http://www.us.kworld.kpmg.com/newsite/ss/cld/kc/locationframe.html

Message0024	
Subject:	**Solution Activity Reports - SC2**
From:	Stein, Jeff (US/Vice Chairman)
Date:	8/6/2000 3:44:28 PM
To:	Atkin, Andrew S; Cohen, David-CHI; Duncan, Douglas P; Duty, James V; Gray, Mike - RALEIGH; Hutchison, Mark-Warner Cntr; Leak, Councill; Manth, Larry E; Pichette, Craig L; Schrier, John V; Silver, Lawrence G; Speiss, Timothy P; Terracina, Michael P; Warley, Carol G; Wise, Richard

Message Body

Date: August 6, 2000

To: National Deployment Champions

From: Jeff Stein
Rick Rosenthal

cc: Mark Springer
Marsha Peters

Subject: Solution Activity Reports

As National Deployment Champions we are counting on you to drive significant market activity. We are committed to providing you with the tools that you need to support you in your efforts. A few reminders in this regard.

The Tax Services Marketing and Research Support is prepared to help you refine your existing and/or create additional target lists. In some cases your team may have exhausted the initial list or you may have uncovered new parameters that help you better hone in on targets. Working closely with your National Marketing Directors you should develop the relevant prospect profile. Based on the criteria you specify the marketing and research teams can scour primary and secondary sources to compile a target list. This will help you go to market more effectively and efficiently.

Many of you have also tapped into the Practice Development Coordinator resource. Our team of telemarketers is particularly helpful in a number of respects:

- to further qualify prospects

- to set up phone appointments for you and your deployment team

Again to get the PDCs involved work through your National Marketing Director. They will help you conduct a training session for the PDCs, brief your area deployment champions and develop talk points for the PDCs and your team.

Finally tracking reports generated from OMS are critical to measuring your results. If you don't analyze the outcome of your efforts you will not be in a position to judge what is working and what is not. Toward that end you must enter data in OMS. We will generate reports once a month from OMS and share them with you, your team, Service Line leaders and the AMPs. These will be the focal point of our discussion with you when we revisit your solution on the Monday night call. You should also be using them on your bi-weekly team calls. I have attached a sample report for you. Expect that you will receive them every month from here on in.

Thanks again for assuming the responsibilities of a National Deployment Champion. We are counting on you to make the difference in achieving our financial goals.

Attachment
SC2 7-26.XLS

Outlook Header Information
Conversation Topic: Solution Activity Reports Subject: Solution Activity Reports - SC2 From: Stein, Jeff (US/Vice Chairman) Sender Name: Stein, Jeff (US/Vice Chairman) To: Atkin, Andrew S; Cohen, David-CHI; Duncan, Douglas P; Duty, James V; Gray, Mike - RALEIGH; Hutchison, Mark-Warner Cntr; Leak, Councill; Manth, Larry E; Pichette, Craig L; Schrier, John V; Silver, Lawrence G; Speiss, Timothy P; Terracina, Michael P; Warley, Carol G; Wise, Richard Received By: Schrier, John V Delivery Time: 8/6/2000 3:44:28 PM Creation Time: 8/6/2000 3:44:13 PM Modification Time: 8/6/2000 7:03:14 PM Submit Time: 8/6/2000 3:44:18 PM Importance: 8/1 Priority: 8/0 Sensitivity: 8/0 Flags: 8/17 Size: 8/141726

Message0174	
Subject:	FW: SW SC2 Channel Conflict
From:	Beakley, William D
Date:	11/17/2000 8:55:09 AM
To:	Warley, Carol G; Terracina, Michael P; Choate, Gary M

Message Body

I assume ya'll have reviewed this list & have an aggressive, organized approach to attacking this list.....

-----Original Message-----
From: Pullano, Jonathan C
Sent: Friday, November 17, 2000 9:01 AM
To: US-Southwest Tax Services Partners; Gilman, Tobin M; Bruce Meissner; Catherine Offerle; David Fisher; Donald Allison; Donald Moore; Keenan Carstens; Kirk Caldwell; Matthew Lavan; Melinda Dobbs; Nannon Roosa; Patricia Snyder; Richard Kirkpatrick; Richard Rollins
Cc: Scheffler, Kenneth J
Subject: FW: SW SC2 Channel Conflict
Importance: High

Attached is a list of SC2 targets in the Southwest that we are including in an upcoming telemarketing program. These targets are made up largely of auto dealers and home builders.

Please review and let me know if there are any targets on this list that you DO NOT want the PDC's to contact. Please respond by COB on Monday November 27, 2000.

If you have any questions, please let me know.

jp

Attachment

Companies_069313.xls

Outlook Header Information

Conversation Topic: SW SC2 Channel Conflict
Subject: FW: SW SC2 Channel Conflict
From: Beakley, William D
Sender Name: Beakley, William D
To: Warley, Carol G; Terracina, Michael P; Choate, Gary M

Received By: Terracina, Michael P
Delivery Time: 11/17/2000 8:55:09 AM
Creation Time: 11/17/2000 8:40:53 AM
Modification Time: 11/17/2000 8:55:09 AM
Submit Time: 11/17/2000 8:43:17 AM
Importance: 112
Priority: 111
Sensitivity: 110
Flags: 1117
Size: 11757649

From: Manth, Larry E
Sent: Friday, December 15, 2000 1:38 PM
To: Atkin, Andrew S; Bendheim, Redge E; Bergmann, Jeffrey K; Black, Suzanne J; Bottini, Wayne F; Boyar, Adam W; Choy, Susie K; Coughlin, Sean S; Cozart, Toby; Dougherty, Timothy M; Duncan, Douglas P; Gergen, Patricia A; Greenberg, David; Hacker, Barry C; Harrison, Mark E; Hirata, Masanori; Huber, Robert; Hutchison, Mark-Warner Cntr; Ida, Walter Y; Ito, Dennis A; Jackman, Thomas E; Kamahele, Dean B; Lytle, Norman W; Maxfield, W B; Mojica, Raquel M; Morris, Craig S; Murakami, Alton A; Orshansky, Anthony J; Prager, Daniel; Robideaux, Robert W; Shen, Stephanie L; Sparkman, James; Tom, Randall G; Turski, Douglas A; Walker, James D; Wilson, John H; Wise, Richard
Cc: Affonso, Dale A; Midlock, Eugene J; Songey, Jim H; Stone, Michael E
Subject: FW: STRATECON WEST -- KICK OFF PLAN FOR '01

Please find attached a list of solutions we will discuss on our call today at 3 pm.

Thanks,

Larry

```
USA Toll Free Number: 877-915-4783
PASSCODE: 40658

CALL DATE:       DEC-15-2000  (Friday)
CALL TIME:       03:00 PM PACIFIC TIME
```

Stratecon_Strategies.xls

-----Original Message-----
From: Manth, Larry E
Sent: Saturday, December 02, 2000 12:15 PM
To: Atkin, Andrew S; Bendheim, Redge E; Bergmann, Jeffrey K; Black, Suzanne J; Bottini, Wayne F; Boyar, Adam W; Choy, Susie K; Coughlin, Sean S; Dougherty, Timothy M; Duncan, Douglas P; Gergen, Patricia A; Greenberg, David; Harrison, Mark E; Hirata, Masanori; Huber, Robert; Hutchison, Mark-Warner Cntr; Ida, Walter Y; Jackman, Thomas E; Kamahele, Dean B; Lytle, Norman W; Maxfield, W B; Mojica, Raquel M; Morris, Craig S; Murakami, Alton A; Orshansky, Anthony J; Prager, Daniel; Robideaux, Robert W; Shen, Stephanie L; Sparkman, James; Tom, Randall G; Turski, Douglas A; Walker, James D; Wilson, John H; Wise, Richard
Cc: Affonso, Dale A; Midlock, Eugene J; Songey, Jim H; Stone, Michael E
Subject: STRATECON WEST -- KICK OFF PLAN FOR '01

Hello everyone. We will be having a conference call to kick-off our Stratecon marketing efforts to aggressively pursue closed deals by 6/30/01. The main purpose of the call is to discuss our marketing and targeting strategy and to get everyone acquainted with a number of Stratecon's high-end solutions. If you have clients, at least one of these strategies should be applicable to your client base. As you all know, to reach plan in the West, we must aggressively pursue these high-end strategies.

If there are others we need to add to the distribution list please send me an e-mail with their name(s) so I can include them.

The agenda is as follows:

1) Game plan on our marketing and targeting strategy.
2) Brief discussion of each strategy (you will receive a PowerPoint presentation prior to the call).
3) Roadshows.
4) Weekly calls.

Permanent Subcommittee on Investigations
EXHIBIT #25

XX-000021

We are planning this call for Friday December 15th from 3 pm to 5 pm. A dial-in number and passcode will be forthcoming. If you cannot attend or have any questions, please call me (213-630-8101) or send me an e-mail. I will also be contacting a number of you individually in the next week to discuss the agenda in more detail.

Thanks,

Larry

From: Manth, Larry E
Sent: Tuesday, March 13, 2001 12:07 PM
To: Alvarez, Adele M; Atkin, Andrew S; Baumann, Dale R; Bendheim, Redge E; Bergmann, Jeffrey K; Black, Suzanne J; Bottini, Wayne F; Boyar, Adam W; Brown, Brad L; Busick, Ronald L; Choy, Susie K; Coughlin, Sean S; Cozart, Toby; Curtis, Gary L; D'Addio, Michael R; De La Hoya, Raquel M; DeCredico, David G; Dougherty, Timothy M; Duncan, Douglas P; Frimershtein, Oleg; Garigliano, Thomas; Gergen, Patricia A; Greenberg, David; Hacker, Barry C; Harrison, Mark E; Hirata, Masanori; Huber, Robert; Hutchison, Mark-Warner Cntr; Ida, Walter Y; Ito, Dennis A; Jackman, Thomas E; Kamahele, Dean B; Kreutzer, Conrad B; Lytle, Norman W; Maxfield, W B; Mcgrath, Michael W; Morris, Craig S; Murakami, Alton A; Orshansky, Anthony J; Pace, Kevin A; Perez, Frank; Pfatteicher, Linda E; Prager, Daniel; Robideaux, Robert W; Shen, Stephanie L; Sparkman, James; Tafoya, Angela M; Takaki, Cheryl M; Tom, Randall G; Turski, Douglas A; Walker, James D; Wilson, John H; Wise, Richard
Cc: Songey, Jim H; Midlock, Eugene J; Affonso, Dale A; Stone, Michael E; Crawford, Russell W
Subject: Friday's Stratecon Call

This is a reminder that we will be having a call this Friday (March 16th) at 3 pm.

Due to the significant push for year-end revenue, all West Region Federal tax partners have been invited to join us on this call and we will discuss our "Quick Hit" strategies and targeting criteria.

A list of strategies will be sent prior to the call.

Thanks,

Larry

CALL DATE: MAR-16-2001 (FRIDAY)
CALL TIME: 3 PM PACIFIC TIME
TOLL FREE NUMBER: 877-915-4783
PASSCODE: 83658

Permanent Subcommittee on Investigations
EXHIBIT #26

XX-001437

From: Manth, Larry E
Sent: Wednesday, April 25, 2001 9:00 PM
To: Mccrimlisk, George H; Hasting, Carl D; Bickham, Randall S; Alvarez, Adele M; Atkin, Andrew S; Baumann, Dale R; Bendheim, Redge E; Bergmann, Jeffrey K; Black, Suzanne J; Boyar, Adam W; Brown, Brad L; Busick, Ronald L; Choy, Susie K; Coughlin, Sean S; Cozart, Toby; Curtis, Gary L; D'Addio, Michael R; De La Hoya, Raquel M; DeCredico, David G; Dougherty, Timothy M; Duncan, Douglas P; Frimershtein, Oleg; Garigliano, Thomas; Gergen, Patricia A; Greenberg, David; Hacker, Barry C; Harrison, Mark E; Hirata, Masanori; Huber, Robert; Hutchison, Mark-Warner Cntr; Ida, Walter Y; Ito, Dennis A; Jackman, Thomas E; Jordan, Ty N; Kamahele, Dean B; Kreutzer, Conrad B; Lytle, Norman W; Maxfield, W B; Mcgrath, Michael W; Morris, Craig S; Murakami, Alton A; Orshansky, Anthony J; Pace, Kevin A; Perez, Frank; Pfatteicher, Linda E; Prager, Daniel; Robideaux, Robert W; Robinson, Christopher J; Shen, Stephanie L; Shepherd, John; Sparkman, James; Tafoya, Angela M; Takaki, Cheryl M; Tom, Randall G; Turski, Douglas A; Walker, James D; Wilson, John H; Wise, Richard
Cc: Songey, Jim H; Affonso, Dale A; Crawford, Russell W; Stone, Michael E; Midlock, Eugene J
Subject: Friday's Stratecon Call

This is a reminder of our conference call this Friday (April 27th) at 3 pm (PST). Carl Hasting and Randy Bickham from PFP will have a high level discussion of two excellent tax minimization opportunities for individuals (this includes flow-through income from S-corporations). The strategies have a quick revenue hit for us, so I strongly suggest you try and make this call.

USA Toll Free Number: 877-915-4783
PASSCODE: 83658

Thanks,

Larry

Permanent Subcommittee on Investigations
EXHIBIT #27

XX-001438

Unknown

From: Eischeid, Jeffrey A
Sent: Wednesday, May 05, 1999 10:51 AM
To: Baumann, Dale; Bickham, Randall; Bloom, Richard; Carbo, Deke; Eischeid, Jeffrey; Hasting, Carl; Henderson, Tracie; Jordan, Robert; Lipschultz, Brent; Pace, Katherine; Pedersen, Robert; Rivkin, David; Speiss, Timothy; Warley, Carol; Watkins, B; Watson, Mark; Zaudtke, David; Zysik, Jeffrey
Cc: Ammerman, Douglas K; Springer, Mark A
Subject: Marketing BLIPS

Importance: High

Following is an extract of an excellent message Carol Warley sent to her fellow Houston partners (and managers):

> This past Friday and Saturday, Deke Carbo and I participated in a meeting which primarily focused on the status of our new investment strategy for clients with significant capital gain income (BLIPS). Although this tax product is not yet approved for marketing to clients, BLIPS was far enough along to conduct a meeting of the individuals who will be responsible for marketing.
>
> Some of the key points discussed in the meeting were:
>
> - BLIPS will have a $20 million minimum just like OPIS
> - ***DPP has indicated that we will only be able to do 50 BLIPS transactions***
> - Providing a copy of a draft opinion letter will no longer be done to assist clients in their due diligence process
> - Signed nondisclosure agreements will have to be obtained before any meetings can be scheduled
> - BLIPS cannot be done for a corporate client (this includes S corporations)
>
> Given the current limitation on number of transactions, it is imperative we identify, start to talk about and screen candidates now. Therefore, it is imperative that you talk to Deke or me about BLIPS prospects so we can fine tune our prospect list and immediately attempt to close these prospects once we get the go ahead to market BLIPS.

I believe it is entirely appropriate to prospect for opportunities. Unfortunately, it some instances the prospecting is being carried too far in light of the fact that we do not have approval for the product. For example, area PICs have been contacted/solicited and the assistance of BDM's has been enlisted (in no circumstance should a BDM work with the product). There is a fine line that we all have to tread between being ready to go to market when approval comes and jumping the gun.

Call me if you have any questions. Thanks.

Jeff

Unknown

From: Ito, Dennis A
Sent: Wednesday, May 05, 1999 1:09 PM
To: Eischeid, Jeffrey A
Cc: Ammerman, Douglas K; Hasting, Carl D
Subject: RE: BLIPS

Yep. I think this will satisfy Penelope (afterall, we hired her to identify and pre-qualify prospects for the PFP practice and gets paid based upon her ability to do so). As you know, there will likely be some PFP partners and senior managers/directors that will be "upset" by the directive. Some names that come to mind that have (in my judgement) the capabilities to present and deliver the BLIPS strategy (having proven themselves in other complex strategies, including OPIS) are George McCrimlisk, Robin Paule, Jack Nuckolls, and Shannon Liston. Again at the risk of stating the obvious, we are potentially handcuffing some of our best talent and essentially limiting their compensation (vis-a-vis incentive bonuses) and success by eliminating one significant tool in their tool box. By way of understatement, our folks are not happy with this directive.

If the question is where do we draw the line, given that the Western Area is now the largest area both from a Gross Revenue and Contribution standpoint and we happened to have some of the hottest markets in the country between Southern California and Northern California/Pacific Northwest, adding four more people to the BLIPS sales/implementation team should only help assure the successful deployment and implementation of this product. For example, if only Jack or Dale were allowed to sell TRACT, our prospects would be more than halved because we would not be as effective in covering network contacts within our geography. Isn't there some way we can be a bit more inclusive, rather than so absolutely exclusive?

Enough for now, thanks for listening!

Dennis

> -----Original Message-----
> **From:** Eischeid, Jeffrey A
> **Sent:** Wednesday, May 05, 1999 12:43 PM
> **To:** Ito, Dennis A; Hasting, Carl D
> **Cc:** Ammerman, Douglas K
> **Subject:** RE: BLIPS
>
> Dennis -
>
> Carl is absolutely "on the money" in describing our discussions and conclusions with respect to using BDMs to market BLIPS. They are to be used only to identify prospects. However, I recognize your special circumstances in having a well-trained, professional PFP BDM. In such case, I would imagine it is appropriate to have her pre-qualifying prospects as well as identifying prospects.
>
> The "training" is a bit of a red herring. One does not need to understand how the program is structured to determine whether someone has sufficient gain and has the tax risk appetite to do an OPIS/BLIPS type strategy. Obviously that's an overly simplistic and inflammatory comment!! However, it is fairly clear that we won't be putting out white papers, Tax Product Alerts, doing conference calls, etc. It will be word of mouth. DPP wants to insure that only "designated partners" make the client presentations on this strategy. That way, there is some assurance that a consistent, accurate message is conveyed to the client.
>
> Make sense?
>
> Jeff
>
>> -----Original Message-----
>> **From:** Ito, Dennis A
>> **Sent:** Wednesday, May 05, 1999 2:53 PM
>> **To:** Hasting, Carl D
>> **Cc:** Eischeid, Jeffrey A; Ammerman, Douglas K
>> **Subject:** RE: BLIPS
>>
>> Thanks for the info. I am not fully aware of the "limitations" imposed by Larry. Seems like some work is needed in

defining "trained". Is it fair to assume that whatever information I, or any partner/manager, will have related to BLIPS for purposes of identifying prospects and pre-qualifying leads will also be available to the BDMs? I suspect that Penelope, as with everyone in the practice, expects to know enough to understand what an appropriate target is and whether a follow-up meeting is appropriate. We all have been in too many "dead-end" meetings to know that a bit of pre-qualification goes a long way to efficient use of our limited time and respect for our client target's limited time. Also, I wonder if the comment regarding BDMs was made as relates to the generic BDM, rather than our BDM who specializes in PFP-only products.

Jeff - Any comments regarding our unique situation with a PFP-only BDM here in the Western area.

Thanks

-----Original Message-----
From: Hasting, Carl D
Sent: Wednesday, May 05, 1999 11:35 AM
To: Ito, Dennis A
Subject: BLIPS

Dennis:

You should know that at the task force meeting, it was made extremely clear that BDM's are not to be involved in the marketing of BLIPS. I do not believe they mean that the BDMs cannot and should not identify prospects. However, they are not to be trained on the product or be in a position to discuss even generally any of the technical or structural aspects of the product. You might want to clarify this with Eischeid or Ammerman.

I mention this because I get the impression that Penelope thinks she is going to be "trained" on the product.

See you this afternoon if you will be in Warner Center.

Carl

Unknown

From:	Eischeid, Jeffrey A
Sent:	Monday, September 13, 1999 6:05 AM
To:	'John Larson'; Eischeid, Jeffrey A; Bickham, Randall S
Cc:	bob pfaff; kbratton@presidioadv.com
Subject:	RE: BLIPS - managing deal flow

I'm in basic agreement with all of your comments. Kerry, are you available for today's KPMG Innovative Strategies conference call at 5 p.m. EST to discuss your flowchart and improvements to the KPMG side of the process?

-----Original Message-----
From: John Larson [SMTP:jlarson@presidioadv.com]
Sent: Saturday, September 11, 1999 9:48 PM
To: eischeid@kpmg.com; rbickham@kpmg.com
Cc: bob pfaff; kbratton@presidioadv.com
Subject: BLIPS - managing deal flow

Jeff/Randy-
As you know, we have until 10/15 at the latest to close loans and 10/22 to activate the FX trading etc. (the 60 day countdown). Currently we have approximately 25- 28 deals on our active list with another 25 or so on our "highly likely" list. Hence the total expected backlog is at least 50 deals. I know that your count gives a slightly higher number, perhaps indicating a backlog of 60. As of Friday, we had closed only 3 loans. This gives us only 5 weeks to complete all the closings.

We think it is possible to complete all the backlog in the available time if everything proceeds according to the closing schedules that Kerry developed. I am, however, very concerned about adding more deals to the already huge backlog. Therefore, my suggestion is to cut back on the sales effort, without closing the door on a few more significant deals. Accordingly, I propose that we raise the limit on new sales solicitations to deals of $50 or greater effective this Monday. I also suggest that we inform everyone that the limit will be raised again in 10 days or so to $100 (?).

I know this change will upset some KPMG partners who are still trying to set up more meetings. I also suspect that they will be even more upset if they sell a new deal now that we are unable to deliver. Those are the two choices I see.

Apart from limiting the addition of new deals, there are other incremental process changes that we have made and will continue to make. While this is really a subject for a more detailed discussion, I will note two ideas that I have discussed with Randy, Steve, and Kerry. First, we need to get key KPMG people in certain areas to liase very closely with Presidio and the clients/investors in their area. We have been experiencing problems with slow and incomplete turnaround of information requests and signature pages that could be mitigated by much closer local monitoring.

Second, as an experiment last week I spent a day working out of DB's New York office. I found that being there I was able to trouble shoot very effectively. This made me think that a temporary Presidio outpost at the bank might be helpful. Conceivably, stationing someone knowledgeable from KPMG at the bank might also be good.

John L.

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #29

KPMG 0005588

Unknown

From: DeLap, Larry
Sent: Friday, October 01, 1999 1:58 PM
To: Ammerman, Douglas K; Eischeid, Jeffrey A; Watson, Mark T
Subject: FW: BLIPS

Gentlemen -

We also agreed that:

18 OPIS "slots" were reserved for the intended BLIPS participants noted in the third paragraph below. To the extent those slots are not filled by the intended BLIPS participants, they may be offered to individuals who were on the "grandfathered" list of OPIS potential participants (those individuals to whom an OPIS presentation was made in 1998, but who did enter into an OPIS transaction). No more than 18 OPIS transactions will be entered into and they will be entered into only with persons from one of the two preceding groups.

A year 2000 BLIPS transaction may be entered into with respect to individuals to whom BLIPS has already been presented and whom have expressed an interest in a year 2000 BLIPS transaction. Jeff Eischeid has a list of such "grandfathered" BLIPS potential participants and will see that year 2000 BLIPS transactions are entered into only with persons on that list.

Larry

-----Original Message-----
From: DeLap, Larry
Sent: Friday, October 01, 1999 3:15 PM
To: Ammerman, Douglas K; Eischeid, Jeffrey A; Watson, Mark T
Subject: BLIPS

FW BLIPS Representations.rtf

Gentlemen -

I refer to condition #11 of the attached message relative to the marketing of BLIPS.

We have had various discussions thereon over the last nine days. My understanding of the discussions is that we have agreed that marketing of BLIPS has ceased and that no more BLIPS transactions will be marketed.

We also discussed a specified number of instances (less than 20) where an engagement letter had been concluded with a client for a BLIPS transactions, but a capacity problem arose with Presidio. We agreed that with respect to those particular identified clients, but only those clients, it would be permissible to enter into an OPIS engagement, assuming the client agreed to an OPIS engagement.

We further discussed a specified number of other instances (about 20) where a perceived commitment to a BLIPS transaction had been made, but an engagement letter had not been signed. We agreed that with respect to those particular identified clients as well as any clients mentioned in the preceding paragraph who do not enter into an OPIS engagement, but only those clients, it would be permissible to enter into a particular "enhanced BLIPS" transaction suggested by Randy Bickham, provided Washington National Tax approves the enhanced transaction from a technical standpoint.

If your understanding varies from the above, please get back to me.

Larry

Proprietary Material
Confidentiality Requested

KPMG 0003999

Permanent Subcommittee on Investigations
EXHIBIT #30

Close call

Unknown

From: Wiesner, Philip J
Sent: Wednesday, August 04, 1999 5:07 PM
To: Ammerman, Douglas K; DeLap, Larry; Springer, Mark A; Watson, Mark T; Eischeid, Jeffrey A; Smith, Richard H (WNT); Bickham, Randall S
Cc: Lanning, John T; Stein, Jeff; Lippman, Michael H; Wiesner, Philip J
Subject: BLIPs - Approval

The WNT team reviewing BLIPs has completed our review of the loan documents and LLC agreement related to BLIPs. If a BLIPs transaction is executed using these documents (with revisions provided to Randy Bickham) and the actual facts . the transaction comport with those in the fact and representation sections of the opinion, we believe that, while it is a close call, a "more-likely-than-not" federal tax opinion with respect to the transaction is, on balance, appropriate.

As we discussed, we anticipate that the PFP team will assure that the actual facts of each transaction are in accord with the facts and representations provided for in the opinion (for example, the client believes that there is a reasonable opportunity to earn a reasonable pre-tax profit in excess of transaction costs). Also, we expect that the following conditions established by Larry DeLap in his message dated May 18, 1999, approving the marketing of BLIPs will be satisfied:

1. BLIPS is to be marketed only to individuals. This includes a pass-through entity in which all the persons to whom attributes are passed through are individuals.

2. BLIPS is not to be marketed to corporations, nor to any pass-through entity that includes a corporation (other than an S corporation not subject to corporate tax on recognized built in gains or excess net passive income) as a member, partner, etc.

3. A member of the PFP Innovative Strategies group, or another person specifically designated by Doug Ammerman, is to be present at all presentations to prospective BLIPS clients.

4. A determination is to be made that a prospective BLIPS client has a high tolerance for investment risk and tax risk before presenting an engagement letter to the prospective client.

5. The attached memorandum on penalty issues is to be provided to a prospective BLIPS client prior to providing the prospective client an engagement letter.

6. The attached standard engagement letter is to be used on all BLIPS engagements. Minor revisions to the standard letter may be approved by the applicable Professional Practice Partner - Tax. Significant revisions require the approval of DPP-Tax.

7. Our prospective client evaluation process is to be followed for each BLIPS client who is not an existing KPMG client. Where a pass through entity is involved, this includes each member, partner, etc,. of the pass through entity.

8. Before the first BLIPS engagement letter is issued, Mark Watson and other relevant Washington National Tax personnel are to receive, review, and approve the intended language of the documents to be used. [This message satisfies this condition]

9. Mark Watson, or his designee, is to be involved in each BLIPS transaction to the extent necessary to determine that the underlying documentation and transactions are such that the contemplated opinion letter(s) can later be issued.

10. Mark Watson, or his designee, is to review and approve each opinion letter issued to a BLIPS client.

11. There will be an overall limit on the number of BLIPS engagements that can be sold. That overall limit is not being established at this time, but will be the subject of periodic discussions among Doug Ammerman, Jeff Eischeid, Mark Watson, and me [Larry DeLap].

12. Third parties ( ) are not to be used a referral source or otherwise in connection with marketing of BLIPS without express advance permission of DPP-Tax.

REDACTED

13. If there is an intention to use Business Development Managers in connection with the marketing of BLIPS, the intended script and other aspects of the BDMs participation are to be approved in advance by DPP-Tax.

If there are other conditions that we have agreed to, or should agree to, that are not included in the above list, please let me [Larry DeLap] know.

Best regards,

Phil

Unknown

From: Kerry Bratton [kbratton@presidioadv.com]
Sent: Wednesday, November 03, 1999 1:21 PM
To: eischeid@kpmg.com; tanapier@kpmg.com
Cc: John Larson; Steven Buss
Subject: RE:

We are working on that currently, as well.

Kerry Bratton
Presidio Advisory Services, LLC
Phone: (415) 284-7282
Fax: (415) 284-7284

>>> "Eischeid, Jeffrey A" <eischeid@kpmg.com> 11/03/99 01:16PM >>>
It occurs to me that it would be useful to know something about the investment performance as we call these clients to discuss their go forward strategy....

Jeff

> -----Original Message-----
> From: Kerry Bratton [SMTP:kbratton@presidioadv.com]
> Sent: Wednesday, November 03, 1999 3:12 PM
> To: eischeid@kpmg.com; tanapier@kpmg.com
> Cc: John Larson; Steven Buss
> Subject:
>
>
> As you may be aware, the 60-day anniversary of your client's participation
> in the Strategic Investment Fund is November 22nd. As a reminder for you
> and your client, we have summarized certain procedures that may be of
> interest.
>
> · Withdrawals are allowed on the 60th day after the initial contribution
> and on each subsequent 60-day anniversary.
>
> · Each withdrawing Class A Member should copy and complete Annex A
> (Withdrawal Request) from their copy of the Amended and Restated Limited
> Liability Company Agreement. If you cannot locate a copy, we can e-mail
> the document to you or the investor.
>
> · 10 business days prior to the withdrawal, the Withdrawal Request should
> be faxed to the Fund c/o Steven Buss/Kerry Bratton at Presidio Growth
> (415) 284-7284.
>
> · The original Withdrawal Request should be sent to the Fund c/o Presidio
> Growth LLC at 333 Hayes Street, Suite 200, San Francisco, CA 94102.
>
> We also need some information to enable us to properly execute withdrawal
> requests that we may receive. Please complete the attached "Information
> Sheet" and fax it to me as soon as possible at (415) 284-7284.
>
>
> Please contact me if you have any questions.
>
> Best regards,
>
> Kerry
>
>

REDACTED

Permanent Subcommittee on Investigations
EXHIBIT #31

>
> Kerry Bratton
> Presidio Advisory Services, LLC
> Phone: (415) 284-7282
> Fax: (415) 284-7284
> << File: T1_11_MEHInfo.xls >>

Generating Capital Losses

A Presentation for ________

KPMG Peat Marwick LLP

________, 1996

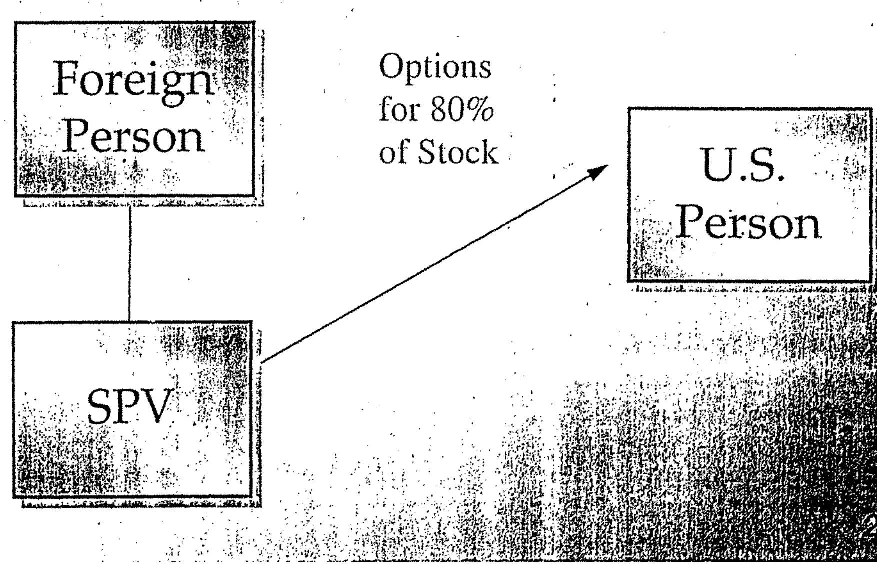
A 0063

Permanent Subcommittee on Investigations

EXHIBIT #32

UBS000325

Step 1-Sale of 80% Option in Special Purpose Vehicle (SPV)

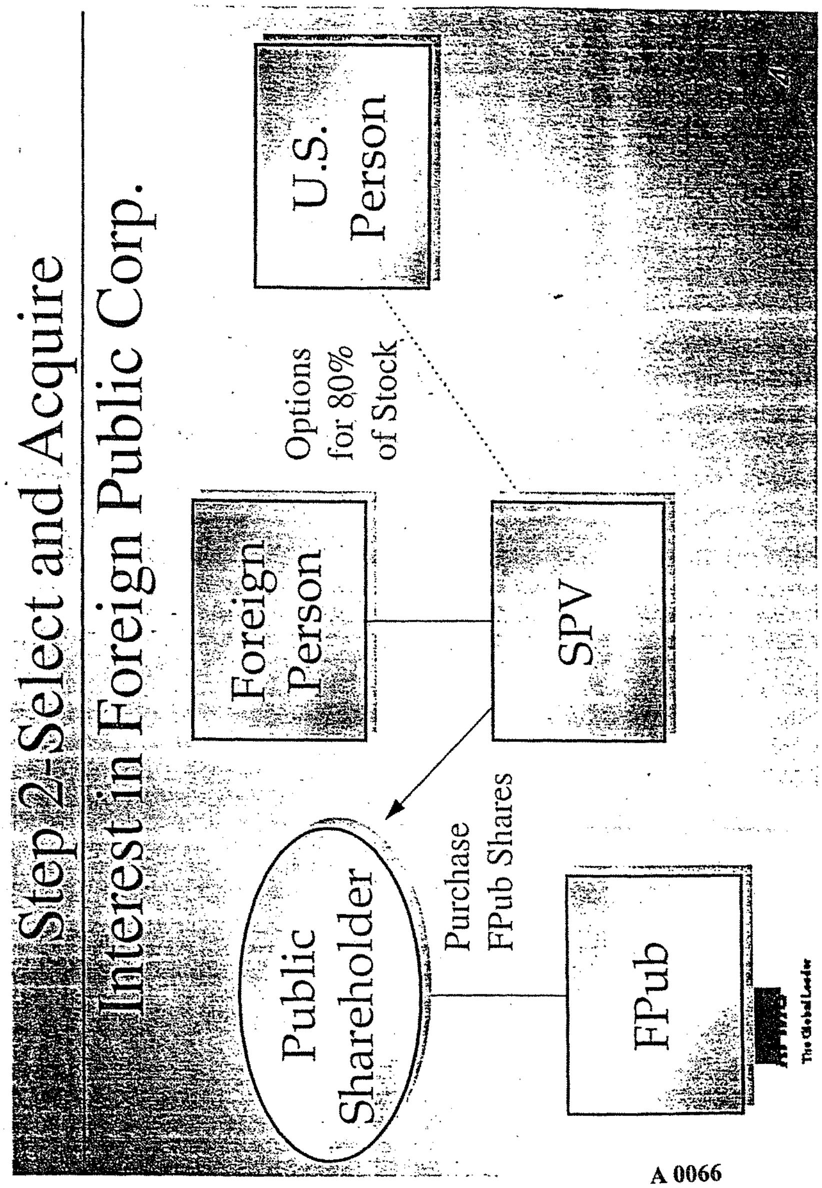


A 0064

Step 1-Sale of Option In Special Purpose Vehicle (SPV)

- Foreign Person creates Special Purpose Vehicle (SPV) to effect transaction.
- SPV borrows necessary cash.
- U.S. Person purchases options for 80% of SPV's stock.
- Options allow U.S. Person to be considered related to SPV and indirectly own shares held by SPV (see Step 3).

The Global Leader



A 0066

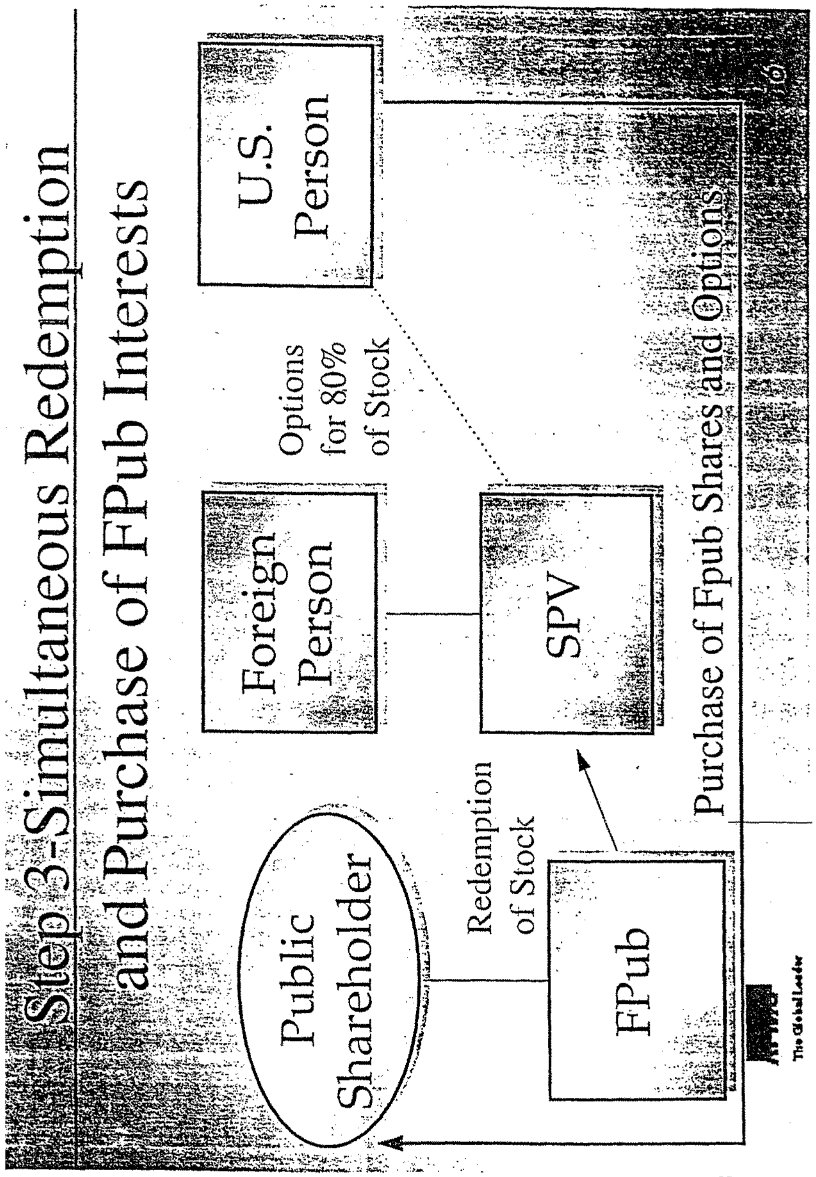
UBS000328

Step 2-Select and Acquire Interest in Foreign Public Corp.

- Select Foreign Public Corp. (FPub) that has willingness to redeem its own stock.
- SPV acquires shares in FPub from its public shareholders.

The Global Leader

A 0067



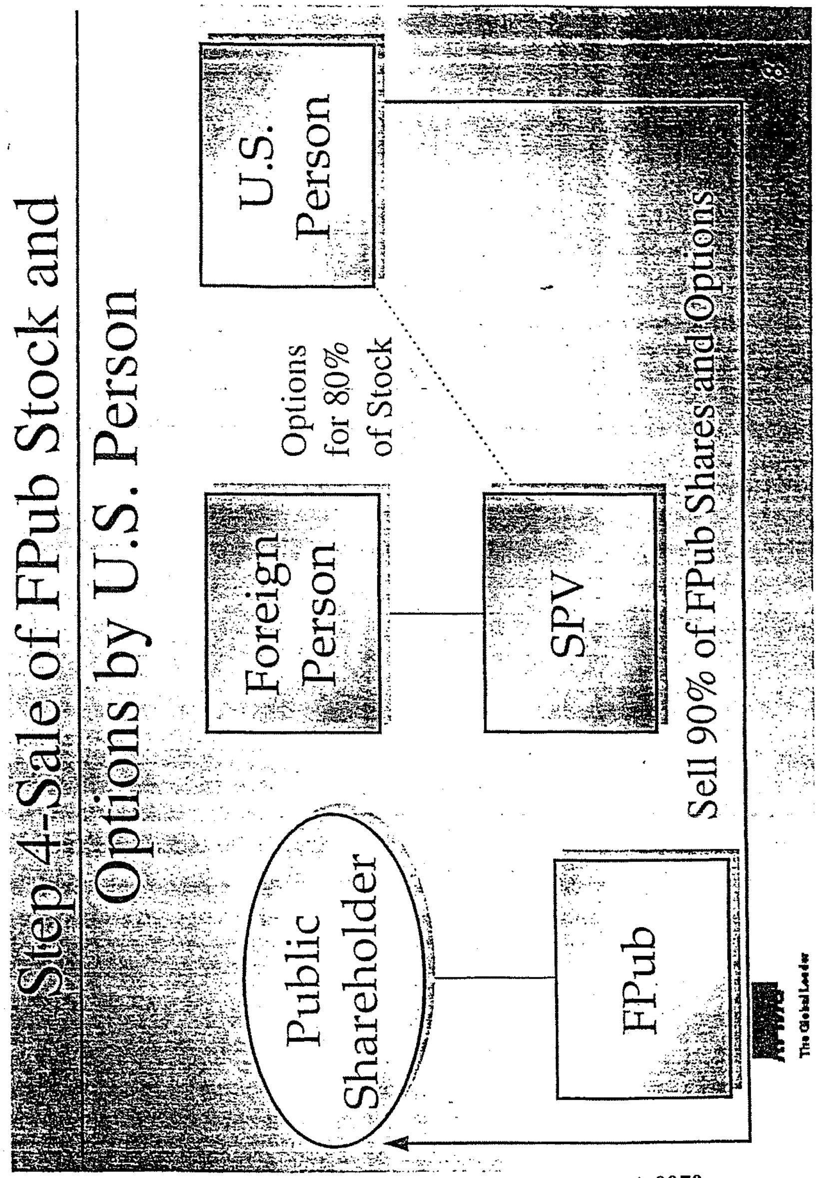
A 0068

UBS000330

Step 3-Simultaneous Redemption and Purchase of FPub Interests

- SPV sells its shares to FPub in accordance with the latter's agreement to redeem.
- Simultaneously U.S. Person purchases shares and options for shares in FPub equal to number of shares redeemed from SPV.
- Redemption of shares is deemed dividend to SPV; basis of SPV's shares in FPub is attributed to U.S. Person's FPub Stock and options.

The Global Leader


Step 4-Sale of FPub Stock and
Options by U.S. Person
Public Shareholder
FPub
Foreign Person
SPV
U.S. Person
Options for 80% of Stock
Sell 90% of FPub Shares and Options
8

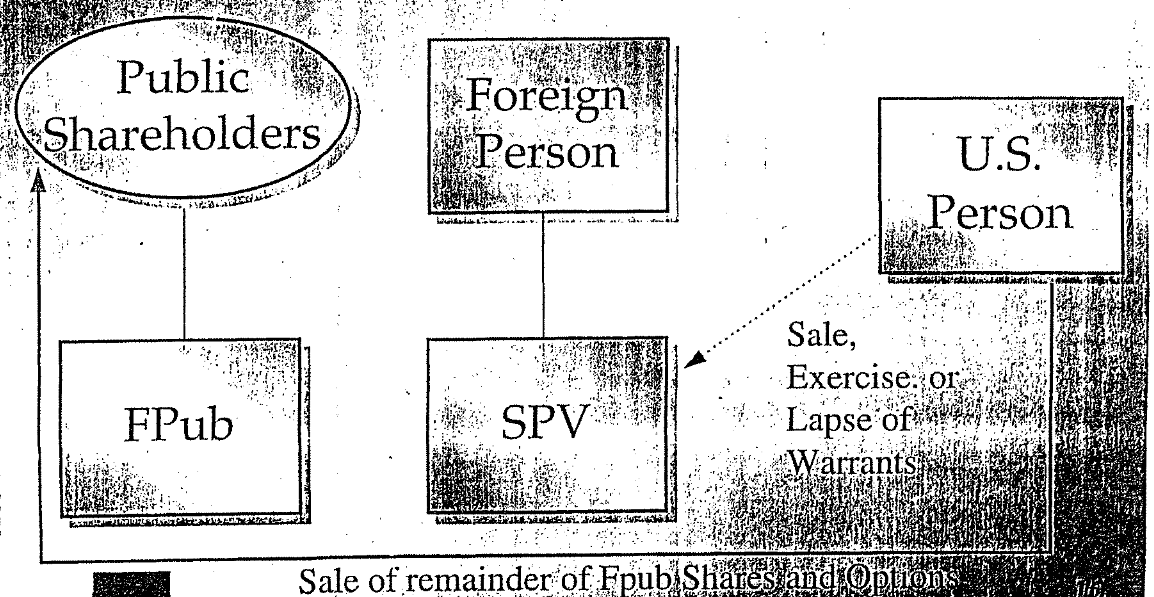
Step 4-Sale of FPub Stock and Options

- U.S. Person sells 90% of its FPub stock and options to public.
- U.S. Person recognizes capital loss on sale as a result of attribution of basis from SPV's redeemed FPub shares

The Global Leader

A 0071

Step 5- Sell Remainder of Fpub Stock and Options (Next Year)



The Global Leader

Accounting Consequences If US Person Is A Corporation

- No gain or loss recognized for accounting purposes.
- No deferred tax accounting consequences because capital loss is a permanent item.
- Possible F/S disclosure if exceeds 5% threshold

The Global Leader

Tax Consequences

- Section 1059 Extraordinary Dividend
- Application of Step Transaction Doctrine
- Section 318(a)(4) Warrant Attribution
- Section 1091 Wash Sale
- Section 302(b)(3) Redemption
- New Legislation
- Section 269

The Global Leader

A 0074

kpmg Peat Marwick LLP

Personal Financial Planning

To CaTS Team

Date June 17, 1998

From Gregg W. Ritchie
Warner Center

Steno cas
Ref p:\users\gritchie\wp\cats\jun11 fu.doc

cc Larry DeLap
Mountain View

June 11 OPIS Conference Call

The CaTS team held a conference call on June 11th to discuss several items associated with the OPIS strategy. The following is a list of the items discussed and certain follow-up required.

- ***Engagement letter.*** Larry DeLap has reviewed a draft of the engagement letter and certain changes are being made. We are still awaiting a response from DeLap and DPP Assurance related to the payment of the KPMG fee (in particular, the payer). Also, DeLap has requested that all engagement letters for OPIS be reviewed by him prior to execution by the client/target. GWR to follow-up with DeLap relative to the payment of our fees.

- ***Use of Nondisclosure Agreements.*** The standard Nondisclosure Agreement has been posted in the KMAN CaTS Conference in the OPIS file. It must be used in all cases when making a presentation to all clients/targets. Modifications to the agreement should be cleared with GWR or Zysik. Ideally, the agreement will be sent to the client/target in advance of the initial meeting.

- ***Referral fees.*** While KPMG policy may allow for the payment of referral fees to third parties who identify a target, payment should be discouraged in most cases. Referral fees will not be permitted in any cases where the target is already a KPMG client. As a general rule, the market for referral fees approximates 10% of the total fee paid by a client with respect to a tax strategy. Due to the sensitivity of this issue, proposed referral fees must be submitted to GWR along with a brief description of why the payment is warranted. GWR will clear with DeLap for appropriate cases. Referral fees will never be paid to existing KPMG audit clients. GWR to check with DeLap for additional firmwide guidelines (if any).

- ***Presidio capacity.*** Due to the long delay in obtaining approval of OPIS, it is likely that Presidio will be unable to immediately meet the client demand. Accordingly, CaTS team members should immediately submit to GWR the name and notional amount of clients/targets who are ready to initiate the strategy. We will consult with

Presidio and rank these opportunities by deal size and other relevant criteria. Presidio will make presentations and begin to set up accounts to clients/targets on the basis of this list (i.e., the "Organ Donor" List). CaTS team members must manage the expectations of the clients/targets relative to timing.

- ***Outside Advisors***. We should discourage clients/targets from having their incumbent lawyers/CPAs/etc. review the strategy from a technical perspective. This will help to prevent the spread of the strategy to competitors and other advisors who may not protect its confidentiality. Clients/targets may have full access to Brown & Wood should they wish to obtain input from a legal perspective. In those rare cases where the client/target will not proceed with OPIS without technical review by their advisors, CaTS team members should provide the name and affiliation of the advisor to GWR, Watson, or Bickham. In appropriate cases, the advisor may be included in the technical review provided they will execute our Nondisclosure Agreement. *This does not apply to investment advisors who are to provide the client/target with advice concerning the investment aspects of the strategy. Clients/targets are to be encouraged to seek such advice from outside investment advisors.*

- ***Presidio involvement and analysis***. To the extent possible, a representative from Presidio Advisors should be invited to attend every initial client visit. In some cases, this will not be possible. It is appropriate for KPMG personnel to be involved in the initial client meetings without Presidio, provided that no investment is made prior to the client/target meeting with Presidio. Furthermore, Presidio will provide to clients/targets an analysis of the expected profit from the investment transactions given the expected price movement of the stock *prior to the client/target's investment*.

- ***Tax Shelter registration***. The Firm has concluded that OPIS does not meet the definition of a tax shelter and, therefore, registration is not required under IRC section 6111(c). Any further inquiries on this subject should be referred to GWR.

- ***Legal documents***. Presidio is working with Brown & Wood and other lawyers in the drafting of the required legal documents. Furthermore, they are in the process of working with Deutche Bank (and their outside counsel) in drafting the required loan documents. Presidio has indicated they expect the drafting process to be completed by the third week in June.

kpmg Peat Marwick LLP

Page 3
CaTS Team
February 6, 2002

- *Reporting Requirements.* Robin Paule has drafted a memorandum concerning the reporting requirements relative to the OPIS investment on Form 5471. We have posted her memorandum to our KMAN conference. This memorandum will be expanded to include any other reporting responsibilities which may be imposed on the client/target. These requirements must be communicated to all clients/targets prior to their execution of the strategy (regardless of whether KPMG is their tax preparer).

- *Substantial underpayment penalties.* Our communication to clients/targets relative to potential substantial underpayment penalties must be accurate and consistent. Zysik and Bickham to review the provisions of Treasury Reg. 1.6662-4 and prepare a brief memorandum describing the use of our tax opinion letter to provide protection from penalties. This memorandum will be posted to our KMAN conference.

- *Prospective legislation.* It is possible that legislation will be enacted which will significantly impact or eliminate OPIS. John Gardner to coordinate the evaluation of the status of the legislation proposed by the Administration earlier this year and keep the team informed. In the event that there were a change in the tax law (or other relevant authority) which rendered the strategy ineffective and a client/target had not completed the strategy, it is unclear whether KPMG would be able to refund some or all of the fees paid by the client. GWR to follow-up with DeLap to see if such action would violate the rules relative to contingent fees. In any case, clients/targets must be informed in all initial client visits that the law in this area can change at any time and may have a severe impact on the strategy.

- *Face-to-face meetings.* The team agreed that all meetings with clients/targets related to OPIS will take place in person. There will be no meetings undertaken by telephone.

- *Representation letters.* To support the conclusions of our tax opinion letter, clients will be asked to sign a letter indicating their agreement with the facts stated in the opinion. Furthermore, they will be asked to sign a letter making certain representations to KPMG on which we will rely, in part, in reaching our conclusions. Clients/targets must be made aware of this requirement in all initial client visits (it will also be disclosed in the engagement letter).

- ***KPMG tax opinion letter.*** The tax opinion letter for each client will be prepared immediately following the execution of the strategy. The draft opinion letter will be forwarded to the engagement team which executed the strategy and they will modify it for the client's facts. The engagement team will obtain the client's concurrence with the factual section of the letter and their representation letter. Upon completion, the opinion letter will be forwarded to the technical team (to be named later) for their review. *Sample tax opinion letters will not be made available to clients or their advisors prior to execution of the strategy.*

Rosenthal, Steven M

From: Watson, Mark T
Sent: Thursday, July 22, 1999 9:26 AM
To: Smith, Richard H (WNT); Wiesner, Philip J
Subject: BLIPS -- Economic Substance Issue

Gentlemen, we have completed our review of the BLIPS loan documents. In general, these documents indicate that the loan proceeds will be invested in very safe investments (e.g., money market instruments). Thus, it seems very unlikely that the rate of return on the investments purchased with the loan proceeds will equal or exceed the interest charged on the loan and the fees incurred by the borrower to secure the loan.

The loan documents clarify that it is anticipated that there will be a negative spread on the loan proceeds, and the hope is that the portion of the equity contributed by the client that is invested in foreign currencies -- an amount equal to approximately 5% of the loan premium -- will generate a sufficient rate of return to offset the negative spread on the loan proceeds and the fees charged to enter into the transaction.

For example, assume the client borrows $100 million dollars at 16% and receives $150 million from the bank ($50 million of which represents a premium). Also assume that the $150 million is invested in instruments that generate a 5% annual rate of return. Thus, on an annual basis *and ignoring fees*, the client pays $16 million in interest expense ($100 million x .16) and receives $7.5 million in interest income ($150 million x .05). As a result, the client has a negative spread of $8.5 million before fees.

In an effort to offset this negative spread, the client will invest approximately $2.5 million ($50 million x .05) in foreign currencies. Before any fees are considered, the client would have to generate a 240% annual rate of return on the $2.5 million foreign currencies investment in order to break even. If fees are considered, the necessary rate of return to break even will be even greater.

This example also highlights the issue of how long the client reasonably intends to stay in the partnership/investment. Although the loan is structured as a seven-year loan, the client has a tremendous economic incentive to get out of loan as soon as possible due to the large negative spread.

Before I submit our *non*-economic substance comments on the loan documents to Presidio, I want to confirm that you are still comfortable with the economic substance of this transaction. I have committed to submitting our comments by 3:30 pm on Friday, July 23 (tomorrow).

Also, Richard, have you (or has your designee) had a chance to review the BLIPS LLC agreement I sent to you on July 16?

Permanent Subcommittee on Investigations
EXHIBIT #34

From: Eischeid, Jeffrey A
Sent: Thursday, May 18, 2000 7:50 AM
To: Warley, Carol G; Napier, Angie
Cc: Prescott, Peter A
Subject: RE: Brown & Wood BLIPS Opinion letters

No objection.

-----Original Message-----
From: Warley, Carol G
Sent: Wednesday, May 17, 2000 7:40 PM
To: Eischeid, Jeffrey A; Napier, Angie
Cc: Prescott, Peter A
Subject: FW: Brown & Wood BLIPS Opinion letters

FYI

Please let Peter know if you have any objections to him discussing these items with R.J. These affect the other opinion letters as well (I assume).

-----Original Message-----
From: Warley, Carol G
Sent: Wednesday, May 17, 2000 6:30 PM
To: Prescott, Peter A
Subject: FW: Brown & Wood BLIPS Opinion letters

Peter, can you please discuss these items with R.J. at Brown & Wood. thanks

-----Original Message-----
From: Watson, Mark T
Sent: Tuesday, May 16, 2000 10:14 AM
To: Warley, Carol G
Subject: RE: Brown & Wood BLIPS Opinion letters

Carol, yes, I think you should ask Brown & Wood to make the changes indicated in Peter's message. Quality work by B&W, eh?

-----Original Message-----
From: Warley, Carol G
Sent: Monday, May 15, 2000 6:29 PM
To: Watson, Mark T
Subject: FW: Brown & Wood BLIPS Opinion letters

Mark, let me know after you have the chance to look at this. I would like to go back to RJ and get some changes made, agree?

-----Original Message-----
From: Prescott, Peter A
Sent: Tuesday, May 09, 2000 11:36 AM
To: Warley, Carol G
Subject: Brown & Wood BLIPS Opinion letters

Carol,

Here are the more significant errors that I found in the Brown & Wood BLIPS Opinion letters. Typos that are not critical (such as omission of the word "of" or "Court") are not listed. As you know, there are quite a few of these "non-critical" typos.

<u>Financial Instrument Opinion Letter</u>

Permanent Subcommittee on Investigations
EXHIBIT #35

- Opinion Summary 1 (page 12) attempts to put together two distinct ideas in one sentence and ends up saying something completely different. The two concepts are that the Investor will recognize no gain or loss upon receipt of the Loan proceeds (including the Premium) and that the Premium is an amount that should be amortized against the Investor's interest expense over the life of the Loan. The current sentence appears to state that the *Loan proceeds* are an amount that should be amortized against the Investor's interest expense. This statement is incorrect because the note is a balloon note.
- Page 21 contains the sentence "As stated in representation 3 above, Trust has represented that it has not and will not elect to integrate the Loan and the Swap under Treas. Reg. 1.1275-6." In the opinion letter I was reviewing, there was no trust involved in the transaction. Furthermore, the Investor did not make a representation similar to "representation 3" regarding the integration of the Loan and Swap.
- Page 36 contains footnote 38 discussing the tax treatment of a modification to a debt instrument that triggers an exchange under IRC 1001. Despite the fact that this footnote contains amounts that relate to the "instant case," it was identical in all the opinion letters I reviewed. The $100 million and $150 million dollar amounts mentioned were not appropriate for any of them.
- Page 44 contains the statement that, under IRC 1222(1)-(4), gain or loss from the sale or exchange of a capital asset is a capital loss.
- Page 70 contains an internal reference to an earlier discussion of the <u>Cottage Savings Association</u> case. The case is not discussed anywhere in the Opinion.
- Page 74 contains a reference to "foreign currency" distributed to the Investor. The Investor did not receive any foreign currency. Note that the sentence containing this reference is hopelessly garbled and is missing critical words like "distributed."
- The Opinions that I received did not contain either the Presidio Confidential Memorandum or their Analysis of Financing Alternatives. Both of these attachments are referenced in the Opinion.

<u>Foreign Currency Opinion Letter</u>

- All of the above errors are also contained in the Foreign Currency Opinion Letter (except for the errors on pages 44 & 74). Some of the page numbers may have changed.
- On Page 30, Revenue Rulings are "interrupted" instead of "interpreted." (This one isn't that serious, but it is pretty funny.)
- Pages 43-44 contain a citation from IRC 988. This is the citation B&W used in their Short Option opinion letter and is not really appropriate for our clients. In particular, the last line "(iii) Entering into or acquiring any...option..." does not fit. Furthermore, the citation in the first sentence after the citation should be "Section 988(c)(1)(C)(i)".

As we discussed, the B&W opinion letters touch all the necessary bases. The fact and representation sections are almost identical to the ones in our Opinion and many analysis sections are exact copies of our Opinion. Please let me know if you want further details about the "non-critical" typos.

Peter Prescott
Personal Financial Planning
KPMG LLP
Phone: 713-319-3212
Fax: 713-319-2040
email: pprescott@kpmg.com

new

From: Napier, Angie
Sent: Tuesday, July 20, 1999 7:48 AM
To: Eischeid, Jeffrey A
Subject: FW: brown&wood

Jeff,

I think that 48 hours is a bit optimistic for B&W to issue their opinions. They have issued about half of the 98 OPIS opinions, but the norm has not been 2 days. R.J.'s schedule is full and he is in London next week.

Angie

-----Original Message-----
From: Gray, Mike - RALEIGH
Sent: Tuesday, July 20, 1999 10:04 AM
To: Napier, Angie
Subject: FW: brown&wood

assume more B&W opinions to follow

-----Original Message-----
From: Eischeid, Jeffrey A
Sent: Tuesday, July 20, 1999 9:29 AM
To: Gray, Mike - RALEIGH
Subject: RE: brown&wood

For the most part, yes. If you have a KPMG opinion, you should also have a B&W opinion. We do ours and they use it as a factual template for their opinion, usually within 48 hours.

Jeff

-----Original Message-----
From: Gray, Mike - RALEIGH
Sent: Sunday, June 20, 1999 9:43 AM
To: Eischeid, Jeffrey A
Subject: brown&wood

have their opinion letters been delivered re 1998 OPIS transactions?

Internal Revenue bulletin

Bulletin No. 2000–36
September 5, 2000

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 2000–41, page 248.
Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for September 2000.

T.D. 8896, page 249.
REG–103735–00; REG–110311–98;
REG–103736–00, page 258.
Proposed and temporary regulations modify the disclosure, registration, and list maintenance requirements relating to tax shelters under sections 6011, 6111, and 6112 of the Code.

T.D. 8897, page 234.
Final regulations under section 263A of the Code provide guidance relating to the application of the uniform capitalization rules to property produced in the trade or business of farming. Notices 87–76, 88–24, and 88–86 (section V) obsolete.

Notice 2000–44, page 255.
Tax avoidance using artificially high basis. Taxpayers and their representatives are alerted that the purported losses arising from certain types of transactions are not properly allowable for federal income tax purposes. Also, the Service may impose penalties on participants in these transactions or, as applicable, on persons who participate in promoting or reporting these transactions.

Notice 2000–45, page 256.
Capitalization; business expenses; farmers. This notice provides guidance to taxpayers engaged in the trade or business of farming in determining whether a plant has a preproductive period in excess of 2 years for purposes of section 263A(d) of the Code.

Rev. Proc. 2000–33, page 257.
Acquisition of corporate debt. This procedure provides guidance on whether an acquisition of corporate debt by a beneficiary of the decedent creditor's estate or by a beneficiary of a revocable trust that became irrevocable upon the creditor's death is a direct acquisition within the meaning of section 1.108–2(b) of the regulations.

EMPLOYEE PLANS

Announcement 2000–77, page 260.
This announcement provides guidance on the types of plan amendments that may be needed to obtain a favorable determination letter for volume submitter plan applications.

ADMINISTRATIVE

T.D. 8896, page 249.
REG–103735–00; REG–110311–98;
REG–103736–00, page 258.
Proposed and temporary regulations modify the disclosure, registration, and list maintenance requirements relating to tax shelters under sections 6011, 6111, and 6112 of the Code.

Announcement 2000–76, page 260.
The Service expects to post planned changes to the 2001 Forms W-2 and W-3 on the IRS web site by mid-October 2000. Earlier drafts are being modified in response to public comments.

Finding Lists begin on page ii.
Announcement of Disbarments and Suspensions begins on page 262.
Index for August begins on page iv.

Department of the Treasury
Internal Revenue Service

Permanent Subcommittee on Investigations
EXHIBIT #37

Part III. Administrative, Procedural, and Miscellaneous

Tax Avoidance Using Artificially High Basis

Notice 2000–44

In Notice 99–59, 1999–52 I.R.B. 761, the Internal Revenue Service and the Treasury Department described certain transactions that were being marketed to taxpayers for the purpose of generating artificial tax losses. This notice concerns other similar transactions that purport to generate tax losses for taxpayers.

As stated in Notice 99–59, a loss is allowable as a deduction for federal income tax purposes only if it is bona fide and reflects actual economic consequences. An artificial loss lacking economic substance is not allowable. See *ACM Partnership v. Commissioner*, 157 F.3d 231, 252 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999) ("Tax losses such as these . . . which do not correspond to any actual economic losses, do not constitute the type of 'bona fide' losses that are deductible under the Internal Revenue Code and regulations."); *Scully v. United States*, 840 F.2d 478, 486 (7th Cir. 1988) (to be deductible, a loss must be a "genuine economic loss"); *Shoenberg v. Commissioner*, 77 F.2d 446, 448 (8th Cir. 1935) (to be deductible, a loss must be "actual and real"); § 1.165–1(b) of the Income Tax Regulations ("Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.").

Notice 99–59 describes an arrangement that purported to give rise to deductible losses on disposition of stock by applying the rules relating to distributions of encumbered property to shareholders in order to create artificially high basis in the stock. The Service and the Treasury have become aware of similar arrangements that have been designed to produce noneconomic tax losses on the disposition of partnership interests. These arrangements purport to give taxpayers artificially high basis in partnership interests and thereby give rise to deductible losses on disposition of those partnership interests.

One variation involves a taxpayer's borrowing at a premium and a partnership's subsequent assumption of that indebtedness. As an example of this variation, a taxpayer may receive $3,000X in cash from a lender under a loan agreement that provides for an inflated stated rate of interest and a stated principal amount of only $2,000X. The taxpayer contributes the $3,000X to a partnership, and the partnership assumes the indebtedness. The partnership thereafter engages in investment activities. At a later time, the taxpayer sells the partnership interest.

Under the position advanced by the promoters of this arrangement, the taxpayer claims that only the stated principal amount of the indebtedness, $2,000X in this example, is considered a liability assumed by the partnership that is treated as a distribution of money to the taxpayer that reduces the basis of the taxpayer's partnership interest under § 752 of the Internal Revenue Code. Therefore, disregarding any additional amounts the taxpayer may contribute to the partnership, transaction costs, and any income realized or expenses incurred at the partnership level, the taxpayer purports to have a basis in the partnership interest equal to the excess of the cash contributed over the stated principal amount of the indebtedness, even though the taxpayer's net economic outlay to acquire the partnership interest and the value of the partnership interest are nominal or zero. In this example, the taxpayer purports to have a basis in the partnership interest of $1,000X (the excess of the cash contributed ($3,000X) over the stated principal amount of the indebtedness ($2,000X)). On disposition of the partnership interest, the taxpayer claims a tax loss with respect to that basis amount, even though the taxpayer has incurred no corresponding economic loss.

In another variation, a taxpayer purchases and writes options and purports to create substantial positive basis in a partnership interest by transferring those option positions to a partnership. For example, a taxpayer might purchase call options for a cost of $1,000X and simultaneously write offsetting call options, with a slightly higher strike price but the same expiration date, for a premium of slightly less than $1,000X. Those option positions are then transferred to a partnership which, using additional amounts contributed to the partnership, may engage in investment activities.

Under the position advanced by the promoters of this arrangement, the taxpayer claims that the basis in the taxpayer's partnership interest is increased by the cost of the purchased call options but is not reduced under § 752 as a result of the partnership's assumption of the taxpayer's obligation with respect to the written call options. Therefore, disregarding additional amounts contributed to the partnership, transaction costs, and any income realized and expenses incurred at the partnership level, the taxpayer purports to have a basis in the partnership interest equal to the cost of the purchased call options ($1,000X in this example), even though the taxpayer's net economic outlay to acquire the partnership interest and the value of the partnership interest are nominal or zero. On the disposition of the partnership interest, the taxpayer claims a tax loss ($1,000X in this example), even though the taxpayer has incurred no corresponding economic loss.

The purported losses resulting from the transactions described above do not represent bona fide losses reflecting actual economic consequences as required for purposes of § 165. The purported losses from these transactions (and from any similar arrangements designed to produce noneconomic tax losses by artificially overstating basis in partnership interests) are not allowable as deductions for federal income tax purposes. The purported tax benefits from these transactions may also be subject to disallowance under other provisions of the Code and regulations. In particular, the transactions may be subject to challenge under § 752, or under § 1.701–2 or other anti-abuse rules. In addition, in the case of individuals, these transactions may be subject to challenge under § 165(c)(2). See *Fox v. Commissioner*, 82 T.C. 1001 (1984). Furthermore, tax losses from similar transactions designed to produce noneconomic tax losses by artificially overstating basis in corporate stock or other property are not allowable as deductions for federal income tax purposes.

Appropriate penalties may be imposed on participants in these transactions or, as applicable, on persons who participate in the promotion or reporting of these transactions, including the accuracy-related penalty under § 6662, the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701.

Transactions that are the same as or substantially similar to the transactions described in this Notice 2000–44 are identified as "listed transactions" for the purposes of § 1.6011–4T(b)(2) of the Temporary Income Tax Regulations and § 301.6111– 2T(b)(2) of the Temporary Procedure and Administration Regulations. See also § 301.6112–1T, A-4. It should be noted that, independent of their classification as "listed transactions" for purposes of §§ 1.6011–4T(b)(2) and 301.6111–2T(b)(2), the transactions described in this Notice 2000–44 may already be subject to the tax shelter registration and list maintenance requirements of §§ 6111 and 6112 under the regulations issued in February 2000 (§§ 301.6111–2T and 301.6112–1T, A-4), as well as the regulations issued in 1984 and amended in 1986 (§§ 301.6111–1T and 301.6112–1T, A-3). Persons required to register these tax shelters who have failed to register the shelters may be subject to the penalty under § 6707(a) and to the penalty under § 6708(a) if the requirements of § 6112 are not satisfied.

In addition, the Service and the Treasury have learned that certain persons who have promoted participation in transactions described in this notice have encouraged individual taxpayers to participate in such transactions in a manner designed to avoid the reporting of large capital gains from unrelated transactions on their individual income tax returns (Form 1040). Certain promoters have recommended that taxpayers participate in these transactions through grantor trusts and use the same grantor trusts as vehicles to realize the capital gains. Further, although each separate capital gain and loss attributable to a portion of a trust that is treated as owned by a grantor under the grantor trust provisions of the Code (§ 671 and following) is properly reported as a separate item on the grantor's individual income tax return (see § 1.671–2(c) and the Instructions to Form 1041, U.S. Income Tax Return for Estates and Trusts), the Service and the Treasury understand that these promoters have advised that the capital gains and losses from these transactions may be netted, so that only a small net capital gain or loss is reported on the taxpayer's individual income tax return. In addition to other penalties, any person who willfully conceals the amount of capital gains and losses in this manner, or who willfully counsels or advises such concealment, may be guilty of a criminal offense under §§ 7201, 7203, 7206, or 7212(a) or other provisions of federal law.

The principal authors of this notice are David A. Shulman of the Office of Associate Chief Counsel (Passthroughs and Special Industries) and Victoria S. Balacek of the Office of Associate Chief Counsel (Financial Instruments and Products). For further information regarding this notice, contact Mr. Shulman at (202) 622-3080 or Ms. Balacek at (202) 622-3930 (not toll free calls).

List of Plants, Grown in Commercial Quantities in the United States, Having a Preproductive Period in Excess of Two Years Based on the Nationwide Weighted Average Preproductive Period for Such Plant

Notice 2000–45

PURPOSE

This notice provides guidance to taxpayers engaged in the trade or business of farming in determining whether a plant has a preproductive period in excess of 2 years for purposes of § 263A(d) of the Internal Revenue Code. This guidance is derived from the nationwide weighted average preproductive period for various plants grown in commercial quantities in the United States.

BACKGROUND

Section 263A requires generally that the direct costs and an allocable share of indirect costs of real or tangible personal property produced by a taxpayer be capitalized. Under § 263A, taxpayers generally are required to capitalize the costs of producing property in a farming business (including animals and plants without regard to the length of their preproductive period).

Sections 263A(d) and (e) set forth special rules for property produced in the trade or business of farming. Under § 263A(d)(1) and § 1.263A–4(a)(2) of the Income Tax Regulations, taxpayers neither required by § 447 to use an accrual method nor prohibited by § 448(a)(3) from using the cash method ("qualified taxpayers") are not required to capitalize the costs of producing plants that have a preproductive period of 2 years or less or animals. In addition, under § 263A(d)(3) and § 1.263A–4(d), a qualified taxpayer may elect to have § 263A not apply to the cost of producing plants in a farming business. Thus, unless an election is made to have § 263A not apply in accordance with § 263A(d)(3), qualified taxpayers generally are required to capitalize the costs of producing plants that have a preproductive period in excess of 2 years.

Section 263A(e)(3)(B) and § 1.263A–4(b)(2)(i)(B) provide that, for purposes of determining whether a plant has a preproductive period in excess of 2 years, the preproductive period of plants grown in commercial quantities in the United States must be based on the nationwide weighted average preproductive period for such plants. The legislative history of § 263A explains that Congress expected the Treasury Department to periodically publish a list of the preproductive periods of various plants based on the nationwide weighted averages for such plants. *See* H.R. Rep. No. 426, 99th Cong., 1st Sess. 628 (1985), 1986–3 (Vol. 2) C.B. 628. A proposed list was included in the preamble of the proposed § 1.263A–4 regulations (62 FR 44542). The Internal Revenue Service and Treasury Department received and considered comment letters relating to this proposed list.

Based upon information provided by the United States Department of Agriculture, the Service Treasury Department have determined that plants producing the following crops or yields have a nationwide weighted average preproductive period in excess of 2 years:

almonds, apples, apricots, avocados, blackberries, blueberries, cherries, chestnuts, coffee beans, currants, dates, figs, grapefruit, grapes, guavas, kiwifruit, kumquats, lemons, limes, macadamia nuts, mangoes, nectarines, olives, oranges, papayas, peaches, pears, pecans, persimmons, pistachio nuts, plums, pomegranates, prunes, raspberries, tangelos, tangerines, tangors, and walnuts.

PFP Practice Reorganization

Innovative Strategies Business Plan – DRAFT (May 18, 2001)

History

Before looking forward to the proposed operating structure and business plan for fiscal year 2002, it might be helpful to look back at the relatively brief history of the Capital Transaction Services (CaTS) practice, which was later renamed the Innovative Strategies (IS) practice. In 1997 Gregg Ritchie formed CaTS around the Foreign Leveraged Investment Program (FLIP) capital loss strategy. The initial revenue goal was $4 million and the practice delivered $11 million in fiscal '98.

After calendar1997, DPP retired the FLIP strategy leaving Ritchie (before his 1998 retirement from the Firm), Randy Bickham and Jeff Eischeid to devise a replacement capital loss strategy, the Offshore Portfolio Investment Strategy (OPIS). The fiscal '99 IS revenue goal was $18 million and the practice delivered $28 million. The practice's success was largely attributable to OPIS revenue generated in calendar '98.

After calendar 1998, DPP retired the OPIS strategy leaving Bickham, Eischeid and Mark Watson (WNT) to devise a replacement strategy, the Bond Linked Issue Premium Structure (BLIPS). The fiscal '00 IS revenue goal was $38 million and the practice delivered $52 million (without accruals). Again, the success was largely attributable to a single strategy, BLIPS. It is noteworthy that the strategy was very flexible in that it generated either capital or ordinary losses (or both).

After calendar 1999, DPP retired the BLIPS strategy leaving Eischeid to devise a replacement strategy. At that time, we decided to approach the market in two segments. First, we attempted to market a boutique arranger's strategy on a "program" basis without a KPMG MLTN opinion. In this regard we selected the Short Option Strategy (SOS) offered by both Presidio and Helios. Second, we attempted to develop and market a "customized solution" approach to the upper end of the market where deal sizes typically exceed $100 million and KPMG fees typically exceed $1 million.

The fiscal '01 IS revenue goal was $38 million and the practice has delivered $16 million through period 10. The shortfall from plan is primarily attributable to the August 2000 issuance of Notice 2000-44. This Notice specifically described both the retired BLIPS strategy and the then current SOS strategy. Accordingly, we made the business decisions to stop the implementation of "sold" SOS transactions and to stay out of the "loss generator" business for an appropriate period of time. In addition, it is noteworthy that the softening in the overall economy (e.g. the decline in new IPO's, the devaluation of technology stock valuations, etc.) adversely effected our ability to broadly sell our Monetization Tax Advisory Services suite of solutions.

Definition & Focus

The Innovative Strategies practice has grown to loosely encompass any "value-added" strategy or idea offered to individual clients by the PFP practice. These strategies vary widely from income tax strategies to estate and gift tax strategies and philanthropic strategies. Going forward, the practice will narrow its focus to those strategies meeting the Tax Innovation Center definition of "solution" and to those strategies for which a national deployment group is appropriate.

Current solution offerings meeting this definition include Monetization Tax Advisory Services and Leveraged Private Split Dollar. The Innovative Strategies lab has several other strategies under development and/or review that would significantly expand the practice's revenue generation potential.

The first of these is a gain mitigation solution, POPS. Judging from the Firm's historic success in generating revenue from this type of solution, a significant market opportunity obviously exists. We have completed the solution's technical review and have almost finalized the rationale for not registering POPS as a tax shelter. The last significant hurdle in aggressively taking the solution to market impediment will likely be obtaining a commitment from tax leadership to re-enter the individual "loss generator" business.

A second near-term opportunity is for a conversion transaction – a strategy that halves the taxpayer's effective tax rate by effectively converting ordinary income to long term capital gain. We have nearly completed technical review of such a solution sponsored by European American Investment Group. The most significant open issue is tax shelter registration and the impact registration will have on the solution.

Finally, there is a significant opportunity with respect to tax advantaged investment products. For example, the Bigelow/Presidio municipal bond offering promises the opportunity to double the tax exempt yield on municipal bond investments with a small increase in interest rate risk. Another example we are actively pursuing is the opportunity in the domestic and foreign private placement life insurance markets to create significant income tax deferrals on portfolio income. The primary impediment remaining in taking these solutions to market are the SEC broker dealer issues.

Market Approach

The Innovative Strategies practice has done a good job generally up-scaling its solutions and client base. Accordingly, it has largely modified its market approach from a "program trade" approach to a "customized solution" approach. The Innovative Strategies team positions itself as a client advocate/advisor in helping the client understand the market place opportunities and devise a portfolio of tax advantaged solutions that meet the client's various personal financial objectives.

These solutions are both KPMG developed solutions where KPMG is willing to write at least a more likely than not opinion and third party solutions where KPMG has determined that it is willing to sign client's tax returns and where another tax advisor (usually a nationally recognized law firm) is willing to write the tax opinion for the client.

Market Dynamics

As previously mentioned, the softening in the US economy has slowed wealth creation. There are fewer monetization/gain recognition opportunities, particularly as investors await a rebound in share values. In addition, there has been a significant increase in the regulation of "tax shelters". Not only is this regulatory activity dampening market appetite, it is changing the structural nature of the underlying strategies. Specifically, taxpayers are having to put more money at risk for a longer period of time in order to improve the business purpose economic substance arguments. All things considered, it is more difficult today to close tax advantaged transactions. Nevertheless, we believe that the Innovative Strategies practice is a sustainable business opportunity with significant growth opportunity.

Business Plan - Specific Metrics

The Innovative Strategies practice should be expected to generate $27 million of revenue in fiscal '02. This revenue would be derived from both our existing solutions as well as those solutions identified above that we reasonably expect to receive approval to market in the near term. Specifically:

- Monetization Tax Advisory Services $5 million
- Leveraged Private Split Dollar $5 million
- POPS (assuming approval) $12 million
- Conversion trade (assuming approval) $5 million

This revenue is inclusive of any revenue allocated to other KPMG practices to "compensate" them for their development or implementation assistance. Contribution margin should equal, or somewhat exceed, the tax practice norm. Assuming the team composition described below, the planned revenue per partner would be $3 million and the planned contribution per partner would equal or exceed $1.5 million.

These are very aggressive goals given the current regulatory and economic environment. This is particularly true in that the bulk of the planned revenue is derived from solutions that are not yet approved for distribution.

Team Composition

The Innovative Strategies team will be comprised of a group of partners geographically dispersed across the US. Specifically, we propose:

■ Midwest	David Zaudtke (Minneapolis)
■ Northeast	Tim Speiss (New York)
■ Southeast	Tracie Henderson (Atlanta)
	Jeff Eischeid (Atlanta) – Team Leader
■ Southwest	Carol Warley (Houston)
■ West	Dale Baumann (Mtn. View)
	Deke Carbo (Mtn. View)
	Randy Bickham (San Francisco)
	Carl Hasting (Warner Center)

There is an obvious weighting of team resources on the West coast which has the best market opportunities and which has traditionally accounted for a very significant portion of the innovative strategies revenue. It will be necessary to work out a transition plan with the AMPs and the BUPICs to quickly transition these partners' client service responsibilities to other partners and TMDs.

Operating Structure

The Innovative Strategies practice will be part of the personal financial planning practice. We understand that this separate national practice will be part of the non-core federal tax practice much like the Stratecon practice.

new

From: Stein, Jeff
Sent: Tuesday, May 11, 1999 10:30 PM
To: DeLap, Larry; Lanning, John T
Subject: RE: BLIPS Update

Sensitivity: Private

Yikes!

-----Original Message-----
From: DeLap, Larry
Sent: Tuesday, May 11, 1999 11:50 PM
To: Lanning, John T
Cc: Stein, Jeff
Subject: FW: BLIPS Update
Importance: High
Sensitivity: Private

John -

Let's discuss, in person on Wednesday if there is time, or by telephone on Thursday.

Larry

-----Original Message-----
From: Watson, Mark T
Sent: Tuesday, May 11, 1999 6:39 PM
To: DeLap, Larry
Subject: RE: BLIPS Update

Larry, I don't like this product and would prefer not to be associated with it. However, if the additional representations I sent to Randy on May 9 and May 10 are in fact made, based on Phil Wiesner's and Richard Smith's input, I can reluctantly live with a more-likely-than-not opinion being issued for the product.

-----Original Message-----
From: DeLap, Larry
Sent: Monday, May 10, 1999 11:19 PM
To: Mark Watson
Subject: FW: BLIPS Update

It's not entirely clear to me what this means. The essential question in my mind still is whether *you* are comfortable with a more-likely-than-not opinion on this product.

-----Original Message-----
From: Wiesner, Philip J
Sent: Monday, May 10, 1999 5:24 PM
To: Lippman, Michael H; DeLap, Larry; Rosenthal, Steven M; Smith, Richard H (WNT); Watson, Mark T
Cc: Ammerman, Douglas K; Lanning, John T; Stein, Jeff; Eischeid, Jeffrey A
Subject: BLIPS Update

The group of Wiesner, R Smith, Watson and Rosenthal met this afternoon to bring closure to the remaining technical tax issues concerning the BLIPS transaction. After a thorough discussion of the profit motive and who is the borrower issue, recommendations for additional representations were made (Mark Watson to follow up on with Jeff Eischeid) and the decision by WNT to proceed on a more likely than not basis affirmed. Concern was again expressed that the critical juncture will be at the time of the first real tax opinion when the investor, bank and Presidio will be asked to sign the appropriate representations. Finally, it should be noted that Steve Rosenthal expressed his dissent on the who is the investor issue, to wit, "although reasonable people could reach an opposite result, he could not reach a more likely than not opinion on that issue."

Permanent Subcommittee on Investigations
EXHIBIT #39

Message8071	
Subject:	FW: Weekly Tax Solutions Call
From:	Klein, Wendy (NSS-Tax)
Date:	12/22/2000 8:17:20 AM
To:	Stein, Jeff (US/Vice Chairman)
Message Body	

hmmm.... not good.
-----Original Message-----
From: Springer, Mark A
Sent: Friday, December 22, 2000 10:15 AM
To: DeLap, Larry; Weber, Elizabeth J; Klein, Wendy (NSS-Tax)
Cc: Gremminger, Steven L; Brockway, David H; Smith, Richard H (WNT); Cvach, Gary Q; Peters, Marsha F
Subject: RE: Weekly Tax Solutions Call

Larry -- OK

Liz/Wendy -- We will take 401(k)Accel off the revisit list for the 1/8/01 call.

Mark

-----Original Message-----
From: DeLap, Larry
Sent: Thursday, December 21, 2000 7:19 PM
To: Springer, Mark A
Cc: Gremminger, Steven L; Brockway, David H; Smith, Richard H (WNT); Cvach, Gary Q
Subject: RE: Weekly Tax Solutions Call

The latter.

-----Original Message-----
From: Springer, Mark A
Sent: Thursday, December 21, 2000 1:25 PM
To: DeLap, Larry
Cc: Gremminger, Steven L; Brockway, David H; Smith, Richard H (WNT); Cvach, Gary Q
Subject: RE: Weekly Tax Solutions Call

Larry -- Are you suggesting that we stop marketing the solution, or that you just don't want a public discussion of the solution in light of the IRS focus?

Mark

-----Original Message-----
From: DeLap, Larry
Sent: Thursday, December 21, 2000 3:19 PM
To: Mark Springer (E-mail)
Cc: Steven Gremminger (E-mail); David Brockway (E-mail); Richard Smith (E-mail); Gary Cvach (E-mail)
Subject: FW: Weekly Tax Solutions Call

Mark -

In light of a recent information request received from the IRS, it may be advisable to remove 401kAccelPlus from the January 8 call.

Larry

-----Original Message-----
From: POSTMASTER-US
Sent: Thursday, December 21, 2000 8:53 AM
Subject: Weekly Tax Solutions Call

Tax Solutions Conference Call
Monday, December 25, 2000
&
Monday, January 1, 2001

No Call Scheduled

Below is the confirmed list of scheduled solution revisits:

January 8
Benefits.Prep (TSA 01-06)
401kAccelPlus (TSA 01-02)
Fee-Deferral Strategy (CARDS 2000) (TSA 01-08)
Rescission Strategy

January 15
Pollution Control Initiative (TSA 99-28)
Strategic Timing of Assignment Remuneration (TSA 01-01)
Expatriate Cost Minimization (TSA 00-16)
Stock Like-Kind Exchange (TSA 01-05)
Tax Account Analysis Review Program (TSA 98-01)

January 22
e-Procurement Tax Solutions (TSA 01-04)
Tax Portal (TSA 01-03)
Net Ventures Tax Suite (TSA 00-31)

January 29
S-Corporation Charitable Contribution Strategy (TSA 00-28)
Tax Accounting Strategies (TSA 00-18)

Proprietary Material
Confidentiality Requested

Visit the Tax Innovation Center's Homepage
http://taxkm.us.kworld.kpmg.com/homepages/tic/index.htm

This message has been approved for distribution to all Tax Partners by Mark Springer.

KPMG 0043949

Outlook Header Information
Conversation Topic: Weekly Tax Solutions Call Subject: FW: Weekly Tax Solutions Call From: Klein, Wendy (NSS-Tax) Sender Name: Klein, Wendy (NSS-Tax) To: Stein, Jeff (US/Vice Chairman) Delivery Time: 12/22/2000 8:17:20 AM Creation Time: 12/22/2000 8:17:20 AM Modification Time: 12/22/2000 8:17:21 AM Submit Time: 12/22/2000 8:17:21 AM Importance: 121 Priority: 120 Sensitivity: 120 Flags: 121 Size: 126536

BLIPS AND TRACT

CAROL WARLEY

JUNE 1999

Personal Financial Planning

Bond Linked Issue Premium Structure (BLIPS) Targeting - Qualifying Questions

- Clients With At Least $20 Million Of Capital Gain or Ordinary Income
- Ability To Do With Ordinary Income Is Contingent On Potential Proposed Legislation
- Is Client Willing To Pay A Value Added Fee? (KPMG Fee 1.25% Of Gain/Ordinary Income)
- Is Client Willing To Take An Aggressive Position With A More Likely Than Not Opinion Letter? (About A 10 Risk On Scale Of 1-10)
- Is Client Willing To Sign A Nondisclosure Agreement?

BLIPS Targeting

- BLIPS Has Been Approved By DPP Tax
- Screen Candidates and Set Up ICVs
- DPP Has Indicated That We Will Only Be Able To Do A Limited Number of Transactions
- BLIPS Will Be Available For Individuals, Partnerships, and Trusts
- BLIPS Cannot Be Done For A Corporate Client (This Includes S Corporations)
- Area Product Champions - Deke Carbo and Carol Warley

BLIPS Benefit

- Avoid All Of The Capital Gains And Ordinary Income Tax
- Net Benefit To Client - Effective Tax Rate Less After Tax Cost of Transaction of Approximately 5%

Taxpayer Relief Act Charitable Trust (TRACT)
Targeting - Qualifying Questions

- Clients With Highly Appreciated Publicly Traded Stock That Has More Than Doubled In Value
- Is Client Willing To Pay A Value Added Fee? Minimum Fee $100,000 (1.25% of Gain)
- Is Client Willing To Take An Aggressive Position With A More Likely Than Not Opinion Letter? (About 6-7 Risk On Scale Of 1-10)
- Is Client Willing To Sign A Nondisclosure Agreement (Other Than Corporate Clients)?
- Is Client Willing To Give Up Most Of The Upside Appreciation Potential?

TRACT Targeting

- TRACT Is a Tax Product Approved by DPP Tax
- Screen Candidates and Set Up ICVS
- TRACT is Available For Individuals, Trusts, Partnerships And Corporations Who Are Not Audit Clients
- Area Product Contacts - Deke Carbo, Bill Goldberg, Bob Perez, Ray Poage, Dan Slattery, Carol Warley and Pamela Weems

TRACT Benefit

- Avoid Most Of The Capital Gains Tax
- Benefit To Charity - Charitable Contribution Deduction
- Net Benefit To Client Dependent On Facts - 10 to 15% Of The Gain
- May Avoid Certain Securities Law Reporting - Consult Corporate Securities Counsel

Sequential

From: Nelson, Dennis G [dnelson@KPMG.com]
Sent: Wednesday, April 28, 1999 9:11 PM
To: DeLap, Larry
Subject: RE: BLIPS

Larry

Sorry for the delay in my response I was on vacation for a couple days and then working on the hard close. I have looked over the materials and would not characterize the investment as an investment in a hedge fund per se. However I have seen where a money manager will structure an investment partnership to manage only one clients funds and as a part of that arrangement take a performance allocation from the partnership (minimizing Section 212 limitation issues for part of the managers "fee"). Mark Harrison in San Fran has a client with several such arrangements and I don't know if they have any restrictions on the client pulling out his funds.

In the hedge fund world (as opposed to private equity or venture capital funds) there is more liquidity provided for the investors since generally the investments are marketable securities. Some funds will start with the requirement of a one year "lock-up" on the investors funds so that the manager has a chance to work his strategy and until July of 1998 the regulations under Investment Advisors Act of 1940 prevented registered investment advisors from taking a performance allocation unless the performance covered a period of at least one year. After the changes to these regulations there is less of a need for these lock ups in order to collect a performance fee however money managers are always concerned about "hot" money and what it can do to their track record if withdrawn at an inopportune time and may still consider imposing a lock up of some sort.

From the standpoint of how often Hedge funds allow their partners to withdraw funds I would say the most prevalent is quarterly followed by yearly and then monthly. I would also say that although quarterly is prevalent they are fairly evenly distributed between the quarterly, yearly and monthly redemption options from my experience.

I would also say that I don't think a money manager would start a hedge fund if he thought all of his clients would pull out after 60 or 120 days since there is no guarantee that they would recover their start up costs over such a short time frame unless they charged those start up costs to the fund or they new the net assets were going to be so huge that the management fee (usually 1 to 2%) during this period of time would cove them and give them a profit. Also, is there a performance allocation to the manager that would motivate him to give it a go for potentially such a short period?

Hope this helps your analysis.

Dennis G. Nelson
Tax Partner
KPMG LLP
4200 Norwest Center, Minneapolis, MN 55402-3900
Telephone: (612) 305-5435 Fax: (612) 305-5042 e-mail: dnelson@kpmg.com

Permanent Subcommittee on Investigations
EXHIBIT #42

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*

> -----Original Message-----
> From: DeLap, Larry
> Sent: Thursday, April 22, 1999 9:59 PM
> To: Nelson, Dennis G
> Subject: BLIPS
>
> << File: BLIPS0308.doc >> << File: Blips investment strategy (8).doc >>
>
> Dennis -
>
> Please see attached writeups. The underlying tax planning is such that the
> investor is likely to bail out after Stage 1; i.e., after about 60 days.
>
> According to the product developer, "The ability to exit the investment
> partnership at periodic intervals is consistent with most hedge fund
> investment programs". I don't know is this is a hedge fund to begin with.
> If it is, is an ability to exit at the end of 60 days, 180 days, or 7
> years "consistent with most hedge fund investment programs".
>
> Larry

Unknown

From: Manth, Larry E [lmanth@KPMG.com]
Sent: Monday, March 27, 2000 11:58 AM
To: DeLap, Larry; Galbreath, Phillip L
Cc: Springer, Mark A; Smith, Richard H (Vice Chair-Tax)
Subject: RE: S-corp Product

Larry, regarding your below message, I definately agree on disclosing the risks upfront and would prefer to have the separate memo that states the risks involved. Do you have standard language we can use for the engagement letter? We can begin to put together the risk memo. Also, is there a way to make the risk memo be covered under 7525?

Thanks,

Larry

> -----Original Message-----
> From: DeLap, Larry
> Sent: Monday, March 27, 2000 6:37 AM
> To: Manth, Larry E; Galbreath, Phillip L
> Cc: Springer, Mark A; Smith, Richard H (WNT)
> Subject: RE: S-corp Product
>
> Larry -
>
> No, we don't disclose all risks in all engagement letters. However,
> where there is a significant downside, as with this strategy, it is
> important that the downside risk be disclosed. If the risk has been
> disclosed and the IRS is successful in a challenge, the client can't
> maintain he was bushwhacked because he wasn't informed of the risk. If
> the risk has been disclosed, the client would have a difficult time
> maintaining we had been grossly negligent with our advice.
>
> We probably should also make sure penalty issues have been discussed
> with the client. We could do that by providing a memorandum similar to
> the attachment.
>
>
> << File: T_IDVPEN.DOC >>
>
> We could have a statement in the engagement letter that the client
> acknowledges receipt of a memorandum concerning risks associated with
> the strategy, then cover the double taxation risk and penalty risks
> (and other relevant risks) in that separate memorandum. Depending on
> how one interprets section 7525(b), such a memorandum arguably
> qualifies for the federal confidential communications privilege under
> section 7525(a). In any case, the technical risks will be discussed in
> our opinion letter. I'd think it advisable that the client not learn
> first learn of those risks after he has already contributed stock to
> the pension plan.
>
> Larry
>
>
> -----Original Message-----
> From: Manth, Larry E
> Sent: Saturday, March 25, 2000 7:58 AM
> To: DeLap, Larry; Galbreath, Phillip L
> Cc: Springer, Mark A; Smith, Richard H (WNT)
> Subject: RE: S-corp Product
>
> Larry, regarding the below, since Bill Kelliher has said that he is

> at a "should" opinion with respect to the S election, do we need to
> disclose the risk in the engagement letter? Do we disclose all risks
> in engagement letters? If we do, then we have about 10 - 12 that we
> would need to disclose. Could we have an addendum that discloses
> risks? If so, could the Service have access to that? Obviously the last thing we want
> to do is provide the Service with a road map.
>
> Thanks,
>
> Larry
>
> -----Original Message-----
> From: DeLap, Larry
> Sent: Friday, March 24, 2000 9:01 AM
> To: Galbreath, Phillip L
> Cc: Springer, Mark A; Manth, Larry E; Smith, Richard H
> (WNT)
> Subject: FW: S-corp Product
>
> On further thought, it seems to me that we need to explicitly
> disclose the downside risk if the IRS disagreed with the "second class
> of stock" arguments.
>
> After the paragraph about the basis of our conclusions, I think we
> should add something like:
>
> The opinions we render will not be binding upon the Internal
> Revenue Service, any other tax authority or any court, and no
> assurance can be given that a position contrary to that expressed
> therein will not be asserted by a tax authority and ultimately
> sustained by a court. In particular, the Internal Revenue Service
> might argue, and the courts might agree, that the non-voting stock
> constitutes a second class of stock, thus invalidating the S
> corporation election. In that event, the corporate earnings would be
> subjected to tax at the corporate level, and distributions to you would be subject to a
second level of tax.
> Under "Other Matters", I think we should add something like:
> You acknowledge that you understand the strategy
> involves risk, including the risk of disputes with the section 401(a)
> pension plan concerning valuation or other matters relating to the
> stock contributed to it and the risk of double taxation should the
> Internal Revenue Service successfully maintain that the transaction
> terminated the S corporation election, and that you are prepared to
> accept those risks.
>
> Larry
>
>
>
>
>
>
> -----Original Message-----
> From: DeLap, Larry
> Sent: Friday, March 24, 2000 7:12 AM
> To: Galbreath, Phillip L
> Cc: Springer, Mark A; Manth, Larry E; Smith, Richard H
> (WNT)
> Subject: RE: S-corp Product
>
> << File: S-CAEPS_ENGAGE.DOC >>
>
> See additional revisions attached.
>
> -----Original Message-----
> From: Galbreath, Phillip L
> Sent: Thursday, March 23, 2000 3:12 PM
> To: DeLap, Larry

> Cc: Springer, Mark A; Manth, Larry E; Smith,
> Richard H (WNT)
> Subject: RE: S-corp Product
>
> Attached is the S-CAEPS engagement letter which has
> been revised to incorporate your comments. Nancy Galib (member of the
> WNT TCS group) reviewed and provided comments which have been
> incorporated as well. Please review and provide me with any
> additional comments you have. Thanks.
>
> << File: S-CAEPS_ENGAGE.DOC >>
>
> Phillip Galbreath
> KPMG Tax Innovation Center
> Phone: 202.533.4162
> Fax: 202.533.4163
> MailTo:pgalbrea@kpmg.com
>
>
>
> -----Original Message-----
> From: DeLap, Larry
> Sent: Tuesday, March 21, 2000 7:57 PM
> To: Galbreath, Phillip L
> Cc: Springer, Mark A; Manth, Larry E
> Subject: FW: S-corp Product
>
> Phillip -
>
> I think that the engagement letter needs to
> explicitly state that the client needs to engage legal counsel to
> advise on non-tax legal aspects of the transaction and to draft
> required legal documents.
>
> I suggest you have the WNT TCS group look at the
> letter to see if they have any suggestions to add a greater business
> purpose/economic substance concern.
>
> My principal concern lies with how we introduce the
> donee to the client, whether we may have an "alliance" relationship
> with the donee (particularly if a particular donee participates in
> multiple transactions), and whether we should have some sort of
> written agreement with the donee if deemed not to be an alliance.
> Larry Manth can discuss those particular issues with me, but it seems
> to me the Scope of Services should say something about how we help the
> client select the donee.
>
> In the absence of an ICV, how do we establish the
> fixed fee?
>
> Presumably, a valuation will be needed to establish
> the amount of the charitable contribution. Shouldn't engagement letter
> say something about need for a valuation?
>
> The "restriction on use" language needs to be
> changed from "will not be provided" to "may not be relied upon".
>
>
> Larry
>
> -----Original Message-----
> From: Galbreath, Phillip L
> Sent: Monday, March 20, 2000 4:28 PM
> To: DeLap, Larry
> Subject: FW: S-corp Product
>
> Please see messages below. I know you are already

> aware of this strategy and may have already reviewed some of the
> related materials. I received and responded to questions raised by
> Chris Galer
> (DPP-Assurance) last week. Based on the messages below, Larry Manth will
> be sending the whitepaper and powerpoint presentation directly to you.
> Attached below is the sample engagement letter. Please review and provide
> me with your comments. At this point, there will be no Tax Solution Alert
> or other toolkit documents.
>
> << File: S-CAEPS_ENGAGE.DOC >>
>
> Phillip Galbreath
> KPMG Tax Innovation Center
> Phone: 202.533.4162
> Fax: 202.533.4163
> MailTo:pgalbrea@kpmg.com
>
>
>
> -----Original Message-----
> From: Manth, Larry E
> Sent: Monday, March 20, 2000 5:08 PM
> To: Springer, Mark A; Galbreath, Phillip L
> Cc: Kelliher, William B; Smith, Richard H (WNT);
> Atkin, Andrew S; Duncan, Douglas P; Huber, Robert; Bailine, Richard W
> Subject: RE: S-corp Product
>
> Mark and Phillip, I believe that we have sent the engagement letter
> to Larry DeLap. Also, we do not plan on using an ICV letter. I
> believe the only missing item is the powerpoint presentation. We are
> just about complete (I still have not heard from the Southeast
> regarding a product champion). We are working on an updated technical
> write-up covering the assignment of income issues, changing the put
> arrangement (Richard Bailine), and deleting 501(c)(3)'s. Please let
> me know if we are missing anything. Thanks, Larry
>
> -----Original Message-----
> From: Springer, Mark A
> Sent: Monday, March 20, 2000 1:37 PM
> To: Manth, Larry E; Galbreath, Phillip L
> Cc: Kelliher, William B; Smith, Richard H (WNT);
> Atkin, Andrew S; Duncan, Douglas P; Huber, Robert; Bailine, Richard W
> Subject: RE: S-corp Product
>
>
> I believe this leaves as the only open item the
> assignment of income issues.
>
> Larry: Assume you are working directly w/ Mark
> Watson.
>
> Philip: Are the other toolkit items (eng letter,
> ICV letter)-ready to go to Larry DeLap w/ formal request for review
> and approval to deploy the solution?
>
> Mark Springer
> KPMG Tax Innovation Center
> 202-533-3076
> maspringer@kpmg.com
>
> -----Original Message-----
> From: Manth, Larry E
> Sent: Monday, March 20, 2000 3:42 PM
> To: Bailine, Richard W; Kelliher, William B
> Cc: Smith, Richard H (WNT); Springer, Mark A;
> Atkin, Andrew S; Duncan, Douglas P; Huber, Robert
> Subject: RE: S-corp Product

>
> Richard, we will send you a draft of a pledge for
> your review, thanks, Larry
>
> -----Original Message-----
> From: Bailine, Richard W
> Sent: Monday, March 20, 2000 12:40 PM
> To: Bailine, Richard W; Kelliher, William B;
> Manth, Larry E
> Cc: Smith, Richard H (WNT); Springer, Mark A
> Subject: RE: S-corp Product
>
> Folks--One point I should have made clear. While I
> have no problem with the timing of the shareholders funding of the
> pledge being stretched out, one thing that can NOT happen is that the
> funding can NOT be tied to, or contingent upon, the receipt of
> distributions (or the existence of profits etc) from the S Corp. To do
> so would simply resurrect all the issues we just eliminated. Thanks.
>
> -----Original Message-----
> From: Bailine, Richard W
> Sent: Monday, March 20, 2000 3:34 PM
> To: Kelliher, William B; Manth, Larry E
> Cc: Smith, Richard H (WNT)
> Subject: RE: S-corp Product
>
> Larry--Bill Kelliher and I had lunch today and
> discussed this business solution idea. We are in agreement that having
> the Put to the S Corp at FMV as of the date of exercise of the Put
> with a shareholder pledge to Exempt-Org as suggested in my March 16th
> email below will enhance the technical aspects of this solution.
>
> I would think that the economics of having the
> shareholder make this pledge would not be materially different (in
> most
> cases) than having the S Corp do so. One would think the major wealth
> component of most S Corp shareholders is their S Corp stock and,
> ultimately the source of the funds to make this pledge (if funding should
> ever be necessary) would be from the S Corp. I have no problem with the
> shareholders pledge stretching over more than one year to facilitate a
> smooth cash flow. Thus, one will not know for two years (i.e. the expected
> timing of the exercise of the Put) whether funding the pledge will be
> necessary. Assume such funding is necessary, I have no problem with the
> shareholders pledge saying "I will fund this amount over 2 years (or 3, or
> 4 etc years)". This cash flow timing should be worked out between the
> Exempt-Org and the shareholder and be mutually agreeable to them. All I am
> interested in is that this "pledge/guaranty" does not come from the S Corp
> so that in its capacity as an S Corp shareholder, Exempt-Org has no
> downside protection vis-a-vis the stock ownership and no right to a
> preferential distribution. Rights, if any, come from an individual, not
> the corporation.
>
> With these changes, I approve the Sub Chapter C
> aspects of this business solution. Thanks to all for your valuable
> input and helping to achieve the overall desired result!
>
> -----Original Message-----
> From: Kelliher, William B
> Sent: Monday, March 20, 2000 2:53 PM
> To: Manth, Larry E; Bailine, Richard W
> Cc: Smith, Richard H (WNT)
> Subject: RE: S-corp Product
>
> It's correct (reg. sec. 1.1368-2(d)(1)(i)).
>
> Bill
>

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```
>                 -----Original Message-----
>                 From: Manth, Larry E
>                 Sent: Monday, March 20, 2000 9:35 AM
>                 To:   Bailine, Richard W; Kelliher, William B
>                 Cc:   Smith, Richard H (WNT)
>                 Subject:    RE: S-corp Product
>
>                 Richard, I like your suggestion on the put.  If you
> think it strengthens our case, all the better!  From the S-corp side,
> since most shareholders think the company is going up in value, they
> should not care.  The practical concern is if the company decreases in
> value and the shareholder has to pay cash to the tax-exempt -- will
> the shareholder have enough cash to make the payment if they had not
> been paid distributions for two years?  Perhaps we could extend the
> pledge for a year longer than the put.
>
>                 With respect to the AAA reduction, Bill can confirm
> this, the example on page 8 is correct.
>
>                 Also, with respect to UBIT issues, the tax-exempts
> we are dealing with are using section 115 to exclude the income from
> UBTI, so they are not concerned about UBIT.
>                 Thanks, Larry
>
>
>
>
>                 -----Original Message-----
>                 From:       Bailine, Richard W
>                 Sent: Thursday, March 16, 2000 4:06 PM
>                 To:   Manth, Larry E; Kelliher, William B
>                 Cc:   Smith, Richard H (WNT)
>                 Subject:    RE: S-corp Product
>
>                 Larry/Bill--I think we need to talk in re the
> following issues.
>
>                 Pg 8 of the opinion states that S Corp will reduce
> AAA by 90% (or some $7.2 million) even though the amount paid out in
> redemption of stock is a mere $1.3 million. Is this correct?
>
>                 More importantly, I continue to be concerned that a guaranteed PUT
> right has the potential effect of giving IRS an argument that no stock
> has been given to Exempt-Org as Exempt-Org has no downside. More over,
> as this right to get a guaranteed FMV price runs from the S Corp to
> Exempt-Org, even if exempt-Org is deemed to be a shareholder why don't
> we have a second class of stock issue as Exempt-Org certainly has
> distribution rights that differ from, and are superior to, those of
> the other shareholder.
>
>                 Can we solve all this as follows;
>
>                 (i) Assume the S Corp stock has a value of $1.3
> million on the date of the gift to Exempt-Org.
>
>                 (ii) Give Exempt-Org a right to Put the stock back
> to S Corp at FMV as of the date the Put is exercised.
>
>                 (iii) Have Shareholder make a pledge to Exempt-Org
> such that he will contribute an amount of money equal to the amount,
> if any, that any Put proceeds received by Exempt-Org are less than
> $1.3 million.
>
>                 In this way, Exempt-Org is assured of getting the
> cash BUT the assurance does not come from S Corp. Shouldn't this
> eliminate the above concerns. Doesn't it also have the effect of
> helping Exempt-Org; to wit, if the Put is exercised at $1 million then
```

> Shareholder must give $300,000 to Exempt-Org. Isn't this $300,000
> clearly a charitable gift so that Exempt-Org has no UBIT issues
> whereas the redemption proceeds may be UBIT.
>
> Thoughts. Let's talk on Friday.
>
> -----Original Message-----
> From: Manth, Larry E
> Sent: Wednesday, March 15, 2000 12:53 PM
> To: Bailine, Richard W
> Cc: Smith, Richard H (WNT); Galbreath, Phillip
> L; Springer, Mark A; Peters, Marsha F; Atkin, Andrew S; Duncan,
> Douglas P; Huber, Robert
> Subject: S-corp Product
>
> Rick, please see my comments below.
>
> Thanks, Larry
>
> -----Original Message-----
> From: Galbreath, Phillip L
> Sent: Monday, March 13, 2000 4:49 PM
> To: Manth, Larry E
> Cc: Smith, Richard H (WNT); Springer, Mark A;
> Peters, Marsha F
> Subject: FW: S-CAEPS
>
> Below are Rick Bailine's comments relating to the
> Sub C issues in the S-CAEPS whitepaper.
>
> Phillip Galbreath
> KPMG Tax Innovation Center
> Phone: 202.533.4162
> Fax: 202.533.4163
> MailTo:pgalbrea@kpmg.com
>
>
>
> -----Original Message-----
> From: Bailine, Richard W
> Sent: Monday, March 13, 2000 7:29 PM
> To: Galbreath, Phillip L
> Cc: Bloom, Gilbert D; Springer, Mark A; Peters,
> Marsha F
> Subject: RE: S-CAEPS
>
> Phillip--I have read the attached and have the
> following comments related solely to Sub Chapter C.
>
> 1. This appears to be little more than a old give
> stock to charity and then redeem it play and as pointed out in the
> write-up at footnote 51, the IRS has, for the most part, thrown in the
> towel on these (despite a strong record in court). Having said this
> please read on.
>
> [Manth, Larry E] Yes, very similar, but during the
> time the tax-exempt owns the stock it will be allocated 90% of the
> income, be paid no distributions, and be redeemed for a small value.
>
> 2. I think the section 269 discussion is weak. It
> seems clear to me there is an acquisition of control by Exempt-Org as
> it acquires 90% of the number of shares of the S Corp and even if
> discounted at 35% (which would be questionable I think) for lack of
> voting rights as discussed in the write-up at footnote 4, this 90% of
> the number of shares should have >50% of the value of the S Corp (90%
> times 65%=58.5%). Thus, I think the argument is that (i) Exempt-Org
> receives no tax benefit from the acquisition of control, its tax

> benefits stem from its status under section 501 and (ii) the S Corp
> gets no tax benefit from the acquisition of control as its tax
> benefits stem from its status under section 1361 et seq. Thus, the
> acquisition of control is not material to any tax benefit. The
> write-up does go down this path but spends more time arguing that
> there is no acquisition of control which I think is a mistake. Also,
> the write-up speaks in very conclusive terms when it should be using
> words like "should not apply" as opposed to "...section 269 does not
> apply...". See page 7.
>
> [Manth, Larry E] See revised technical paper
> attached. Please note that the way the transaction is structured, the
> non-voting stock will not be greater than 50% of the value of the
> S-corp (the warrants significantly dilute the value).
>
> 3. My biggest concern is the redemption right given
> to Exempt-Org; why does this right guaranty Exempt-Org will receive
> cash equal to the greater of FMV at time of redemption versus FMV at
> date of gift? This right takes all downside risk away from Exempt-Org
> and one of the hallmarks of ownership is that the owner inherits the
> "benefits and burdens" of ownership. By relieving Exempt-Org of the
> burden of downside risk are we not allowing IRS an alternative
> argument that Shareholder did NOT give S Corp stock to Exempt-Org,
> rather what was truly given was a right to a fixed amount of cash plus
> a SAR (Stock Appreciation Right).
>
> At page 11, the write-up discusses the potential
> issue that the warrants may be stock and in this light looks at Rev
> Rul 82-150. As for the analysis on this point, I think the write-up is
> fine but this revenue ruling also clearly tells us that if one is to
> be viewed as the owner of equity, one must assume the risks associated
> with equity ownership. Traditionally, one such risk is the risk the
> equity investment will decrease in value. Exempt-Org has no such risk
> and, therefore, arguably may not be viewed as an equity owner.
>
> Moreover, why is this downside protection either
> necessary or desirable? I would think giving Exempt-Org a right to
> demand redemption (i.e. a "put") at FMV as of the date of exercise of
> the put, is more in keeping with the desires of Shareholder and
> Exempt-Org gets a windfall even if it get one cent! It would also seem
> that put at FMV as of date of exercise is truly in keeping with the
> requirements of Treas Reg 1.1361-1(l)(2)(iii). See footnote 20, page
> 6.
>
> [Manth, Larry E] The reason we guarantee the
> tax-exempt a minimum is that there is a potential burden -- federal
> taxes. It is not a certainty that the tax-exempt is totally exempt
> from tax on holding the stock. Also, very few tax-exempts would ever
> take this stock because of the UBIT concerns. So we are using the
> floor as an incentive for the tax-exempts to take the stock.
> Hopefully the discussion under economic substance regarding beneficial
> ownership on pages 12 through 19 will suffice in addressing your
> concerns on ownership issues.
>
>
> << File: S_Corp_Strategy.doc >>
>
>
>
> Let's chat.
>
>
>
>
> -----Original Message-----
> From: Galbreath, Phillip L
> Sent: Monday, March 13, 2000 2:46 PM

```
>                To:   Bailine, Richard W
>                Subject:    FW: S-CAEPS
>
>                Attached below is the most recent version of the
> S-CAEPS whitepaper.  As I was telling you, this Tax Solution is
> getting some very high level (Stein/Rosenthal) attention.  Please
> review the whitepaper as soon as possible and provide your comments to
> Larry Manth directly.  Please copy Richard Smith, Mark Springer, Marsha Peters, and me
> on your message to Larry. Thanks for your help.
>
>                Phillip Galbreath
>                KPMG Tax Innovation Center
>                Phone: 202.533.4162
>                Fax: 202.533.4163
>                MailTo:pgalbrea@kpmg.com
>
>
>
>                 -----Original Message-----
>                From:       Manth, Larry E
>                Sent: Sunday, March 12, 2000 10:35 AM
>                To:   Watson, Mark T; Smith, Richard H (WNT);
> Rosenthal, Richard P; Springer, Mark A; DeLap, Larry; Galbreath, Phillip L
>                Cc:   Atkin, Andrew S; Duncan, Douglas P; Huber,
> Robert
>                Subject:    RE: S-CAEPS
>
>                Mark, thanks for your comments.  I will address each
> one separately.
>
>                1)  Assignment of Income Issues.  We have included
> an additional paragraph under the assignment of income section.  But
> also see the economic substance arguments.  Bill Kelliher
> substantially enhanced that section and it addresses many issues,
> including beneficial ownership and income allocation.
>
>                2)  No charitable or gift tax deduction and
> reallocation of income back to original shareholders.  Again, I think
> the economic substance arguments cover these issues.  But I am not
> convinced that the Service would be successful in disallowing a
> charitable deduction.  After the transaction, the tax-exempt will have
> cash based on the fair market value of the stock.  It does nothing but
> hold the stock. The split-dollar transactions have the tax-exempt buy
> insurance.  Also, this transaction is quite similar to the charitable
> FLP. Is this a concern for that transaction as well?
>
>                3)  Per Larry DeLap's E-mail, we are not discussing penalty issues.
>
>                4)  Self-Dealing Issues.  We have inserted a
> discussion on section 4958, drafted by our EXO-Tax group in D.C.    We do,
> however, plan on using only 401's.
>
>                Larry
>
>
>
>                 << File: S_Corp_Strategy.doc >>
>
>
>                 -----Original Message-----
>                From:       Watson, Mark T
>                Sent: Friday, March 10, 2000 8:24 AM
>                To:   Manth, Larry E; Smith, Richard H (WNT);
> Rosenthal, Richard P; Springer, Mark A; DeLap, Larry; Galbreath, Phillip L
>                Subject:    S-CAEPS
>
>                OK.  I have reviewed the revised S-CAEPs white paper
```

> and I am still not convinced that the assignment of income issues
> associated with this strategy and the ramifications of Notice 99-36
> have been adequately addressed and/or considered. The assignment of
> income discussion in the white paper is very brief and contains little
> case law analysis. While the conclusion reached in the white paper on
> this matter may very well be correct, the brief discussion contained
> in the white paper does not give me a tremendous amount of comfort
> that all of the relevant cases and rulings have been considered,
> particularly wrt whether or not the Shareholder is assigning the S
> corp's earnings to the Exempt Organization.
>
> More importantly, the paper's discussion of Notice
> 99-36 seems to miss the point. Yes, we can certainly distinguish the
> S-CAEPS transaction from the transaction that was the subject of
> Notice 99-36, but my point in raising Notice 99-36 is to make sure
> everyone is aware of the potential downside of this transaction. If
> the Service comes after the S-CAEPS transaction the way it attacked
> the Charitable Split-Dollar transaction (and I believe Notice 99-36
> and the recent section 643(a)(7) regulations indicate it will),
> clients who enter into the S-CAEPS transaction could be faced with a
> situation where: (1) they don't get an income OR gift tax charitable
> contribution deduction for the contribution of the S-Corp stock to
> charity (and, thus, they may incur a ~~substantial~~ gift tax liability);
> and (2) they are required to recognized all or most of the S corp's
> earnings. Further, as stated in Notice 99-36, the Service may attempt
> to impose a variety of penalties on the participants in this
> transaction (including KPMG) including the penalty under section 6701
> for aiding and abetting the understatement of tax liability. Finally,
> the white paper contains no discussion as to why the Service cannot
> claim the S-CAEPS transaction involves private inurement, an
> impermissible private benefit, or self dealing, all issues raised in
> Notice 99-36. Perhaps if the "Exempt-Org" is a section 401(a) entity rather than a
section 501(c)(3) entity these issues go away. If so, the
> white paper should so indicate.
>
> Mark T. Watson
> Partner
> KPMG - Washington National Tax
> 202-533-3092 (phone)
> 202-533-8451 (fax)
>

KPMG 0016995

OCT-09-03 11:45AM 2066219686 T-977 P.002/003 F-585
07/24/02 WED 18:28 FAX 7038071122 PRIVATE CONSULTING GROUP 002

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July 23, 2002

VIA FEDERAL EXPRESS

Dear

I enjoyed speaking with you today regarding the tax issues of and I hope that we can help him reach a satisfactory resolution of his matter. The following terms and conditions would apply to our representation of and are for his review and acceptance.

An initial $5,000 retainer is required. Our monthly fees will be based upon the time we spend on your matter and our then prevailing hourly charges. We will do our best to keep our time to the minimum. My current billing rate is $485 per hour. Other lawyers who are working with me on this matter are Tom Cullinan, who has a current rate of $310, Mike Wilson, whose current rate is $185, and Jennifer Ide, whose current rate is $175. Since we are representing a number of other clients with respect to similar transactions, time spent that benefits all such clients (e.g., global settlement negotiations) will be apportioned so that there is no duplication of hourly charges. Our fees and out-of-pocket expenses (long-distance telephone, photocopying, messenger and delivery service, travel when necessary, telecopying, filing fees, etc.) will be billed monthly. If any travel is necessary, such as travel to attempt to settle this matter in Washington, D.C., it will be at the lowest practical airfare.

In the event you desire to pursue claims against the parties who advised you to enter into the transaction, we would not be able to represent you in any such claims because of the broad malpractice defense practice of our litigation team (representing all of the Big Five accounting firms, for example).

You have the right to terminate our services and representation at any time upon written notice. We reserve the right to withdraw from our representation if, among other things, irreconcilable conflicts arise with another existing client, if any fact or circumstance arises that

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OCT-09-03 11:46AM ... 18:30 FAX 7038071122 PRIVATE CONSULTING GROUP 003

July 23, 2002
Page 2 of 2

would, in our view, render our continuing representation unlawful, unethical or inconsistent with the terms of this engagement letter, or if you fail to pay our fees and expenses. We would, of course, honor instructions to take reasonable measures under the circumstances to facilitate the orderly transfer of responsibility to other counsel of your choice.

If this letter is an acceptable summary of the terms and conditions of our representation, please indicate acceptance by having the enclosed copy of this letter signed in the space provided below. A self-addressed envelope is enclosed for the return of a signed copy.

Once we have received the necessary information to prepare a Power of Attorney, we will forward it to you for signature and return to our office for filing with the IRS, as required. I am also enclosing one of our firm's brochures, which will give you some information about our tax and tax litigation practices.

Best regards.

Sincerely,

N. Jerold Cohen

NJC/mjr
Enclosure

AGREED AND ACCEPTED: DATE:

24 July 2002

KPMG

500 E. Middlefield Road
Mountain View, CA 94043

Telephone 650 404 5000
Fax 650 960 0566

September 3, 2002

PRIVILEGED & CONFIDENTIAL

N. Jerold Cohen
Sutherland, Asbill & Brennan LLP
999 Peachtree Street, NE
Atlanta, GA 30309-3996

Dear Mr. Cohen:

We are pleased you have engaged KPMG LLP ("KPMG") to assist Sutherland, Asbill & Brennan LLP ("Counsel") in Counsel's representation of Mr. ("Client"), including investigation of facts, review of tax issues, and other such matters as Counsel may direct. This letter confirms the scope and related terms of our engagement. Counsel will specify the nature and limitations of the services that we will provide as a consultant to Counsel as Counsel's agent in its representation of

We will prepare work papers and other papers and writings as Counsel may request. We understand that our preparation of such writings will be solely for the benefit of Counsel and is intended by Counsel to be a part of Counsel's privileged attorney work product. All information that KPMG, its partners or employees may acquire solely from this engagement will be part of privileged attorney-client communications and will not be disclosed by KPMG to third parties except as required by law.

In connection with Counsel's work, you have advised that Counsel may disclose to us certain information, data, and documents ("Confidential Materials"). We understand that the sole purpose of our receipt of Confidential Materials is to assist Counsel. We agree to keep confidential all Confidential Materials and not to make any use thereof except as requested by Counsel or as required by law. We further agree to return to Counsel at Counsel's written request all Confidential Materials.

If, as a result of any work that we perform pursuant to this engagement, access to work papers and files that we supply to counsel is necessary in order for us to defend and protect ourselves or any of our partners or employees, or to assert any of our or their claims, rights, interests or privileges, we understand that we will be given reasonable access to and the right to copy the work papers and files.

We will refer all inquiries from Federal and state authorities with respect to this engagement to Counsel. Our obligation in this regard is subject to all requirements of law, and in the event that any information or testimony is sought from us pursuant to a summons or subpoena, services relating to compliance with such summons or subpoena shall be within the scope of this engagement.

Our engagement cannot be relied on to uncover errors in the underlying information or irregularities, should any exist. However, we will inform you of any such matters that come to our attention.

Fees

Our fees for this engagement will be based on the complexity of the issues and the time required of individuals who will be performing the services. We will perform the work at 60% of our standard billing rates plus an administrative surcharge which will approximate 11% of the hourly fee. Circumstances encountered during the performance of these services that warrant additional time or expense could cause us to be unable to deliver them within the above estimates. We will endeavor to notify you of any such circumstances as they are assessed.

We will render progress billings to Counsel as work is performed and you will remit payments to us after you have been reimbursed for such amounts by client.

The attached Standard Terms and Conditions are made a part of this engagement letter with the following modifications:

1. **Scope**

   The second and third sentences in the first paragraph are modified to read: Should KPMG encounter issues or circumstances that are beyond the scope of this engagement, we will notify Counsel of such circumstances as they arise and will not incur additional expenses without Counsel's prior consent. Unless expressly provided for, KPMG's services do not include assisting Counsel in the event of a challenge by the IRS or other tax or revenue authorities.

2. **Term**

   The last two sentences of the second paragraph are modified to read: If at any time during this engagement, Client and Counsel decide for any other reason it is not in the best interest of Client to continue with this engagement, Counsel may notify KPMG to that effect. In the event of such notification, Counsel agrees to pay KPMG for time and expenses incurred to the date of notification in accordance with the engagement letter.

3. **Payment of Invoices**

   The first sentence is modified to read: Counsel agrees, by accepting the terms of the engagement letter, to pay all invoices to KPMG in accordance with the engagement letter to which these Standard Terms and Conditions are attached.

KPMG

N. Jerold Cohen
Sutherland, Asbill & Brennan LLP
September 3, 2002
Page 3

4. Cooperation

The first sentence is modified to read: Counsel and Client shall cooperate with KPMG in the performance by KPMG of its services hereunder, including, without limitation, providing KPMG with timely access to data, information and personnel of Client.

12. Entire Agreement

The entire paragraph is replaced with the following: These terms and the engagement letter to which these terms are appended, including any Exhibits, constitute the entire agreement between KPMG and Counsel with respect to the subject engagement and supersede all other oral and written representation, understandings or agreements relating to the subject engagement.

Please sign the enclosed copy of this letter to confirm our agreement and return it to us within 30 days. If you have any questions, please call me.

Very truly yours,

KPMG LLP

Dale R. Baumann

Dale R. Baumann
Partner

ACCEPTED:

Sutherland, Asbill & Brennan LLP

N Jerold Cohen
Authorized Signature

Partner
Title

9/8/02
Date

Message0068	
Subject:	RE: Script
From:	Jones, Ken-WASH-DC
Date:	11/4/2002 2:12:03 PM
To:	Jones, Ken-WASH-DC; Taylor, Theresa S; Ely, Mark H; Lewis, Harve; Sherlock, Victoria J; Collins, Erin M; Abkin, Wendy; Heroux, Mark S; Adelson, Jonathan S; Katz-pearlman, Sharon D; Burquest, Patricia L; DePew, Joseph M; Kay, Sheldon-ATLANTA M; Topolka, Paul G; Ammerman, Douglas K; Baumann, Dale R; Branan, Carolyn B; Carbo, Deke G; Cohen, David (US/CHICAGO); Eischeid, Jeffrey A; Fuller, Diane D; Gibson, Robert G; Goldberg, William J; Hamilton, Randall A; Hasting, Carl D; Henderson, Tracie K; Hottle, Robert Y; Ito, Dennis A; Jackson, William M; Jandl, George P; Jones, Allan L (US/Minneapolis); Jordan, Robert M; Maguire, Thomas E; Maughan, John F; Mccrimlisk, George H; O'Neal, Kenneth; Pace, Katherine A; Paule, Robin M; Perez, Robert L; Remo, Dee Ann; Rivkin, David; Schorr, Eugene G; Slattery, Daniel M; Smolin, Jay M; Speiss, Timothy P; Tendler, Neil J; Warley, Carol G; Weld, Gary E; Wise, Richard; Wolfson, Neil E; Wright, Glen A; Heath, R. Jeffrey; Karpen, Patrick N; Monaco, John W; Powell, Gary N; Toole, G.Maxwell

Message Body

Everyone: Attached is a list of law firms that are handling FLIP/OPIS cases. Note that there are easily another 15 or so law firms ... but these are firms that we have dealt with in the past. Note that we are not making a recommendation, although if someone wants to talk about the various strengths/weaknesses of one firm vs. another ... we can do that.

KEN JONES
Tax Controversy Services
kjones@kpmg.com
tel 202-533-3080
fax 202-533-8553
cell 703-362-1623
kpmg

-----Original Message-----
From: Jones, Ken-WASH-DC
Sent: Friday, November 01, 2002 5:40 PM

To: Taylor, Theresa S; Jones, Ken-WASH-DC; Ely, Mark H; Lewis, Harve; Sherlock, Victoria J; Collins, Erin M; Abkin, Wendy; Heroux, Mark S; Adelson, Jonathan S; Katz-pearlman, Sharon D; Jones, Ken-WASH-DC; Burquest, Patricia L; DePew, Joseph M; Kay, Sheldon-ATLANTA M; Topolka, Paul G; Ammerman, Douglas K; Baumann, Dale R; Branan, Carolyn B; Carbo, Deke G; Cohen, David (US/CHICAGO); Eischeid, Jeffrey A; Fuller, Diane D; Gibson, Robert G; Goldberg, William J; Hamilton, Randall A; Hasting, Carl D; Henderson, Tracie K; Hottle, Robert Y; Ito, Dennis A; Jackson, William M; Jandl, George P; Jones, Allan L (US/Minneapolis); Jordan, Robert M; Maguire, Thomas E; Maughan, John F; Mccrimlisk, George H; O'Neal, Kenneth; Pace, Katherine A; Paule, Robin M; Perez, Robert L; Remo, Dee Ann; Rivkin, David; Schorr, Eugene G; Slattery, Daniel M; Smolin, Jay M; Speiss, Timothy P; Tendler, Neil J; Warley, Carol G; Weld, Gary E; Wise, Richard; Wolfson, Neil E; Wright, Glen A; Heath, R. Jeffrey; Karpen, Patrick N; Monaco, John W; Powell, Gary N; Toole, G.Maxwell
Subject: Script

Attached is the script ... waiver language and list of attorneys to follow.

<< File: 7BFC011.DOC >>

KEN JONES
Tax Controversy Services
kjones@kpmg.com
tel 202-533-3080
fax 202-533-8553
cell 703-362-1623
kpmg

Attachment

Attorney List 110402.doc

Outlook Header Information

Conversation Topic: Script
Subject: RE: Script
From: Jones, Ken-WASH-DC
Sender Name: Jones, Ken-WASH-DC
To: Jones, Ken-WASH-DC; Taylor, Theresa S; Ely, Mark H; Lewis, Harve; Sherlock, Victoria J; Collins, Erin M; Abkin, Wendy; Heroux, Mark S; Adelson, Jonathan S; Katz-pearlman, Sharon D; Burquest, Patricia L; DePew, Joseph M; Kay, Sheldon-ATLANTA M; Topolka, Paul G; Ammerman, Douglas K; Baumann, Dale

R; Branan, Carolyn B; Carbo, Deke G; Cohen, David (US/CHICAGO); Eischeid, Jeffrey A; Fuller, Diane D; Gibson, Robert G; Goldberg, William J; Hamilton, Randall A; Hasting, Carl D; Henderson, Tracie K; Hottle, Robert Y; Ito, Dennis A; Jackson, William M; Jandl, George P; Jones, Allan L (US/Minneapolis); Jordan, Robert M; Maguire, Thomas E; Maughan, John F; Mccrimlisk, George H; O'Neal, Kenneth; Pace, Katherine A; Paule, Robin M; Perez, Robert L; Remo, Dee Ann; Rivkin, David; Schorr, Eugene G; Slattery, Daniel M; Smolin, Jay M; Speiss, Timothy P; Tendler, Neil J; Warley, Carol G; Weld, Gary E; Wise, Richard; Wolfson, Neil E; Wright, Glen A; Heath, R. Jeffrey; Karpen, Patrick N; Monaco, John W; Powell, Gary N; Toole, G.Maxwell
Received By: Baumann, Dale R
Delivery Time: 11/4/2002 2:12:03 PM
Creation Time: 11/4/2002 2:08:34 PM
Modification Time: 1/20/2003 5:35:08 PM
Submit Time: 11/4/2002 2:11:33 PM
Importance: 111
Priority: 110
Sensitivity: 110
Flags: 1117
Size: 1173122

Sequential

From: DeLap, Larry [ldelap@KPMG.COM]
Sent: Wednesday, March 06, 2002 10:33 AM
To: Rosenthal, Richard P; Springer, Mark A; Brockway, David H; Atkin, Andrew S
Cc: Duncan, Douglas P; Huber, Robert; Manth, Larry E
Subject: RE: SC2

Given the current state of affairs relative to the IRS and accounting firms, I think we should not be discussing SC2 on the Monday night call at this time. Presumably, Andrew has sufficient visibility over SC2 marketing that he can communicate the revised parameters to relevant parties directly.

> -----Original Message-----
> From: Rosenthal, Richard P
> Sent: Wednesday, March 06, 2002 10:14 AM
> To: Springer, Mark A; Brockway, David H; Atkin, Andrew S; DeLap, Larry
> Cc: Duncan, Douglas P; Huber, Robert; Manth, Larry E
> Subject: RE: SC2
>
> I'll leave this up to the deployment team and Walter Duer, unless David or
> Larry have a strong feeling one way or the other.
>
> -----Original Message-----
> From: Springer, Mark A
> Sent: Wednesday, March 06, 2002 10:03 AM
> To: Rosenthal, Richard P; Brockway, David H; Atkin, Andrew S; DeLap,
> Larry
> Cc: Duncan, Douglas P; Huber, Robert; Manth, Larry E
> Subject: RE: SC2
>
>
> Is it still our desire to discuss the revised deployment plan for SC2 on a
> Monday Night call?
>
> Mark Springer
> US Tax Innovation Center
> 202-533-3076
> maspringer@KPMG.com
>
> -----Original Message-----
> From: Rosenthal, Richard P
> Sent: Wednesday, February 06, 2002 4:11 PM
> To: Brockway, David H; Atkin, Andrew S; Springer, Mark A; DeLap, Larry
> Cc: Duncan, Douglas P; Huber, Robert; Manth, Larry E
> Subject: RE: SC2
>
> I agree with your comments. Therefore, lets proceed with the criteria
> below.
>
> Thanks,
>
> Rick
>
> -----Original Message-----
> From: Brockway, David H
> Sent: Wednesday, February 06, 2002 3:02 PM
> To: Rosenthal, Richard P; Atkin, Andrew S; Springer, Mark A; DeLap,
> Larry
> Cc: Duncan, Douglas P; Huber, Robert; Manth, Larry E
> Subject: RE: SC2
>
> Sorry for the delay in commenting, but at one time there was a suggestion
> that this strategy not be taken to continuous audit clients. That

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #47

KPMG 0012693

> constraint does not show up on the list of marketing restrictions set
> forth below. I 'm not sure what the state of play is on this point. My
> own view is that this should not be a restriction; otherwise, it appears
> that we are trying to hide a strategy that we believe works under current
> law.
>
> -----Original Message-----
> From: Rosenthal, Richard P
> Sent: Thursday, January 31, 2002 5:54 PM
> To: Atkin, Andrew S; Springer, Mark A; DeLap, Larry; Brockway, David H
> Cc: Duncan, Douglas P; Huber, Robert; Manth, Larry E
> Subject: RE: SC2
>
> Based on Andrew's message below and a conversation I had with Larry DeLap,
> see my modified comments below. This will finalize our marketing approach
> for SC2. Mark, I think we should have a 5 minute discussion of this
> during an upcoming Monday night call.
>
> Thanks,
>
> Rick
>
> -----Original Message-----
> From: Atkin, Andrew S
> Sent: Monday, January 28, 2002 12:48 PM
> To: Rosenthal, Richard P; Springer, Mark A; DeLap, Larry; Brockway,
> David H
> Cc: Duncan, Douglas P; Huber, Robert; Manth, Larry E
> Subject: RE: SC2
>
> Rick:
>
> Thanks for the comments. Overall, we are in agreement with your
> suggestions.
>
> With respect to your inquiry on why we want to have the option to attend
> all meetings, it is because of over-exuberance by certain people in the
> past. We have had situations in the past where it did not make sense to
> have a meeting (e.g. not a good target because too many shareholders,
> large case audit, not enough income or loss) and the marketing team
> insisited on meeting anyways. We have also had a couple of situations
> where one of us were asked to attend a meeting after an ICV took place and
> when we got to the meeting, the client to our surprise already knew the
> name of the tax-exempt entities. For these reasons, we think that it
> would make sense for one of us in the west to have the option of attending
> every meeting.
>
> Thanks
>
> Andrew
>
> -----Original Message-----
> From: Rosenthal, Richard P
> Sent: Monday, January 21, 2002 10:10 AM
> To: Atkin, Andrew S; Springer, Mark A; DeLap, Larry; Brockway,
> David H
> Cc: Duncan, Douglas P; Huber, Robert; Manth, Larry E
> Subject: RE: SC2
>
> I've added my comments to each of the items below…
>
> Rick
>
> -----Original Message-----
> From: Atkin, Andrew S
> Sent: Friday, January 18, 2002 5:55 PM
> To: Springer, Mark A; DeLap, Larry; Brockway, David H;

\> Rosenthal, Richard P
\> Cc: Duncan, Douglas; Huber, Robert; Manth, Larry
\> Subject: SC2
\>
\> To all:
\>
\> Here are our proposed new restrictions for SC2. Please let me know
\> if you have any questions.
\>
\> Thanks
\>
\> Andrew Atkin
\>
\> * * *
\>
\> 1) The minimum fee for SC2 is raised to $700K. The only exception
\> to this rule is for outstanding engagement letters with a fee already
\> quoted. In order to qualify for this exception, you must immediately
\> forward a copy of the engagement letter to the National Solution Champion,
\> Andrew Atkin. Anyone with questions or concerns with respect to a
\> specific target should address those with Andrew Atkin. Agee.
\>
\> 2) All BDM activity with respect to SC2 is to cease immediately.
\> BDM's are not to market the solution. Agree, however, if a BDM is working
\> on other solutions for S Corps, they should not be discouraged from
\> bringing any SC2 opportunities to our attention. However, the BDM can not
\> discuss this with the client. They must follow the procedure in number 4
\> below.
\>
\> 3) Before any target is approached with SC2, it must be approved by
\> the National Solution Champion, Andrew Atkin. Agree.
\>
\> 4) No ICV or other meeting with a target may be conducted without
\> the attendance of Andrew Atkin or his designate, unless advance approval
\> is obtained from Andrew Atkin. Agree.
\>
\> 4) SC2 will expire as a solution effective as of the end of this
\> fiscal year, September 30, 2002. After this time, no targets may be
\> approached and no ICV's held. I think the cut off date should be December
\> 31, 2002.
\>
\> 5) SC2 will not be implemented for any target that has audit or tax
\> work performed by any of the other "Big 5" or Moss Adams, Grant Thornton
\> and BDO Seidman . In order for KPMG to implement SC2 for any
\> S-corporation using these firms, the target will need to engage a local
\> firm or switch to KPMG. Agree.
\>
\> Andrew S. Atkin
\> kpmg
\> 355 South Grand Avenue
\> Suite 2000
\> Los Angeles, California 90071
\> (213) 955-8830
\> Fax (213) 630-2279
\> aatkin@kpmg.com
\>
\>
\>
\>

Proprietary Material
Confidentiality Requested

Unknown

From: Bickham, Randall S
Sent: Tuesday, August 10, 1999 4:12 PM
To: Watson, Mark T
Cc: Eischeid, Jeffrey A
Subject: BLIPS Engagement Letter

Importance: High

Mark,

Attached is the engagement letter approved by Larry. It is updated to reflect the one-time fixed fee and the use of LLC as the Investment Fund v. a limited partnership

BLIPS Final Engagement Letter....

Randy

Proprietary Material
Confidentiality Requested

KPMG 0007725

Permanent Subcommittee on Investigations
EXHIBIT #48

BLIPS
Version: 08/10/99
[Firm Letterhead]

[NOTE: DPP-Tax has reviewed and preapproved this standard engagement letter for BLIPS. The terms contained in the engagement letter are mandatory. If no changes are made to the standard letter, further review or approval by DPP-Tax is unnecessary; however, a copy of both the issued and signed engagement letter is to be provided to the business unit professional practice partner – tax, Jeff Eischeid and Mark Watson. If modifications to this preapproved standard engagement letter are desired, the reasons for such modifications are to be discussed with the location's professional practice partner - tax. The business unit professional practice partner - tax may approve, at his or her discretion, the desired modifications or may consult with DPP-Tax thereon. Before the engagement letter is sent to the client, the client engagement must be approved by Jeff Eischeid and the proposed legal structure to be used to engage in the BLIPS program must be approved by Mark Watson.]

________, 1999

PRIVATE & CONFIDENTIAL
[AddresseeName]
[StreetLine1]
[StreetLine2]
[CityStateZip]

Dear [AddresseeName]:

We are pleased you have engaged KPMG LLP ("KPMG") to provide tax consulting services for [AddresseeName] ("Client") with respect to participation in an investment program involving investments in foreign currency positions (the "Investment Program"). This letter confirms the scope and related terms of our engagement. [For purposes of this letter, references to "Client" shall be deemed to include all signatories to this letter and each such signatory shall be deemed to be an individual party hereto for all undertakings and agreements of Client contained herein. All signatories to this letter agree to execute this letter in their individual capacities, as well as their capacities as officers, shareholders, partners and/or directors of Client.]

[This letter must be signed by Client and each direct or indirect owner of Client. If a person required to sign by the preceding sentence is an entity, the signature must be made by an individual authorized to act on behalf of, and bind, the entity.]

Background

KPMG understands that Client intends to engage Presidio Growth LLC ("Presidio"), a registered investment advisor, to provide Client with investment advisory services and trading strategies with respect to the foreign exchange contracts entered into pursuant to the Investment Program. We understand that Presidio has advised Client that the utilization of a high degree of leverage is integral to the Investment Program. We also understand that Presidio will assist Client in structuring the requisite financing package by advising Client as to the structure of the financing arrangement and suggesting alternative financial institutions to provide such financing.

We understand that Client and two limited liability companies owned or controlled by Presidio intend to invest in a newly created limited liability company (the "Investment Fund"). We further understand that Presidio will act as Investment Advisor to the Investment Fund and, in such capacity, will facilitate the purchase of foreign currency contracts and other foreign currency-based financial instruments. The purchase of such foreign currency contracts and other financial instruments will involve full economic risk to Client in the foreign currency markets with price movements (up or down) in the purchased securities. Client may realize either profits or losses based upon the price movement of the foreign currency contracts and other financial instruments. Client has informed us that no one has provided Client with any assurances or guarantees that Client will make money in any of these transactions on a pre-tax or after-tax basis. Client acknowledges that it is at all times subject to market risks for both reward and loss. We have recommended to Client that Client seek independent advice concerning the investment aspects of the proposed transactions before agreeing to participate in the transactions. Client has independently determined that there is a reasonable opportunity for Client to earn a reasonable pre-tax profit from the Investment Program in excess of all associated fees and costs, and this determination has been confirmed by Presidio and/or other investment advisors.

KPMG's Role as Tax Advisor

Pursuant to this engagement, KPMG will provide only the following services with respect to your participation in the Investment Program:

- Meet with you to discuss the U.S. federal income tax implications associated with participating in the Investment Program.

- Provide Client with an opinion letter that addresses the U.S. federal income tax consequences associated with participation in the Investment Program based upon your unique facts and circumstances.

The conclusions in our opinion letter will be based on the facts, representations and assumptions that you and Presidio submit to us and we will not independently gather, verify, audit or investigate the accuracy or completeness of this information. Inaccuracy or incompleteness of the information provided to us could have a material effect on our conclusions. In rendering our advice, we will consider the applicable provisions of the Internal Revenue Code of 1986, as amended, the regulations thereunder, and judicial and administrative interpretations thereof, all as in effect as of the date of the opinion letter. These authorities are subject to change, retroactively and/or prospectively, and any such changes could affect the nature or validity of our advice. Unless you specifically engage us to do so in writing, we will not update our advice for subsequent changes or modifications to the law and regulations, or to the judicial and administrative interpretations thereof.

Client acknowledges that any tax opinion issued by KPMG would not guarantee tax results, but would provide that with respect to the tax consequences described in the opinion, there is a greater than 50 percent likelihood (i.e., it is "more likely than not") that those consequences will be upheld if challenged by the Internal Revenue Service. Client further acknowledges that the Investment Program is aggressive in nature and that the Internal Revenue Service might challenge the intended results of the Investment Program and could prevail under any of various tax authorities. Client also acknowledges receipt of a memorandum that discusses certain penalties that might be asserted by the Internal Revenue Service should it challenge any tax deductions or tax losses that might be claimed by Client with respect to participation in the Investment Program.

Client recognizes that KPMG is not a registered broker-dealer and will not be providing services to Client as a broker-dealer or investment advisor. In the course of this engagement, all services provided by KPMG will be strictly as a tax advisor to Client and KPMG will not undertake any activity that would require registration as a broker-dealer or investment advisor under the federal securities laws.

Federal Confidential Communications Privilege

A confidentiality privilege under Internal Revenue Code Section 7525 may pertain to certain communications between KPMG personnel and Client regarding federal tax advice provided pursuant to this engagement. By retaining KPMG, you agree that KPMG is instructed to claim the privilege on your behalf, with respect to any applicable communications, up and until such time as you may waive any such privilege in writing. As disclosure of any such confidential communications to the Internal Revenue Service or other third party may cause any confidentiality privilege to be waived, you should notify us if the Internal Revenue Service or other third party requests information about any tax advice or tax advice documents provided by us.

Client understands that KPMG makes no representation, warranty or promise, and offers no opinion with respect to the applicability of such confidentiality privilege to any communication and agrees to hold KPMG harmless should the privilege be determined not to apply to any or all communications. Client agrees to indemnify KPMG for any attorneys' fees and other costs and expenses incurred by KPMG in defending the confidential communications privilege on Client's behalf.

Professional Fees

Our fees for this engagement will be based on the complexity of the issues and the value of the services provided, rather than directly on the time required of the individuals who will be performing the services. Client agrees to pay KPMG a fixed fee of $________ for the services described above. Client agrees, by accepting the terms of this letter, to pay all invoices to KPMG within 30 days of receipt.

The amount of our fee is not dependent on the amount of Client's investment in the Investment Program, the investment results of the Investment Program, the tax opinion expressed, or on the amount of any tax savings projected or achieved by Client. You agree that all written or oral advice provided by KPMG to Client, including but not limited to the tax opinion, will be for Client's information and use only and will not be provided to any third party without the express advance written permission of KPMG.

Limitation on Liability and Indemnification

By signing this engagement letter, Client agrees to indemnify KPMG and its affiliates, partners, principals, and personnel (collectively, the " Indemnified Parties") from and against any and all losses, claims, damages, and liabilities, including reasonable attorney's fees and other expenses or costs of litigation (collectively, "Damages"), arising out of or relating to this engagement letter and KPMG's services hereunder (including claims by third parties), except to the extent caused by the gross negligence or intentional misconduct of KPMG.

In the event any Indemnified Party is requested pursuant to subpoena or other legal process to produce documents relating to this engagement in judicial or administrative proceedings to which such Indemnified Party is not a party, Client shall reimburse the Indemnified Party at standard billing rates for the Indemnified Party's professional time and expenses, including reasonable attorney's fees, incurred in responding to such requests.

KPMG shall have no liability to Client, under any circumstances, for any special, incidental or consequential damages, including without limitation loss of profits, even if KPMG has been advised of the possibility of such damages.

KPMG's maximum aggregate liability to Client, whether a claim be in contract, tort, or otherwise, for all claims arising out of or relating to this engagement letter or any services rendered under this letter, shall be limited to fifty thousand dollars ($50,000).

Client will not directly or indirectly refer to KPMG or any of its affiliates in any printed, audiovisual, on-line or other advertising or promotional material prepared or distributed by or for you without KPMG's specific advance review and prior written approval. The provisions of this paragraph shall survive the expiration of this Agreement.

All of the provisions of this Section, entitled Limitation on Liability and Indemnification, shall survive indefinitely any termination or expiration of this Agreement.

In the event that any term or provision of this Agreement shall be held to be invalid, void, or unenforceable, then the remainder of this Agreement shall not be affected, impaired or invalidated, and each such term and provision of this Agreement shall be valid and enforceable to the fullest extent permitted by law.

This Agreement is to be construed in accordance with the laws of the state of New York.

Please sign the enclosed copy of this letter to confirm your agreement with all of the terms expressed in this engagement letter and return it to us within [10] days. If you have any questions, please call me.

Very truly yours,

KPMG LLP

[WriterName]
[WriterTitle]

Enclosure

ACCEPTED:

[AddresseeName]

______________________________ ________________
Signature Date

[If the Addressee is not an individual, add lines for all direct or indirect owners of addressee.]

ROUTING/REVIEW INSTRUCTIONS

bcc:
Jeffrey Eischeid, Atlanta
Mark Watson, WNT
business unit professional practice partner – tax

Unknown

From: DeLap, Larry [ldelap@KPMG.COM]
Sent: Friday, March 31, 2000 10:55 AM
To: Springer, Mark A; Manth, Larry E; Galbreath, Phillip L
Cc: Smith, Richard H (WNT); Peters, Marsha F
Subject: RE: S-corp Product

Mark -

The white paper is still purely a technical document. That is fine, but if the guidance below, and guidance that any sample legal documents are to be legended and provided only to the client's legal counsel for legal counsel's consideration in drafting the actual documents, is not in the white paper, it needs to be in another toolkit document.

Larry

```
>  -----Original Message-----
> From:     DeLap, Larry
> Sent:     Thursday, March 23, 2000 10:22 AM
> To: Springer, Mark A; Manth, Larry E; Galbreath, Phillip L
> Cc: Smith, Richard H (WNT); Peters, Marsha F
> Subject:  RE: S-corp Product
>
> Mark -
>
> 1. Yes, it's fine to note the highlighted sentence in the white paper.
>
> 2. I don't think I have received the re-revised white paper and
> PowerPoint presentation.
>
> 3. Provided all the relevant partners in WNT have signed off from a
> technical standpoint, it's fine to discuss the strategy on the Monday
> night call, provided it's made clear that the actual marketing is not
> to start until the strategy has completed the approval process.
>
> Larry
>
>       -----Original Message-----
>      From:       Springer, Mark A
>      Sent: Thursday, March 23, 2000 6:34 AM
>      To:   DeLap, Larry; Manth, Larry E; Galbreath, Phillip L
>      Cc:   Smith, Richard H (WNT); Peters, Marsha F
>      Subject:     RE: S-corp Product
>
>
>      Larry D. -- Is it acceptable to you that the requirement you are
> setting forth in the highlighted paragraph be incorporated into the wp
> in such a way that members of the deployment team are (or should be)
> fully appraised of this requirement?  If not, how should such a
> restriction be memorialized/documented and then communicated.
>
>      Other than the issue below, have you completed your review of the wp
> and ppt presentation...I know you are still waiting for the revised
> (for your comments below) engagement letter...asking another way:  can
> we discuss the strategy on the upcoming Monday night call?
>
>      Philip: Is the engagement letter still in your court?
>
>      Mark Springer
>      KPMG Tax Innovation Center
>      202-533-3076
>      maspringer@kpmg.com
>
```

Permanent Subcommittee on Investigations
EXHIBIT #49

KPMG 0015738

```
>           -----Original Message-----
>           From:       DeLap, Larry
>           Sent: Wednesday, March 22, 2000 6:51 PM
>           To:   Manth, Larry E; Galbreath, Phillip L
>           Cc:   Springer, Mark A; Smith, Richard H (WNT); Peters,
> Marsha F
>           Subject:    RE: S-corp Product
>
>           Larry -
>
>           That's great that the client would select the potential donee and
> that the potential donee would do due diligence on the company.
>
>           If we were engaged by the 401(a), the team serving the
> 401(a) should be different than the team serving the S corporation and
> its shareholder, and we should get a signed letter from each of the
> parties acknowledging the dual representation and waiving any claim of
> conflict of interest.
>
>           Yes, I think we should explicitly state that the client needs to be
> engage an independent qualified valuation firm and that the client is
> responsible for paying that firm. We don't want to get technical in
> the engagement letter, but we do need to make sure the appraiser can
> meet the definition of "qualified appraiser" under section 1.170A
> -13(c)(5). I think the term "independent qualified valuation firm"
> should do the trick.
>
>
>           Larry
>
>                 -----Original Message-----
>                 From:       Manth, Larry E
>                 Sent: Wednesday, March 22, 2000 7:41 AM
>                 To:   DeLap, Larry; Galbreath, Phillip L
>                 Cc:   Springer, Mark A; Smith, Richard H (WNT);
> Peters, Marsha F
>                 Subject:    RE: S-corp Product
>
>                 Larry, in regards to thé donee, we will ask the
> client their particular preference from a list of municipal 401a's
> (there are over 1,000 in the US).  Our preference is that the client
> donate stock to a local 401(a), as opposed to e.g., someone from New
> York giving to the LAPD.  We will then contact the 401 and ask whether
> they would like to receive a charitable contribution (and describe in
> more details the stock they would be receiving).  If the client is in
> the Los Angeles area, we would tell them that the LAPD has accepted
> stock in the past and if interested, we would ask the LAPD (the LAPD
> has engaged outside legal council that has opined on the holding of
> S-corp stock).  We do not have any formal or informal agreement with
> the LAPD.  They are obviously in need of cash due to all of the
> lawsuits being filed against them and the city (the more money the pension gets, the
less the city has to pay into
> the plan, and therefore the more the city will pay the LAPD directly).
>
>                 About 1 in 4 of the 401(a)'s that we have spoken
> with are interested.  All of them have also said that they need to do
> their own due diligence on the company (e.g. making sure that the type
> of company fits within their parameters).  Also, my understanding is
> that we can be engaged by the 401(a) to express an opinion on UBIT and
> 115.  We have not done anything with this yet, but if we are engaged
> by the 401(a), I would anticipate that we would need to disclose this
> to our client (maybe part of the engagement letter?).
>
>                 In regards to the fee, we have been successful is
> getting a fixed fee of 10% of the projected average taxable income
> over two years.  So if the S-corp expects to earn $4 million next year
> and $6 million the following year, our fixed fee would be $500,000.
```

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> If the S-corp earns more or less, our fee would still be $500,000,
> non-refundable.
>
> With respect to the valuation, since we are not
> doing the valuation work, should we state that a valuation needs to be
> done by an independent qualified valuation firm? Or some type of
> language such that the client would not use, e.g. his brother-in-law.
>
> Larry
>
> -----Original Message-----
> From: DeLap, Larry
> Sent: Tuesday, March 21, 2000 4:57 PM
> To: Galbreath, Phillip L
> Cc: Springer, Mark A; Manth, Larry E
> Subject: FW: S-corp Product
>
> Phillip -
>
> I think that the engagement letter needs to
> explicitly state that the client needs to engage legal counsel to
> advise on non-tax legal aspects of the transaction and to draft
> required legal documents.
>
> I suggest you have the WNT TCS group look at the
> letter to see if they have any suggestions to add a greater business
> purpose/economic substance concern.
>
> My principal concern lies with how we introduce the
> donee to the client, whether we may have an "alliance" relationship
> with the donee (particularly if a particular donee participates in
> multiple transactions), and whether we should have some sort of
> written agreement with the donee if deemed not to be an alliance.
> Larry Manth can discuss those particular issues with me, but it seems
> to me the Scope of Services should say something about how we help the
> client select the donee.
>
> In the absence of an ICV, how do we establish the
> fixed fee?
>
> Presumably, a valuation will be needed to establish
> the amount of the charitable contribution. Shouldn't engagement letter
> say something about need for a valuation?
>
> The "restriction on use" language needs to be
> changed from "will not be provided" to "may not be relied upon".
>
>
> Larry
>
> -----Original Message-----
> From: Galbreath, Phillip L
> Sent: Monday, March 20, 2000 4:28 PM
> To: DeLap, Larry
> Subject: FW: S-corp Product
>
> Please see messages below. I know you are already
> aware of this strategy and may have already reviewed some of the
> related materials. I received and responded to questions raised by
> Chris Galer
> (DPP-Assurance) last week. Based on the messages below, Larry Manth will
> be sending the whitepaper and powerpoint presentation directly to you.
> Attached below is the sample engagement letter. Please review and provide
> me with your comments. At this point, there will be no Tax Solution Alert
> or other toolkit documents.
>
> << File: S-CAEPS_ENGAGE.DOC >>

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```
>
>               Phillip Galbreath
>               KPMG Tax Innovation Center
>               Phone: 202.533.4162
>               Fax: 202.533.4163
>               MailTo:pgalbrea@kpmg.com
>
>
>
>                -----Original Message-----
>               From:       Manth, Larry E
>               Sent: Monday, March 20, 2000 5:08 PM
>               To:   Springer, Mark A; Galbreath, Phillip L
>               Cc:   Kelliher, William B; Smith, Richard H (WNT);
> Atkin, Andrew S; Duncan, Douglas P; Huber, Robert; Bailine, Richard W
>               Subject:    RE: S-corp Product
>
>               Mark and Phillip, I believe that we have sent the engagement letter
> to Larry DeLap.  Also, we do not plan on using an ICV letter.  I
> believe the only missing item is the powerpoint presentation. We are
> just about complete (I still have not heard from the Southeast
> regarding a product champion).  We are working on an updated technical
> write-up covering the assignment of income issues, changing the put
> arrangement (Richard Bailine), and deleting 501(c)(3)'s.  Please let
> me know if we are missing anything.  Thanks, Larry
>
>                -----Original Message-----
>               From:       Springer, Mark A
>               Sent: Monday, March 20, 2000 1:37 PM
>               To:   Manth, Larry E; Galbreath, Phillip L
>               Cc:   Kelliher, William B; Smith, Richard H (WNT);
> Atkin, Andrew S; Duncan, Douglas P; Huber, Robert; Bailine, Richard W
>               Subject:    RE: S-corp Product
>
>
>               I believe this leaves as the only open item the
> assignment of income issues.
>
>               Larry:  Assume you are working directly w/ Mark
> Watson.
>
>               Philip:  Are the other toolkit items (eng letter,
> ICV letter) ready to go to Larry DeLap w/ formal request for review
> and approval to deploy the solution?
>
>               Mark Springer
>               KPMG Tax Innovation Center
>               202-533-3076
>               maspringer@kpmg.com
>
>                -----Original Message-----
>               From:       Manth, Larry E
>               Sent: Monday, March 20, 2000 3:42 PM
>               To:   Bailine, Richard W; Kelliher, William B
>               Cc:   Smith, Richard H (WNT); Springer, Mark A;
> Atkin, Andrew S; Duncan, Douglas P; Huber, Robert
>               Subject:    RE: S-corp Product
>
>               Richard, we will send you a draft of a pledge for
> your review, thanks, Larry
>
>                -----Original Message-----
>               From:       Bailine, Richard W
>               Sent: Monday, March 20, 2000 12:40 PM
>               To:   Bailine, Richard W; Kelliher, William B;
> Manth, Larry E
>               Cc:   Smith, Richard H (WNT); Springer, Mark A
```

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```
>               Subject:    RE: S-corp Product
>
>               Folks--One point I should have made clear. While I
> have no problem with the timing of the shareholders funding of the
> pledge being stretched out, one thing that can NOT happen is that the
> funding can NOT be tied to, or contingent upon, the receipt of
> distributions (or the existence of profits etc) from the S Corp. To do
> so would simply resurrect all the issues we just eliminated. Thanks.
>
>               -----Original Message-----
>               From: Bailine, Richard W
>               Sent: Monday, March 20, 2000 3:34 PM
>               To:   Kelliher, William B; Manth, Larry E
>               Cc:   Smith, Richard H (WNT)
>               Subject:    RE: S-corp Product
>
>               Larry--Bill Kelliher and I had lunch today and
> discussed this business solution idea. We are in agreement that having
> the Put to the S Corp at FMV as of the date of exercise of the Put
> with a shareholder pledge to Exempt-Org as suggested in my March 16th
> email below will enhance the technical aspects of this solution.
>
>               I would think that the economics of having the
> shareholder make this pledge would not be materially different (in
> most
> cases) than having the S Corp do so. One would think the major wealth
> component of most S Corp shareholders is their S Corp stock and,
> ultimately the source of the funds to make this pledge (if funding should
> ever be necessary) would be from the S Corp. I have no problem with the
> shareholders pledge stretching over more than one year to facilitate a
> smooth cash flow. Thus, one will not know for two years (i.e. the expected
> timing of the exercise of the Put) whether funding the pledge will be
> necessary. Assume such funding is necessary, I have no problem with the
> shareholders pledge saying "I will fund this amount over 2 years (or 3, or
> 4 etc years)". This cash flow timing should be worked out between the
> Exempt-Org and the shareholder and be mutually agreeable to them. All I am
> interested in is that this "pledge/guaranty" does not come from the S Corp
> so that in its capacity as an S Corp shareholder, Exempt-Org has no
> downside protection vis-a-vis the stock ownership and no right to a
> preferential distribution. Rights, if any, come from an individual, not
> the corporation.
>
>               With these changes, I approve the Sub Chapter C
> aspects of this business solution. Thanks to all for your valuable
> input and helping to achieve the overall desired result!
>
>               -----Original Message-----
>               From: Kelliher, William B
>               Sent: Monday, March 20, 2000 2:53 PM
>               To:   Manth, Larry E; Bailine, Richard W
>               Cc:   Smith, Richard H (WNT)
>               Subject:    RE: S-corp Product
>
>               It's correct (reg. sec. 1.1368-2(d)(1)(i)).
>
>               Bill
>
>               -----Original Message-----
>               From: Manth, Larry E
>               Sent: Monday, March 20, 2000 9:35 AM
>               To:   Bailine, Richard W; Kelliher, William B
>               Cc:   Smith, Richard H (WNT)
>               Subject:    RE: S-corp Product
>
>               Richard, I like your suggestion on the put.  If you
> think it strengthens our case, all the better!  From the S-corp side,
> since most shareholders think the company is going up in value, they
```

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> should not care. The practical concern is if the company decreases in
> value and the shareholder has to pay cash to the tax-exempt -- will
> the shareholder have enough cash to make the payment if they had not
> been paid distributions for two years? Perhaps we could extend the
> pledge for a year longer than the put.
>
> With respect to the AAA reduction, Bill can confirm
> this, the example on page 8 is correct.
>
> Also, with respect to UBIT issues, the tax-exempts
> we are dealing with are using section 115 to exclude the income from
> UBTI, so they are not concerned about UBIT.
> Thanks, Larry
>
>
>
>
> -----Original Message-----
> From: Bailine, Richard W
> Sent: Thursday, March 16, 2000 4:06 PM
> To: Manth, Larry E; Kelliher, William B
> Cc: Smith, Richard H (WNT)
> Subject: RE: S-corp Product
>
> Larry/Bill--I think we need to talk in re the
> following issues.
>
> Pg 8 of the opinion states that S Corp will reduce
> AAA by 90% (or some $7.2 million) even though the amount paid out in
> redemption of stock is a mere $1.3 million. Is this correct?
>
> More importantly, I continue to be concerned that a guaranteed PUT
> right has the potential effect of giving IRS an argument that no stock
> has been given to Exempt-Org as Exempt-Org has no downside. More over,
> as this right to get a guaranteed FMV price runs from the S Corp to
> Exempt-Org, even if exempt-Org is deemed to be a shareholder why don't
> we have a second class of stock issue as Exempt-Org certainly has
> distribution rights that differ from, and are superior to, those of
> the other shareholder.
>
> Can we solve all this as follows;
>
> (i) Assume the S Corp stock has a value of $1.3
> million on the date of the gift to Exempt-Org.
>
> (ii) Give Exempt-Org a right to Put the stock back
> to S Corp at FMV as of the date the Put is exercised.
>
> (iii) Have Shareholder make a pledge to Exempt-Org
> such that he will contribute an amount of money equal to the amount,
> if any, that any Put proceeds received by Exempt-Org are less than
> $1.3 million.
>
> In this way, Exempt-Org is assured of getting the
> cash BUT the assurance does not come from S Corp. Shouldn't this
> eliminate the above concerns. Doesn't it also have the effect of
> helping Exempt-Org; to wit, if the Put is exercised at $1 million then
> Shareholder must give $300,000 to Exempt-Org. Isn't this $300,000
> clearly a charitable gift so that Exempt-Org has no UBIT issues
> whereas the redemption proceeds may be UBIT.
>
> Thoughts. Let's talk on Friday.
>
> -----Original Message-----
> From: Manth, Larry E
> Sent: Wednesday, March 15, 2000 12:53 PM
> To: Bailine, Richard W

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> Cc: Smith, Richard H (WNT); Galbreath, Phillip
> L; Springer, Mark A; Peters, Marsha F; Atkin, Andrew S; Duncan,
> Douglas P; Huber, Robert
> Subject: S-corp Product
>
> Rick, please see my comments below.
>
> Thanks, Larry
>
> -----Original Message-----
> From: Galbreath, Phillip L
> Sent: Monday, March 13, 2000 4:49 PM
> To: Manth, Larry E
> Cc: Smith, Richard H (WNT); Springer, Mark A;
> Peters, Marsha F
> Subject: FW: S-CAEPS
>
> Below are Rick Bailine's comments relating to the
> Sub C issues in the S-CAEPS whitepaper.
>
> Phillip Galbreath
> KPMG Tax Innovation Center
> Phone: 202.533.4162
> Fax: 202.533.4163
> MailTo:pgalbrea@kpmg.com
>
>
>
> -----Original Message-----
> From: Bailine, Richard W
> Sent: Monday, March 13, 2000 7:29 PM
> To: Galbreath, Phillip L
> Cc: Bloom, Gilbert D; Springer, Mark A; Peters,
> Marsha F
> Subject: RE: S-CAEPS
>
> Phillip--I have read the attached and have the
> following comments related solely to Sub Chapter C.
>
> 1. This appears to be little more than a old give
> stock to charity and then redeem it play and as pointed out in the
> write-up at footnote 51, the IRS has, for the most part, thrown in the
> towel on these (despite a strong record in court). Having said this
> please read on.
>
> [Manth, Larry E] Yes, very similar, but during the
> time the tax-exempt owns the stock it will be allocated 90% of the
> income, be paid no distributions, and be redeemed for a small value.
>
> 2. I think the section 269 discussion is weak. It
> seems clear to me there is an acquisition of control by Exempt-Org as
> it acquires 90% of the number of shares of the S Corp and even if
> discounted at 35% (which would be questionable I think) for lack of
> voting rights as discussed in the write-up at footnote 4, this 90% of
> the number of shares should have >50% of the value of the S Corp (90%
> times 65%=58.5%). Thus, I think the argument is that (i) Exempt-Org
> receives no tax benefit from the acquisition of control, its tax
> benefits stem from its status under section 501 and (ii) the S Corp
> gets no tax benefit from the acquisition of control as its tax
> benefits stem from its status under section 1361 et seq. Thus, the
> acquisition of control is not material to any tax benefit. The
> write-up does go down this path but spends more time arguing that
> there is no acquisition of control which I think is a mistake. Also,
> the write-up speaks in very conclusive terms when it should be using
> words like "should not apply" as opposed to "...section 269 does not
> apply...". See page 7.
>

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>               [Manth, Larry E]   See revised technical paper
> attached.  Please note that the way the transaction is structured, the
> non-voting stock will not be greater than 50% of the value of the
> S-corp (the warrants significantly dilute the value).
>
>               3. My biggest concern is the redemption right given
> to Exempt-Org; why does this right guaranty Exempt-Org will receive
> cash equal to the greater of FMV at time of redemption versus FMV at
> date of gift? This right takes all downside risk away from Exempt-Org
> and one of the hallmarks of ownership is that the owner inherits the
> "benefits and burdens" of ownership. By relieving Exempt-Org of the
> burden of downside risk are we not allowing IRS an alternative
> argument that Shareholder did NOT give S Corp stock to Exempt-Org,
> rather what was truly given was a right to a fixed amount of cash plus
> a SAR (Stock Appreciation Right).
>
>               At page 11, the write-up discusses the potential
> issue that the warrants may be stock and in this light looks at Rev
> Rul 82-150. As for the analysis on this point, I think the write-up is
> fine but this revenue ruling also clearly tells us that if one is to
> be viewed as the owner of equity, one must assume the risks associated
> with equity ownership. Traditionally, one such risk is the risk the
> equity investment will decrease in value. Exempt-Org has no such risk
> and, therefore, arguably may not be viewed as an equity owner.
>
>               Moreover, why is this downside protection either
> necessary or desirable? I would think giving Exempt-Org a right to
> demand redemption (i.e. a "put") at FMV as of the date of exercise of
> the put, is more in keeping with the desires of Shareholder and
> Exempt-Org gets a windfall even if it get one cent! It would also seem
> that put at FMV as of date of exercise is truly in keeping with the
> requirements of Treas Reg 1.1361-1(l)(2)(iii). See footnote 20, page
> 6.
>
>               [Manth, Larry E]  The reason we guarantee the
> tax-exempt a minimum is that there is a potential burden -- federal
> taxes. It is not a certainty that the tax-exempt is totally exempt
> from tax on holding the stock.  Also, very few tax-exempts would ever
> take this stock because of the UBIT concerns.  So we are using the
> floor as an incentive for the tax-exempts to take the stock.
> Hopefully the discussion under economic substance regarding beneficial
> ownership on pages 12 through 19 will suffice in addressing your
> concerns on ownership issues.
>
>
>                << File: S_Corp_Strategy.doc >>
>
>
>
>               Let's chat.
>
>
>
>
>
>               -----Original Message-----
>               From: Galbreath, Phillip L
>               Sent: Monday, March 13, 2000 2:46 PM
>               To:   Bailine, Richard W
>               Subject:    FW: S-CAEPS
>
>               Attached below is the most recent version of the
> S-CAEPS whitepaper.  As I was telling you, this Tax Solution is
> getting some very high level (Stein/Rosenthal) attention.  Please
> review the whitepaper as soon as possible and provide your comments to
> Larry Manth directly.  Please copy Richard Smith, Mark Springer, Marsha Peters, and me
> on your message to Larry. Thanks for your help.
>
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KPMG 0015745

```
>               Phillip Galbreath
>               KPMG Tax Innovation Center
>               Phone: 202.533.4162
>               Fax: 202.533.4163
>               MailTo:pgalbrea@kpmg.com
>
>
>
>                -----Original Message-----
>               From:       Manth, Larry E
>               Sent: Sunday, March 12, 2000 10:35 AM
>               To:   Watson, Mark T; Smith, Richard H (WNT);
> Rosenthal, Richard P; Springer, Mark A; DeLap, Larry; Galbreath, Phillip L
>               Cc:   Atkin, Andrew S; Duncan, Douglas P; Huber,
> Robert
>               Subject:    RE: S-CAEPS
>
>               Mark, thanks for your comments.  I will address each
> one separately.
>
>               1)  Assignment of Income Issues.  We have included
> an additional paragraph under the assignment of income section.  But
> also see the economic substance arguments.  Bill Kelliher
> substantially enhanced that section and it addresses many issues,
> including beneficial ownership and income allocation.
>
>               2)  No charitable or gift tax deduction and
> reallocation of income back to original shareholders.  Again, I think
> the economic substance arguments cover these issues.  But I am not
> convinced that the Service would be successful in disallowing a
> charitable deduction.  After the transaction, the tax-exempt will have
> cash based on the fair market value of the stock.  It does nothing but
> hold the stock. The split-dollar transactions have the tax-exempt buy
> insurance.  Also, this transaction is quite similar to the charitable
> FLP. Is this a concern for that transaction as well?
>
>               3)  Per Larry DeLap's E-mail, we are not discussing penalty issues.
>
>               4)  Self-Dealing Issues.  We have inserted a
> discussion on section 4958, drafted by our EXO-Tax group in D.C.    We do,
> however, plan on using only 401's.
>
>               Larry
>
>
>
>                << File: S_Corp_Strategy.doc >>
>
>
>                -----Original Message-----
>               From:       Watson, Mark T
>               Sent: Friday, March 10, 2000 8:24 AM
>               To:   Manth, Larry E; Smith, Richard H (WNT);
> Rosenthal, Richard P; Springer, Mark A; DeLap, Larry; Galbreath, Phillip L
>               Subject:    S-CAEPS
>
>               OK.  I have reviewed the revised S-CAEPs white paper
> and I am still not convinced that the assignment of income issues
> associated with this strategy and the ramifications of Notice 99-36
> have been adequately addressed and/or considered.  The assignment of
> income discussion in the white paper is very brief and contains little
> case law analysis.  While the conclusion reached in the white paper on
> this matter may very well be correct, the brief discussion contained
> in the white paper does not give me a tremendous amount of comfort
> that all of the relevant cases and rulings have been considered,
> particularly wrt whether or not the Shareholder is assigning the S
> corp's earnings to the Exempt Organization.
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> More importantly, the paper's discussion of Notice
> 99-36 seems to miss the point. Yes, we can certainly distinguish the
> S-CAEPS transaction from the transaction that was the subject of
> Notice 99-36, but my point in raising Notice 99-36 is to make sure
> everyone is aware of the potential downside of this transaction. If
> the Service comes after the S-CAEPS transaction the way it attacked
> the Charitable Split-Dollar transaction (and I believe Notice 99-36
> and the recent section 643(a)(7) regulations indicate it will),
> clients who enter into the S-CAEPS transaction could be faced with a
> situation where: (1) they don't get an income OR gift tax charitable
> contribution deduction for the contribution of the S-Corp stock to
> charity (and, thus, they may incur a substantial gift tax liability);
> and (2) they are required to recognized all or most of the S corp's
> earnings. Further, as stated in Notice 99-36, the Service may attempt
> to impose a variety of penalties on the participants in this
> transaction (including KPMG) including the penalty under section 6701
> for aiding and abetting the understatement of tax liability. Finally,
> the white paper contains no discussion as to why the Service cannot
> claim the S-CAEPS transaction involves private inurement, an
> impermissible private benefit, or self dealing, all issues raised in
> Notice 99-36. Perhaps if the "Exempt-Org" is a section 401(a) entity rather than a
section 501(c)(3) entity these issues go away. If so, the
> white paper should so indicate.
>
> Mark T. Watson
> Partner
> KPMG - Washington National Tax
> 202-533-3092 (phone)
> 202-533-8451 (fax)
>

Unknown

From: DeLap, Larry [ldelap@KPMG.COM]
Sent: Tuesday, April 11, 2000 7:52 PM
Subject: S-Corporation Charitable Contribution Strategy (SC2)

SC2_Engage.doc (40 KB) SC2_Risk_Analysis.doc (25 KB)

<<Corporate_forms2.doc>> <<SC2_Engage.doc>> <<SC2_Whitepaper.doc>>
<<SC2_Risk_Analysis.doc>> <<SC2_TSA.DOC>>

Attached are a white paper and approved engagement letter for the S-Corporation Charitable Contribution Strategy (SC2)and an upcoming Tax Solution Alert.

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

This is a relatively high risk strategy. You will note that the heading to the preapproved engagement letter states that limitation of liability and indemnification provisions are not to be waived. On a showing of good cause, appropriate modifications to the standard limitation of liability and indemnification provisions can be made. You will also note that the engagement letter includes the following statement:

> You acknowledge receipt of a memorandum discussing certain risks associated with the strategy and represent that you have read and understand the matters discussed in that memorandum..

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

It is not contemplated that we would be engaged by the section 401(a) governmental pension plan that is the recipient of the S corporation stock. However, if we were engaged by the 401(a), the team serving the 401(a) should be different than the team serving the S corporation and its shareholder, and we should get a signed letter from each of the parties acknowledging the dual representation and waiving any claim of conflict of interest.

Sample legal documents are planned to be used by the deployment team. As indicated on the attached, such sample documents are to be provided only to the client's legal counsel for legal counsel's consideration in drafting the applicable documents. The sample documents are not to be provided directly to the client.

Larry

From: Manth, Larry E
Sent: Saturday, August 18, 2001 3:26 PM
To: Resnick, Joel ; Walker, Charles R (US/Chicago); Engel, Greg A; Smith, Jerry N; Magee, Michael ; Haynor, Daryl J; Schrier, John V
Cc: Duer, Walter M
Subject: RE: New Solutions-WNT

Joel, based on the feedback I have received from our Stratecon people in the West, the following are the types of solutions that we believe can be successful in the West region marketplace:

1) NOL Monetization solutions. We have a number of companies with large NOLs, including 10 large Alaska Native Corporations as clients with over $1 billion of NOLs which will begin to expire in 2 years. Such solutions could include the "sale" of an NOL to a taxpaying entity through a joint venture or a consolidated structure, ways to refresh NOLs by moving/squirting the NOL into basis, and strategies to circumvent the change of ownership rules under 382.

2) Ordinary Income Sheltering Solutions. We believe there is a large appetite to shelter ordinary income without the tax return exposure of loss generators. For example, as mentioned above, a joint venture strategy whereby income is shifted to an NOL party would not expose the company on its tax return to a "loss". We have found that companies prefer "stealth" type solutions with respect to their tax returns. Depreciation and/or amortization enhancements are particularly of interest. Perhaps there are strategies around the anti-churning rules of 197, to enable a company to write-off certain intangibles through amortization deductions.

3) SC2 Basis Enhancer. Beginning in December of this year, companies that have implemented SC2 will be redeeming the stock from charities. The cash earned by these companies, if withdrawn, will be subject to capital gains and/or ordinary income tax. Based on the deals completed to date, we estimate that there will be over $1 billion of earnings built-up in these companies at redemption. The shareholders will most likely want access to the cash (especially if we could get it to them tax-free). If we could design a strategy to increase the shareholders' outside tax basis, we believe there is significant opportunity. $1 billion at an average tax rate of 25% is $250 million of potential tax. If we charged a 10 - 15% fee based on tax savings, our fees could easily exceed $25 million in a two year period. And these folks are buyers!!!

4) Tax Efficient Structuring for Acquisitions. We have a number of private equity funds here in the West and would like to have a suite of strategies that can effectively allow for structuring on the front-end which will provide for a tax efficient exit. This would give us a leg up on the competition, allow for our M&A group to get involved, and potentially allow for us to bid on the audit work. We see this as more of a strategic, long term benefit than quick hits. But we believe with the number of private equity funds in the West and the number of portfolio companies they own, this could provide access for many of our strategies into the portfolio companies.

Thanks for the opportunity to provide you with our feedback.

Please call me with any questions.

Thanks,

Larry
213-630-8101

-----Original Message-----
From: Resnick, Joel
Sent: Thursday, August 16, 2001 9:07 AM
To: Walker, Charles R (US/Chicago); Engel, Greg A; Manth, Larry E; Smith, Jerry N; Magee, Michael ; Haynor, Daryl J; Schrier, John V
Cc: Duer, Walter M
Subject: New Solutions-WNT

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #51

KPMG 0026894

I will be meeting with some WNT partners on Tuesday (8/21) to discuss what types of solutions (aside from structured and cross border financing or leasing) Stratecon needs in the near future. Your thoughts would be appreciated as to the types of things you believe could be successfully marketed if the solutions were available. Please get your thoughts to me by close of business Monday (8/20).

Thanks

Joel

Joel Resnick
KPMG-Chicago
312-665-2007
e-mail-jresnick@KPMG.com
fax-312-665-6079

Message0288	
Subject:	**RE: SC2 Client**
From:	Kelliher, William B
Date:	10/19/2001 8:14:10 AM
To:	Huber, Robert

Message Body

Bob:

I think you can proceed without the little fellow. I agree that the only effects of one shareholder not joining in the contribution would be that (i) the usual post-contribution allocation would be slightly different and (ii) the non-contributing shareholder obviously would not be entitled to a charitable contribution deduction. He also would be unaffected in the event of any potential IRS challenge. So, if he is objecting to the corporation entering into the transaction, he should be advised that it wouldn't affect him one way or the other.

Bill

-----Original Message-----
From: Huber, Robert
Sent: Thursday, October 18, 2001 11:34 PM
To: Kelliher, William B
Subject: SC2 Client

Bill:

We have a client that would like to implement SC2. There are six individual shareholders. One of the six individual owns, one tenth of one percent of the company. The unique fact of this situation is this minority does not wish to gift his proportionate share of the nonvoting stock. His ownership is so minute, he is concerned about it being reduced any further by the charitable contribution. We know that this reduction is only temporary, but this shareholder is set in his decision. Initially he consented to the transaction and the company engaged KPMG, a law firm and an independent appraiser. We have prepared all steps of the transaction except for the gift.

Assuming that this is the only unique fact to the transaction, can we still issue our opinion if the remaining 99.9% of the shareholder proceed with the transaction. The only opinion letter that would be altered is one that covers the income allocation. I would assume we could issue an opinion letter that states:

Municipal Plan: 89.91%
Shareholders: 09.99%
0.10% SH: 00.10%

Please let me know your thought as soon as possible. The client would like to complete the transaction as soon as possible.

Thanks for your help,

Robert E. Huber
kpmg
355 South Grand Avenue
Suite 2000
Los Angeles, CA 90071
(213) 630-5378 (phone)
(213) 630-2279 (fax)
rehuber@kpmg.com

Outlook Header Information
Conversation Topic: SC2 Client Subject: RE: SC2 Client From: Kelliher, William B Sender Name: Kelliher, William B To: Huber, Robert Delivery Time: 10/19/2001 8:14:10 AM Creation Time: 10/19/2001 8:14:10 AM Modification Time: 10/19/2001 8:14:11 AM Submit Time: 10/19/2001 8:14:11 AM Importance: 101 Priority: 100 Sensitivity: 100 Flags: 101 Size: 106219

KPMG

Tax Innovation Center
Product Idea Submission Form

Submit to: "US TAXHOT PRODUCTS" Outlook mailbox.

From (Idea Submitter): Larry Manth, Andrew Atkin, Douglas Duncan, and Robert Huber
Office: Los Angeles
Suggested idea name/brief description: S-Corporation Charitable Contribution and Estate Planning Strategy ("S-CAEPS")
Date submitted: January 31, 2000
Check primary product group: XXX **Federal** ☐ **PFP** ☐ **SALT** ☐ **IES** ☐ **IS**
Identify other affected product groups: PFP

This Product Idea Submission Form is designed to assist in technical and market screening and prioritizing the development of new product ideas. The submitter may need to spend 3 to 8 hours of due diligence on a new idea before submitting this form.

1. Please explain the idea in detail, including how client savings are achieved:
See Attached Memo

2. What do you believe are the tax, business, and financial statement benefits of the idea (please list using bullets):
- Tax Elimination, conversion, and deferral
- Enhanced cash flow
- Philanthropic benefits

3. Please list the transaction steps (if applicable):
See Attached Memo

4. Please include/attach a schematic of the idea (if applicable):
N/A

5. To which tax jurisdictions (countries, states) do you believe the idea applies?
Federal and all states (this is an S-corporation idea)

6. Please summarize any federal, state, and foreign tax technical support. (If possible, list the applicable cites that support the idea's technical premise. Please attach related technical memoranda already produced.)
See Attached Memo

7. Please list any unresolved tax issues of which you are aware:
See Attached Memo

Proprietary Material
Confidentiality Requested

For Internal Use Only
W:\data\J06107570\658\Shrier\John S

Permanent Subcommittee on Investigations
EXHIBIT #53

KPMG 0049991

KPMG

Tax Innovation Center - Product Idea Submission Form

8. If the strategy has been delivered to a client, please attach copies of client deliverables (memos, excel spreadsheet, etc.).
We completed two transactions by 12/31/99 and have not yet finalized the deliverables
9. Please help us determine whether this idea will meet the Tax Product Development Revenue Threshold by providing the following, to the extent you can:

a. List the optimal target characteristics:
S corporations with taxable income > $2 million and less than 5 shareholders

b. List the key target markets:
All large cities

c. Identify the typical buyer (e.g., CEO, CFO, Tax Director):
Owner/CEO

d. Estimate an average tax fee per engagement for this idea:
Minimum fee of $300,000 (the projects we completed had an average fee of approximately $600,000).

THANK YOU for taking the time to submit your idea.

Proprietary Material
Confidentiality Requested

TAX SOLUTION *Alert*

April 24, 2000
FY00-28

Internal Use Only - Not for Distribution or Circulation Outside the Firm

S-Corporation Charitable Contribution Strategy

Digest

S-Corporation Charitable Contribution Strategy is designed to enable shareholders of S-corporations to make charitable contributions in a tax-efficient manner, without the immediate outlay of cash, and enhance S-corporation cash flow for business growth and expansion. S-Corporation Charitable Contribution Strategy is structured as a fixed-fee engagement. Due to the complexity of this strategy, it must be implemented only with the assistance and supervision of the National Deployment Team. The members of the team are listed in this *Tax Solution Alert.*

This *Tax Solution Alert* and any toolkit items that are generally available to all tax professionals can be found on the Tax Innovation Center's Homepage. Please note that toolkit items may be updated and improved and new items added periodically. Tax professionals should check the Tax Innovation Center's Homepage for the most recent versions of toolkit documents.

Solution Profile

An S-Corporation Charitable Contribution Strategy engagement will generally include the following components:

- Benefit Analysis – KPMG will assist the client in analyzing the potential benefits of implementing the strategy.
- Implementation – KPMG will assist the client, the client's legal counsel, and an outside valuation firm in implementing the strategy.
- Tax-Exempt Organization – KPMG will advise the shareholders relative to selection of an appropriate tax-exempt organization to receive the charitable contribution.

- Tax Opinion – KPMG will issue a tax opinion on the strategy.

Recent Success Stories

S-Corporation Charitable Contribution Strategy has been successfully implemented for several clients in a variety of industries. Recently, the strategy was implemented by a homebuilder for a fee of $1.5 million, a real estate company for a fee of $1 million, and a profitable Dot.com company for a fee of $2 million.

Optimal Target Characteristics

An optimal target for S-Corporation Charitable Contribution Strategy has the following characteristics:

- S Corporation or entity willing and able to convert to S status;
- Less than six shareholders; and
- Greater than $2.5 million in projected annual taxable income for the next two years.

Typical Buyer

This solution is best marketed to the shareholders or owners directly.

Pricing and Fee Arrangements

S-Corporation Charitable Contribution Strategy engagements are priced on a fixed fee basis. Our experience with similar engagements has been that the fixed fee generally has approximated 10% of the expected average taxable income of the S Corporation for the two years following implementation. The minimum fee is $250,000.

To maintain consistency in the pricing and delivery of S-Corporation Charitable Contribution Strategy, the terms of all engagements must be approved by a member of the S-Corporation Charitable Contribution Strategy National Deployment Team (identified below).

Service Delivery

Members of National Deployment Team are:

National			
Larry Manth	Partner, **National Deployment Champion**	Los Angeles	(213) 630-8101
Andrew Atkin	Manager	Los Angeles	(213) 955-8830
Robert Huber	Manager	Los Angeles	(213) 630-5378
Doug Duncan	Manager	Los Angeles	(213) 630-5376
Northeast			
John Schrier	Partner, **Area Deployment Champion**	New York	(212) 872-5906
Midatlantic			
Tim Speiss	Partner, **Area Deployment Champion,**	Philadelphia	(215) 299-5053
Southeast			
Councill Leak	Partner, **Area Deployment Champion**	Charlotte	(704) 371-8135
Southwest			
Mike Terracina	Partner, **Area Deployment Champion**	Houston	(713) 319-2293
Midwest			
Craig Pichette	Partner, **Area Deployment Champion**	Chicago	(312) 665-5267
West			
Mark Hutchison	Partner, **Area Deployment Champion**	Warner Center	(818) 227-6904

Assessment of Competition

Key Competitors:
Although we believe that the other Big Five and law firms have the ability to deliver similar services, we are not aware of another firm that has developed such a solution.

Toolkit Documents

The solution toolkit that has been created to assist you with marketing and delivering S-Corporation Charitable Contribution strategy engagements is available through TSA FY 00-28 found on the Tax Innovation Center's Homepage. The toolkit contains the following item:

- Internal Solution Overview Presentation

Additional toolkit items are available only to members of the S-Corporation Charitable Contribution Strategy National Deployment team.

Action Required by the Client Service Professional

An initial target list for S-Corporation Charitable Contribution Strategy has been provided to all tax partners. Please consult the initial target list to identify those companies with which you have a relationship. If you have a relationship with a target or are aware of other clients and targets that fit the S-Corporation Charitable Contribution Strategy target profile, please contact one of the National Deployment Team members named above to discuss action steps for introducing S-Corporation Charitable Contribution Strategy.

Distribution:
U.S. Partners
Assurance Senior Managers and Managers
All Tax Professionals

Tax Solution Alert **is a periodic publication of KPMG's Tax Practice and is edited by Mark A. Springer, Partner-in-Charge, and Marsha Peters, Partner, of the Washington National Tax - Tax Innovation Center. For more information on KPMG's tax solutions, visit the Tax Innovation Center's Homepage at http://taxkm.us.kworld.kpmg.com/homepages/tic/index.htm.**

The information contained in ***Tax Solution Alert*** **is general in nature. Any technical discussion is based on authorities that are subject to change. The reader is responsible for evaluating and determining the applicability of the information contained herein to specific facts and situations. Additional due diligence to assess the viability of any strategy, issue, or opportunity presented in** ***Tax Solution Alert*** **is required.**

Draft PDC Talk Points 6/19
S-Corporation Charitable Contribution Strategy

Who to Contact:
Owner or CFO

Opening: If you reach an assistant

- Greeting and introduction
  - This is __________ with KPMG's Tax Practice. I was wondering if you could help me?
- State purpose of the call
  - The KPMG Tax practice has an innovative tax strategy that could potentially benefit closely-held companies like yours, but I have a couple of questions for decision-makers name to make sure this is a good fit with your company's situation. Would decision-makers name have five minutes to speak with me?
- Make effort to speak directly with the decision maker or arrange a time which is convenient to call back

Owner/CFO Opening:

- Greeting and introduction
  - This is __________ with KPMG's Tax Practice.
- State purpose of the call
  - We have an innovative tax strategy that could potentially benefit closely-held companies like __________. May I ask you a few questions to make sure we have a good fit with your company's situation?

Qualifying Questions:

1.) Confirm that the company is an S-corporation (If not, but a C-corporation go to the CREW P qualifying questions at the bottom of the page).

2.) Ascertain the number of stockholders in the company (need to have 5 or less controlling 90% of the stock)
(If more than 5 go to the non-appointment close)

3.) Confirm expectations for the corporation's net income (at least $3.3 million annually for the next 2-4 years)
(If "no" go to the non-appointment close)

Appointment Close for SC2:

- Confirm that it appears there is an opportunity to hold further discussions
  - Based upon the information you shared with me, it sounds like your corporation could benefit from our tax strategy.

- Schedule an appointment
  - I'd like to schedule a time when our Tax Service Professional ___________, could call to discuss the strategy with you, further. Which would be better for you, day or day. Time or time?

- Thank decision-maker for his/her time.

Non-appointment Close for SC2:

- Indicate that it appears there is not an opportunity for further discussion regarding this strategy
  - Based upon what you've told me, it does not appear that your corporation could benefit from our tax strategy.

- Reaffirm KPMG's commitment to share future opportunities with the decision-maker
  - KPMG has other tax strategies that may be a better fit for your company. May we contact you again in the future regarding these opportunities?

- Thank decision-maker for his/her time.

CREW P

Qualifying questions:

1) Confirm that the company is in a tax-paying situation

2) Ascertain whether they are distributing significant earnings (confirm that the distribution exceeds $15 million this year)

Message0024	
Subject:	**RE: Florida S corporation search**
From:	US-GoSystem Administration
Date:	3/6/2001 11:43:26 AM
To:	Atkin, Andrew S
CC:	Horan, James L; Reach, Gary; Brody, Evan J; Leak, Councill; Messing, Steven G; Manth, Larry E

Message Body

We have received your request for a scan of the national RIA GoSystem locator database. This database includes data extracted from the 1999 (and forward years when products are released) tax returns processed using GoSystem RS. Please note that the database does not include any locators processed in GoWIN, password-protected locators, KPMG employee personal returns processed in Account 2VCL, or any returns processed by the firm partner tax group in Montvale.

Your scan will be processed within 15 business days by a member of the national Engagement Services Practice team. If the assigned team member has any questions about your request, he/she will contact you directly for resolution.

The results of the scan will be returned to you in an Excel spreadsheet via an email message. However, if your scan results are of national relevance (i.e., affects most locations), the Excel file will be posted on the ESP Homepage at <<http://taxkm.us.kworld.kpmg.com/homepages/Esp/Index.htm>>, and an email alert announcing the purpose of the scan and the results posting will be distributed to the tax management group and partners.

Questions should be directed to this mailbox (US-GoSystem Administration), or the Engagement Services Hotline at 201-505-6303.

Andrew: We process scans in the order received. But we can probably meet your 3/15 deadline.

kpmg
GoRS National Administrator 05
Client Service Technology/Montvale
* Phone: (201) 505-6303
* FAX: (201) 307-7773
* Email: <<mailto:US-GoSystem Administration@kpmg.com>>

-----Original Message-----
From: Atkin, Andrew S
Sent: Friday, March 02, 2001 2:12 PM
To: US-GoSystem Administration
Cc: Horan, James L; Reach, Gary; Brody, Evan J; Leak, Councill; Messing, Steven G; Manth, Larry E
Subject: Florida S corporation search

To GoSystem Administrator:

Proprietary Material
Confidentiality Requested

KPMG 0050826

Attached please find a scan request form. In this form, I request a list of all S corporations in Florida with more than $1M in income. This information is needed for marketing of the tax solution SC2. We need this information by no later than 3/15. Please send me a acknowledgment of receipt of this request and confirmation that the list can be generated by 3/15.

Permanent Subcommittee on Investigations
EXHIBIT #55

Thank you for your help.

Andrew Atkin

<< File: scan request form.doc >>

Andrew S. Atkin
KPMG
355 South Grand Avenue
Suite 2000
Los Angeles, CA 90071
(213) 955-8830
Fax (213) 630 2279
aatkin@kpmg.com

Our advice in this email and any attached documents is limited to the conclusions specifically set forth herein and is based on the completeness and accuracy of the above-stated facts, assumptions and representations. If any of the foregoing facts, assumptions or representations is not entirely complete or accurate, it is imperative that we be informed immediately, as the inaccuracy or incompleteness could have a material effect on our conclusions. In rendering our advice, we are relying upon the relevant provisions of the Internal Revenue Code of 1986, as amended, the regulations thereunder, and the judicial and administrative interpretations thereof. These authorities are subject to change, retroactively and/or prospectively, and any such changes could affect the validity of our conclusions. We will not update our advice for subsequent changes or modifications to the law and regulations or to the judicial and administrative interpretations thereof.

Outlook Header Information
Conversation Topic: Florida S corporation search Subject: RE: Florida S corporation search From: US-GoSystem Administration Sender Name: US-GoSystem Administration To: Atkin, Andrew S CC: Horan, James L; Reach, Gary; Brody, ~~Evan J; Leak, Councill; Messing, Steven G; Manth, Larry E~~ Received By: Leak, Councill Delivery Time: 3/6/2001 11:43:26 AM Creation Time: 3/6/2001 11:43:25 AM Modification Time: 3/6/2001 11:43:26 AM Submit Time: 3/6/2001 11:43:26 AM Importance: 3/1 Priority: 3/0 Sensitivity: 3/0 Flags: 3/1 Size: 3/10453

Message0030	
Subject:	South Florida SC2 Year End Push
From:	Leak, Councill
Date:	3/7/2001 4:32:33 PM
To:	Horan, James L; Jordan, Ty N; Reach, Gary; Brody, Evan J; Messing, Steven G; Atkin, Andrew S; Satalino, Frank P
CC:	Manth, Larry E; Colley, Peter M; Smith, Jerry N

Message Body

Jim, Thanks for taking the time to talk with me, Ty Jordan and Andrew Atkin today concerning SC2 and the South Florida market opportunities. The following summarizes our discussion and follow up action items:

1. Benefit Comparison--original SC2 compared to 501(c)(3) alternative. Attached is a 3 year, $5 million per year example of the two alternatives. The 501(c)(3) structure results in about 60% of the original SC2 benefit. The shareholder has much more flexibility in choosing a tax exempt in the 501(c)(3) structure, and if he or she was going to make significant charitable gifts anyway, the 501(c)(3) model should be presented without showing the redemption proceeds as an incremental cost. Our fee--original SC2 = 10% of 1 year's taxable income, 501(c)(3) version = 7.5% of first year's taxable income (maybe some more flexibility for first Beta Test deal).

2. Listing of Live Opportunities in South Florida:
$2-$3M income. Evan working on scheduling ICV
Gary is familiar with this.
RBH. Councill is handling. Oscar Suarez made introduction. Proposal issued 3/5/01. Fee $500,000. Expect answer by 3/15.
Evan handling--delay due to client business circumstances. Any way to encourage them???
Signed engagement, on hold due to shareholder's illness. Jim to revisit with attorney with 501(c)(3) structure.

3. Other potential visits/revisits with 501(c)(3) structure: REDACTED

Others?

4. Our SC2 team members in Texas came across a TX Secretary of State listing of all US S Corps that filed franchise tax returns in TX. Attached is the Florida sort from that list. All it gives is the company name, address and phone. We need you to direct Gary and the SFL BDM's to review the list to see if any new targets should be approached. We can get telemarketing support from Ft Wayne if you think it appropriate. We contacted the FL Secretary of State to see if a similar list exists for Florida and were told it does not. We have requested a Fast Tax search for all 1120S forms filed for FL clients. Andrew will forward that to the group when received.

5. Jim is going to seek out background information and Annual Reports for the Miami, Broward and Dade county community trusts. Key information needed--are they established as trusts (rather than corporations)? How much does each trust give annually in charitable contributions? Do we have any relationships with key trust managers or board members?

6. Andrew and Larry will be available for ICV's in South Florida, March 26--28, 2001. Our goal is to find several revisits with the 501(c)(3) structure and several new ICV's. Jim will ask Gary to spearhead getting ICV's set up. I am available at anytime to come down for ICV's as well.

KPMG 0050834

Thanks in advance for your help.

Permanent Subcommittee on Investigations
EXHIBIT #56

Councill

J. Councill Leak
Partner, Federal Tax Services/Stratecon Practice
kpmg LLP, Charlotte, NC
Direct: 704.371.8135
Fax: 704.335.5377
Cell: 704.906.4520
e-mail: cleak@KPMG.com

Attachment
SampleSC2.xls

Attachment
Sample501c3.xls

Attachment
Florida.xls

Outlook Header Information
Conversation Topic: South Florida SC2 Year End Push Subject: South Florida SC2 Year End Push From: Leak, Councill Sender Name: Leak, Councill To: Horan, James L; Jordan, Ty N; Reach, Gary; Brody, Evan J; Messing, Steven G; Atkin, Andrew S; Satalino, Frank P CC: Manth, Larry E; Colley, Peter M; Smith, Jerry N Delivery Time: 3/7/2001 4:32:33 PM Creation Time: 3/7/2001 4:32:33 PM Modification Time: 3/7/2001 4:32:36 PM Submit Time: 3/7/2001 4:32:35 PM Importance: 3/2 Priority: 3/1 Sensitivity: 3/0 Flags: 3/17 Size: 3/334656

Unknown

From: Manth, Larry E [lmanth@KPMG.com]
Sent: Monday, March 19, 2001 9:50 AM
To: DeLap, Larry
Subject: RE: SC2 - Client Base Expansion

Larry, I am in agreement that we should think about putting a cap on the number of deals that we complete. I suggest that we all have a conference call to discuss and include Dale Affonso and Rick Rosenthal. I will have my assistant set up a call in the next two weeks.

Thanks,

Larry

> -----Original Message-----
> From: DeLap, Larry
> Sent: Friday, March 16, 2001 5:04 PM
> To: Manth, Larry E
> Cc: Kelliher, William B; Smith, Richard H (WNT)
> Subject: FW: SC2 - Client Base Expansion
>
> << Message: SC2 >>
> Larry -
>
> Before committing to an expansion of the client base for SC2 to auto
> dealers contacted through a referral fee arrangement and to community
> trusts, I think we should have a discussion with Bill Kelliher and
> Richard Smith as to whether it would be advisable to put an overall
> limit on the number of engagements given the downside risks if the
> strategy were ultimately disallowed.
>
> Larry
>
>
>
> -----Original Message-----
> From: Choate, Gary M
> Sent: Friday, March 09, 2001 2:54 PM
> To: DeLap, Larry; Duer, Walter M
> Cc: Manth, Larry E; Atkin, Andrew S; Kirkpatrick, Richard D; Mckee,
> James F
> Subject: Alliance Agreement - Leadership Ford
>
> Attached is the first draft of an alliance agreement with Leadership
> Ford. I have requested info on their current audit firm and
> financials. I will send this info when I have it. If you have any
> questions, please let me know.
>
> Gary
>
> << File: alliance approval form1.doc >>

Proprietary Material
Confidentiality Requested

KPMG 0014971

Permanent Subcommittee on Investigations
EXHIBIT #57

Message1455	
Subject:	SC2
From:	Manth, Larry E
Date:	12/27/2001 12:58:13 PM
To:	Atkin, Andrew S; Cohen, David (US/CHICAGO); Duncan, Douglas P; Duty, James V; Gray, Mike - RALEIGH; Huber, Robert; Hutchison, Mark-Warner Cntr; Jackman, Thomas E; Leak, Councill; Pence, Robert M; Schrier, John V; Silver, Lawrence G; Speiss, Timothy P; Terracina, Michael P; Warley, Carol G; Wise, Richard
CC:	Affonso, Dale A; Duer, Walter M; Rosenthal, Richard P; Smith, Richard H (US/WEST/AMP)
Message Body	

Hello everyone. Congratulations on a great December!!

Deals closing are as follows:

(West) -- $800k
(West) -- $415k
(West) -- $400k
(SE) -- $625k minimum, $1.250 potential -- way to go Councill!!
First potential $1 million fee for SC2 outside of the West!!
(MW) -- $500k
(NE/SE) -- $425k
(MW/SW) -- $500k
(W) -- $1 million (SC2--Back-end deal)

REDACTED

Total fees = $4.665 million - $5.29 Million

Marketing. I would like to remind everyone regarding our marketing to S-corps that are serviced by other Big 5 firms. The general rule is that we will not implement SC2 for an S-corp that insists on keeping its current Big 5 firm as its auditor. If the S-corp is seriously considering the transaction, 99% of the time it will have no problem switching accounting firms to KPMG. The same goes for tax work done by other Big 5 firms. Our estimate is that by 12/31/02, there will be approximately $1 billion of income generated by S-corps that have implemented this strategy, and our goal is to maintain the confidentiality of the strategy for as long as possible to protect these clients (and new clients).

Redemption. We have had our first redemption from the LAPD. Particular thanks to Doug Duncan and his outstanding relationship with the LAPD fund administrators, the redemption went smooth. Andrew Atkin, Doug Duncan, and Bob Huber all worked together on structuring the back-end deal allowing for the shareholder to recognize a significant benefit, as well as getting KPMG a fee of approx. $1 million, double the original SC2 fee!!

Joel Resnick is in the process of working on a back-end solution to be approved by WNT that will provide S-corp shareholders additional basis in their stock which will allow for the cash build-up inside of the S-corporation to be distributed tax-free to the shareholders. This should provide us with an additional revenue stream and a captive audience. Our estimate is that if 50% of the SC2 clients implement the back-end solution, potential fees will approximate $25 million ($500 million @ 5%). We will keep everyone posted on the progress.

Please call or e-mail me with any questions.

Thanks,

Larry
213-630-8101

Outlook Header Information

Conversation Topic: SC2
Subject: SC2
From: Manth, Larry E
Sender Name: Manth, Larry E
To: Atkin, Andrew S; Cohen, David (US/CHICAGO); Duncan, Douglas P; Duty, James V; Gray, Mike - RALEIGH; Huber, Robert; Hutchison, Mark-Warner Cntr; Jackman, Thomas E; Leak, Councill; Pence, Robert M; Schrier, John V; Silver, Lawrence G; Speiss, Timothy P; Terracina, Michael P; Warley, Carol G; Wise, Richard
CC: Affonso, Dale A; Duer, Walter M; Rosenthal, Richard P; Smith, Richard H (US/WEST AMP)
Received By: Speiss, Timothy P
Delivery Time: 12/27/2001 12:58:13 PM
Creation Time: 12/27/2001 12:58:10 PM
Modification Time: 12/27/2001 12:58:13 PM
Submit Time: 12/27/2001 12:58:11 PM
Importance: 121
Priority: 120
Sensitivity: 120
Flags: 121
Size: 1212040

Sequential

From: DeLap, Larry [ldelap@KPMG.COM]
Sent: Thursday, January 03, 2002 8:24 PM
To: Springer, Mark A; Manth, Larry E; Atkin, Andrew S
Cc: Butler, Sheila M; Rosenthal, Richard P
Subject: RE: SC2

Please delete the Outlook folder, so Fort Wayne no longer views SC2 as being actively marketed, and retain a copy of the materials in a secure folder on the WNT network.

Can we schedule a conference call for January 16, 17, or 18 to discuss wind-down protocol?

Larry

> -----Original Message-----
> From: Springer, Mark A
> Sent: Thursday, January 03, 2002 12:53 PM
> To: Manth, Larry E; DeLap, Larry
> Cc: Butler, Sheila M
> Subject: RE: SC2
>
>
> Larry -- If/when we pull the solution we (the TIC) would keep a copy of
> the materials in a secure folder on the WNT network.
>
> Mark Springer
> US Tax Innovation Center
> 202-533-3076
> maspringer@KPMG.com
>
> -----Original Message-----
> From: Manth, Larry E
> Sent: Thursday, January 03, 2002 12:51 PM
> To: DeLap, Larry; Springer, Mark A
> Subject: FW: SC2
>
> More clarification.
>
> Its your call Larry. We can probably totally delete the Outlook folder and
> make sure that Andrew and Bob copy the toolkit, and also make sure someone
> in WNT has the files as well.
>
> Mark, since Bill is leaving the firm, who would you suggest?
>
> Thanks,
>
> Larry
>
> -----Original Message-----
> From: Huber, Robert
> Sent: Thursday, January 03, 2002 9:27 AM
> To: Manth, Larry E
> Cc: Atkin, Andrew S
> Subject: RE: SC2
>
> Larry:
>
> The outlook folder is still there. Therefore all designated individuals
> receive the monthly OMS report. We have restricted access to the
> "Toolkit" which is located in Outlook.

> I believe that Ralph is in-charge of the OMS reports for the west. I
> received his name in the past of who to send updates to.
>
> Bob
> -----Original Message-----
> From: Manth, Larry E
> Sent: Wednesday, January 02, 2002 4:53 PM
> To: Atkin, Andrew S; Huber, Robert
> Subject: FW: SC2
>
> I thought we shut down the Outlook folder? If not, who is still listed on
> it. Also, who is Ralph Montejo?
>
> Thanks,
>
> Larry
>
> -----Original Message-----
> From: DeLap, Larry
> Sent: Wednesday, January 02, 2002 4:00 PM
> To: Larry E Manth (E-mail); Atkin, Andrew S
> Cc: Sheila Butler (E-mail)
> Subject: FW: SC2
>
> For your action.
>
> -----Original Message-----
> From: Nance, Shelly
> Sent: Wednesday, January 02, 2002 11:12 AM
> To: DeLap, Larry
> Subject: RE: SC2
>
> SC2 is still in the Outlook folder under USWNT S-Corporation Charitable
> Contribution Strategy(SC2). I send out a monthly report for SC2 that
> shows all activity for a designated list of individuals assigned by the
> Deployment Champion created in Outlook by Sheila M. Butler. In order for
> this distribution list to be removed you need to contact Sheila Butler. I
> have no control over this. (she is in Outlook)
> SC2 is still listed as an active solution. Going forward...this is a
> solution in which I generate reports on a bi-weekly basis for Ralph
> Montejo and Patrick Brooks.
> I personally have no involvement with this activity, I only generate the
> activity report from OMS.
>
>
> -----Original Message-----
> From: DeLap, Larry
> Sent: Wednesday, January 02, 2002 1:53 PM
> To: Nance, Shelly
> Cc: Larry E Manth (E-mail)
> Subject: FW: SC2
>
> Please advise what gave rise to your December 20 message and please
> discontinue any further activity with respect to SC2.
>
> -----Original Message-----
> From: Manth, Larry E
> Sent: Wednesday, January 02, 2002 10:22 AM
> To: DeLap, Larry
> Subject: RE: SC2
>
> Larry, Fort Wayne hasn't done anything for quite a while (its been at
> least 1 year+). I'm not sure why they issue these reports, perhaps
> because SC2 is still on the active solution list. We have limited the
> marketing of SC2 significantly since our agreement 9 months ago. I
> removed myself as National leader and have not pitched SC2 since. We
> mandated strict compliance regarding the marketing of SC2 to all the areas

> -- no cold calls, only warm relationships, and minimum fee of $500k. We
> also shut down the Outlook folder and discontinued bi-weekly calls.
>
> Thanks,
>
> Larry
>
>
>
> -----Original Message-----
> From: DeLap, Larry
> Sent: Wednesday, January 02, 2002 9:54 AM
> To: Manth, Larry E
> Subject: RE: SC2
>
> Shelly Nance is in Fort Wayne, which is "cold call central". How can she
> (or he) be involved in sending out messages about SC2 if it is not being
> mass marketed.
>
> You did agree nine months ago to winding down the marketing of SC2.
>
> << Message: RE: SC2 - Client Base Expansion >>
>
>
> -----Original Message-----
> From: Manth, Larry E
> Sent: Sunday, December 30, 2001 12:46 PM
> To: DeLap, Larry
> Cc: Brockway, David H; Kelliher, William B; Smith, Richard H (US/WEST
> AMP); Rosenthal, Richard P; Atkin, Andrew S; Elgin, Evelyn; Duer, Walter
> M; Affonso, Dale A
> Subject: RE: SC2
>
> Larry, I think there is some misunderstanding over the OMS report and our
> marketing. First of all, after our conference call with Rick, we shut
> down the Outlook folder. We also mandated that there are to be no more
> cold calls for SC2, as well raising the minimum fee to $500,000 from
> $250k. The OMS report is grossly misleading with respect to our marketing
> of SC2. My estimate is that less than 100 S-corporations know about the
> general strategy. Our marketing of the strategy has been extremely
> tight-lipped. More than 90% of the companies on the OMS report never
> heard about SC2 for various reasons -- too many shareholders, not enough
> income, not an S-corp, etc... I agree that we need to put a sunset on this
> strategy, but let's come to some agreement and parameters.
>
> Thanks,
>
> Larry
>
>
> -----Original Message-----
> From: DeLap, Larry
> Sent: Saturday, December 29, 2001 4:55 PM
> To: Larry E Manth (E-mail)
> Cc: David Brockway (E-mail); Kelliher, William B; Richard Smith
> (E-mail); Richard Rosenthal (E-mail); Atkin, Andrew S; Evelyn Elgin
> (E-mail)
> Subject: FW: SC2
>
> Larry -
>
> We had a verbal agreement following a conference call with Rick Rosenthal
> earlier this year that SC2 would not be mass marketed.
>
> In any case, the time has come to formally cease all marketing of SC2.
> Please so notify your deployment team and the marketing directors.
>

> Larry
>
> -----Original Message-----
> From: Brockway, David H
> Sent: Friday, December 21, 2001 2:57 PM
> To: Kelliher, William B
> Cc: DeLap, Larry; Smith, Richard H (US/WEST AMP)
> Subject: RE: SC2
>
>
> It looks like they have already tried over 2/3rds of possible candidates
> already, if I am reading the spread sheet correctly. Could you set up a
> conference call at a convenient time after the holidays for you, Larry,
> Richard and I, so we can all review the bidding. I have a feeling the
> horse is already out of the barn, but let's discuss the situation and see
> if there anything that should be done at this point. Thanks.
>
> -----Original Message-----
> From: Kelliher, William B
> Sent: Thursday, December 20, 2001 3:30 PM
> To: Brockway, David H
> Subject: FW: SC2
>
>
> Dave:
>
> I was copied on the message below, which appears to indicate that the firm
> is intent on marketing the SC2 strategy to virtually every S corp with a
> pulse (if S corps had pulses). Going way back to Feb. 2000, when SC2
> first reared its head, my recollection is that SC2 was intended to be
> limited to a relatively small number of large S corps. That plan made
> sense because, in my opinion, there was (and is) a strong risk of a
> successful IRS attack on SC2 if the IRS gets wind of it. Somewhere along
> the line, that marketing plan seems to have changed. According to the
> list attached to the message below, the intimate group of S corps
> potentially targeted for SC2 marketing has now expanded to 3,184
> corporations. Call me paranoid, but I think that such a widespread
> marketing campaign is likely to bring KPMG and SC2 unwelcome attention
> from the IRS. If so, I suspect a vigorous (and at least partially
> successful) challenge would result. I realize that the fees are
> attractive, but does the firm's tax leadership really think that this is
> an appropriate strategy to mass market?
>
> Bill
>
> -----Original Message-----
> From: Nance, Shelly
> Sent: Thursday, December 20, 2001 9:12 AM
> To: US-WNT S-Corporation Charitable Contribution Strategy
> Subject: SC2
>
> I have attached the Monthly OMS Activity Report for "SC2", and in addition
> the report will be posted to the "SC2" Outlook Deployment folder. We hope
> that the attached file will provide you with the necessary tools to
> further the success and measure the performance of your solution and will
> serve as the center of your discussion on your bi-weekly solution
> deployment team calls.
>
> The file contains a summary report of market activity from OMS for your
> solution. Please, review it and provide any new information to your Area
> Marketing Directors (Names Below) so that they can include it in OMS. In
> particular, look for all opportunities that have not shown any progress
> since last month (Selling Cycle Date clearly marked) and determine why the
> deal has stalled and what help you need to move it forward.
>
> The file is sorted by area, selling cycle step and then alpha by target
> that you can easily pull out your specific area.

```
>
> Tax Marketing Directors:
>
> Mid-Atlantic      Marsha Shelton         Tysons Corners    703-747-6946
> Midwest           Christine Elliot          Chicago
> 312-665-2709
> Northeast         Rita Bacas                New York
> 212-872-7909
> Southeast        Trish McGinty            Atlanta
> 404-614-8662
> Southwest       Jonathan Pullano        Dallas
> 214-840-4055
> West               Melissa Fiorina          San Francisco
> 415-951-7123
>
> Thank You!
>
>  << File: SC2 12-19.XLS >>
>
> Shelly Nance
> National Assistant OMS Administrator
> 219-423-6818
> kpmg
>
>
```

Proprietary Material
Confidentiality Requested

United States Senate
COMMITTEE ON
GOVERNMENTAL AFFAIRS
WASHINGTON, DC 20510–6250

November 6, 2003

VIA U.S. MAIL & FACSIMILE (202/303-2000)

Mr. Eugene D. O'Kelly
Chairman and Chief Executive Officer
KPMG, LLP
280 Park Avenue
New York, New York 10017

Dear Mr. O'Kelly:

The U.S. Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs will hold hearings on November 18 and November 20, 2003, on the role of professional firms such as accounting firms, banks, securities firms, and law firms in the development, marketing and implementation of abusive tax shelters. The purpose of this letter is to request that four employees of KPMG LLP, testify at the hearing on November 18, scheduled to begin at 9:30 a.m. in Room 216 of the Hart Senate Office Building in Washington, D.C.

Among the issues that the Subcommittee will address at the hearings will be the development, marketing and implementation of tax products designed to be sold to multiple clients, with a focus on the Bond Linked Issue Premium Structure (BLIPS) and its predecessors, the Offshore Portfolio Investment Strategy (OPIS) and Foreign Leveraged Investment Program (FLIP), and on the S-Corporation Charitable Contribution Strategy (SC2).

To assist the Subcommittee's review, we ask that Mr. Philip Wiesner and Mr. Jeffrey Eischeid testify on a panel that will discuss BLIPS, OPIS, and FLIP; and Mr. Councill Leak testify on a separate panel that will discuss SC2. These KPMG representatives should be prepared to address and answer questions about the following matters:

(1) An explanation of each tax product that is a focus of the panel; the time period during which each product was sold to clients; how many persons purchased each product; the fee structure and source of fees for each product; and, for each product, the total revenues earned by KPMG;

(2) For each product, how many persons who purchased the product made a pre-tax profit in excess of all associated costs and fees and excluding any tax benefits; and, for each product, how many individuals reported on their tax returns netted

Permanent Subcommittee on Investigations
EXHIBIT #60

Mr. Eugene D. O'Kelly
KPMG, LLP
November 6, 2003 – Page 2

capital gains or losses from these products through a grantor trust, including persons who later amended their returns;

(3) KPMG's general procedures for developing, marketing, and implementing tax products to be sold to multiple clients, including assisting clients to prepare a related tax return; and how KPMG developed, marketed, and implemented each tax product that is a focus of the panel;

(4) KPMG's interaction with, and the role played by, outside parties, such as law firms, banks, securities firms, or charitable organizations, in the development, marketing, or implementation of each tax product that is a focus of the panel;

(5) KPMG's general procedures for discontinuing the marketing of generic tax products, and its discontinuation of the marketing of each tax product that is a focus of the panel; and

(6) KPMG's general approach to complying with federal tax shelter requirements, including whether KPMG registered or provided client information to the Internal Revenue Service (IRS) regarding each tax product that is a focus of the panel, and the current status of the IRS' review of each tax product.

Mr. Wiesner and Mr. Eischeid may submit a single, written statement or separate statements addressing the above matters; their statements will be included in the printed hearing record. In addition, Mr. Wiesner and Mr. Eischeid may provide an individual or a joint oral statement of up to ten minutes at the hearing. Mr. Leak may also submit a written statement to be included in the hearing record, and an oral statement of up to ten minutes at the hearing.

In addition, we request that Mr. Jeffrey Stein, KPMG Deputy Chairman, testify as part of a panel of representatives from several major accounting firms. We ask that Mr. Stein address and be prepared to answer questions about the seven topics listed above, as well as any institutional changes or reforms instituted by KPMG with respect to the development and marketing of abusive tax shelters. Mr. Stein may also submit a written statement to be included in the hearing record as well as an oral statement of up to ten minutes at the hearing.

Please have the original and one hundred copies of each written statement delivered to the Subcommittee at Room 199 of the Russell Senate Office Building, Washington D.C. 20510, by no later than 5:00 p.m. on Friday, November 14, 2003. In addition, by the same date, please send a copy of each statement by electronic mail to the Subcommittee's Chief Clerk at mary_robertson@govt-aff.senate.gov.

Mr. Eugene D. O'Kelly
KPMG, LLP
November 6, 2003 – Page 3

Thank you for your assistance in this matter. If you or your staff have any questions or would like additional information, please contact Robert Roach of the Subcommittee's Minority staff at (202) 224-9505.

Sincerely,

N Col

Norm Coleman
Chairman
Permanent Subcommittee on Investigations

Carl Levin

Carl Levin
Ranking Minority Member
Permanent Subcommittee on Investigations

NC:CL/ejb

cc: Russell L. Smith, Esq.
Willkie Farr & Gallagher
1875 K Street, N.W.
Washington, D.C. 20006
202/303-2000 (fax)

Tax Innovation Center Solution and Idea Development - Year-End Results

May 30, 2001

Permanent Subcommittee on Investigations
EXHIBIT #61

XX-001755

Goal: Deposit 150 New Ideas in Tax Service Idea Bank

Functional Group	Deposits	Expected Deposits	In the Pipeline
◆ SALT	32	7	18
◆ CAB	19	5	11
◆ Passthrough	14	2	9
◆ IES	13	11	27
◆ TCS	5	1	2
◆ Stratecon	2	0	5
◆ ICS	22*	2	6
◆ Methods	4	2	68
◆ Insurance	3	4	7
◆ PFP	3	3	18
◆ Trade & Customs	4	0	0
◆ e-Tax	1	1	0
Total	122	38	171

* Includes 21 Lifecycle conversions posted

Permanent Subcommittee on Investigations
EXHIBIT #62

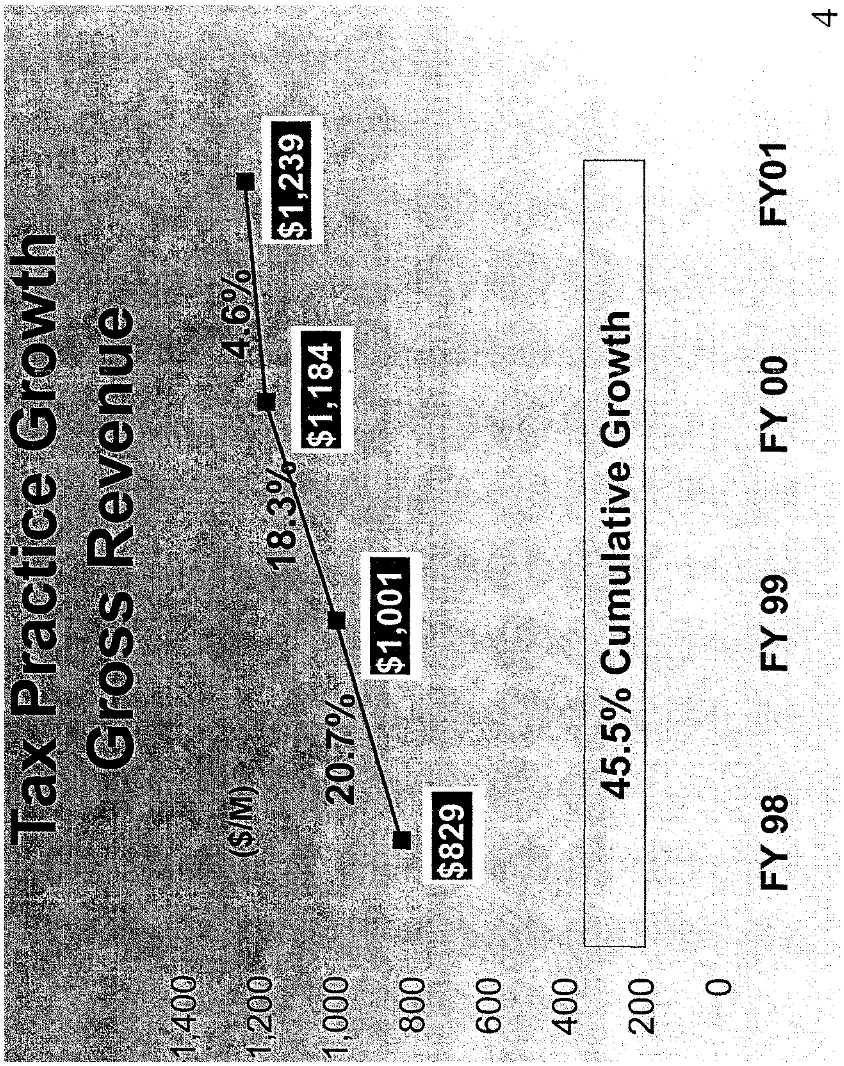
Innovative Tax Solutions
July 19, 2001

Marsha Peters

Washington National Tax

Tax Practice Update

Rick Rosenthal
Vice Chairman – Tax Operations
New York


Tax Practice Growth
Gross Revenue
($/M)
1,400
1,200
1,000
800
600
400
200
0
$829
$1,001
$1,184
$1,239
20.7%
18.3%
4.6%
45.5% Cumulative Growth
FY 98
FY 99
FY 00
FY01
4

Permanent Subcommittee on Investigations
EXHIBIT #63

S-Corporation Charitable Contribution Strategy (SC2) Update

Andrew Atkin, Los Angeles
Bob Huber, Los Angeles
June 18, 2001

FOR INTERNAL USE ONLY -- NOT TO BE USED FOR CLIENT PRESENTATIONS

KPMG

XX-001553

Revenue Results

- Revenue since solution was launched: $20,700,000
- Revenue this fiscal year only: $10,700,000

Revenue by Region this Fiscal Year

- West $7,250,000
- Southeast $1,300,000
- Southwest $ 850,000
- Mid-Atlantic $ 550,000
- Midwest $ 425,000
- Northeast $ 300,000

Solution Enhancement

- Benefit: Greater flexibility in meeting charitable goals of the shareholder (i.e., choice in ultimate recipient of gift).
- However, ultimate benefit of strategy is about half of normal SC2
- Target characteristics:
  - greater than $10M annual taxable income;
  - less than six shareholders;
  - shareholders unwilling to enter into SC2 *because they cannot select/choose* the ultimate beneficiary of the gift

Sequential

From:	Lanning, John T [IMCEAEX-_O=KPMG_OU=US_CN=RECIPIENTS_CN=17627@KPMG.com]
Sent:	Monday, May 10, 1999 6:02 PM
To:	DeLap, Larry
Subject:	RE: BLIPS -- More Likely Than Not?
Sensitivity:	Private

Larry:

I continue to be frustrated with the process on this one as I know everyone is. Perhaps we can spend a few minutes discussing this in Chicago.

John

> -----Original Message-----
> From: DeLap, Larry
> Sent: Monday, May 10, 1999 10:34 AM
> To: Lanning, John T
> Subject: FW: BLIPS -- More Likely Than Not?
> Importance: High
> Sensitivity: Private
>
> John -
>
> Three things:
>
> 1. As this is a PFP product, I believe it is essential that the chief PFP
> technical partner in Washington National Tax be comfortable with it. That
> is why I requested, and received, Mark Watson's "sign off" two weeks ago.
>
> << File: RE BLIPS.rtf >>
>
> 2. I believe it is essential that any WNT technical analysis be based on
> the actual facts. Mark determined, based on disclosures at a meeting on
> April 30 and May 1, that certain essential facts had not been disclosed to
> WNT. As indicated in a separate message I sent you, he has requested some
> changes in the planned facts that could, in his view, make the WNT
> analysis viable.
>
> 3. As previously indicated, a key issue is "Who is the borrower", which
> was not addressed in the initial WNT analysis (although I had highlighted
> the issue back in February). A section on that question has been added to
> the draft opinion by Randy Bickham. I think the appropriate WNT technical
> resource for the "who is the borrower" question is Steve Rosenthal. I
> spoke again with Steve this morning and he is uncomfortable with a
> more-likely-than-not opinion that the investor is the true borrower at any
> point in the transaction. He is meeting with Richard Smith and Phil
> Wiesner this afternoon to discuss this issue.
>
> Larry
> -----Original Message-----
> From: Watson, Mark T
> Sent: Wednesday, May 05, 1999 8:40 AM
> To: DeLap, Larry
> Subject: RE: BLIPS -- More Likely Than Not?
>
> Larry, in my April 27 message I stated that I was comfortable that the
> technical issues associated with BLIPS had been thoroughly reviewed and
> analyzed by WNT. However, based on information that was disclosed to me
> on April 30 and May 1, it appears that WNT was not given complete
> information as to how the strategy will actually be structured. It is

> this subsequent information that caused me to send the message to you
> yesterday.
>
> I will communicate my concerns to Doug, Jeff, and Randy.
>
>
>
> -----Original Message-----
> From: DeLap, Larry
> Sent: Wednesday, May 05, 1999 12:00 AM
> To: Watson, Mark T
> Subject: RE: BLIPS -- More Likely Than Not?
>
> << File: RE BLIPS.rtf >>
>
> Mark -
>
> It's not clear to me how this comports with your April 27 message.
> However, as this is a PFP product and you are the chief PFP technical
> resource, I believe the product should not be approved if you are
> uncomfortable with it. Steve Rosenthal indicated that Randy Bickham is in
> Washington, D.C. now. Can you please discuss your concerns with Randy.
> Also, please discuss with Jeff Eischeid and Doug Ammerman.
>
>
> Larry
> -----Original Message-----
> From: Watson, Mark T
> Sent: Tuesday, May 04, 1999 8:03 AM
> To: DeLap, Larry
> Subject: BLIPS -- More Likely Than Not?
> Importance: High
>
> Larry, while I am comfortable that WNT did its job reviewing
> and analyzing the technical issues associated with BLIPS, based on the
> BLIPS meeting I attended on April 30 and May 1, I am not comfortable
> issuing a more-likely-than-not opinion letter wrt this product for the
> following reasons:
>
> * Based on Presidio's own admission, the probability of actually
> making a profit from this transaction is remote (possible, but remote);
>
> * The bank will control how the "loan" proceeds are invested via a
> veto power over Presidio's investment choices; and
>
> * It appears that the bank wants the "loan" repaid within
> approximately 60 days (and, thus, the reason for the three investment
> stages).
>
> Thus, I think it is questionable whether a client's
> representation that he or she believed there was a reasonable opportunity
> to make a profit is a reasonable representation. Even more concerning,
> however, is whether a loan was actually made. If the bank controls how
> the loan proceeds are used and when they are repaid, has the bank actually
> made a bona fide loan?
>
> I will no doubt catch hell for sending you this message.
> However, until the above issues are resolved satisfactorily, I am not
> comfortable with this product.
>
>
>
> Mark T. Watson
> Partner
> KPMG - Washington National Tax
> 202-467-2433 (phone)
> 202-822-8887 (fax)

Sequential

From:	DeLap, Larry [ldelap@KPMG.COM]
Sent:	Friday, May 14, 1999 1:47 PM
To:	Lippman, Michael H
Cc:	Springer, Mark A; Ammerman, Douglas K
Subject:	RE: BLIPS

```
yep

> -----Original Message-----
> From:     Lippman, Michael H
> Sent:     Friday, May 14, 1999 1:41 PM
> To: DeLap, Larry
> Cc: Springer, Mark A; Ammerman, Douglas K
> Subject:  RE: BLIPS
>
> Let's try this again.
>
> Assuming we receive the representations that Mark has requested, will the
> product be approved.
>
> Thanks
>
>     -----Original Message-----
>     From: DeLap, Larry
>     Sent: Friday, May 14, 1999 10:28 AM
>     To:   Lippman, Michael H
>     Cc:   Springer, Mark A; Ammerman, Douglas K
>     Subject:    FW: BLIPS
>
>
>
>     -----Original Message-----
>     From: Lippman, Michael H
>     Sent: Friday, May 14, 1999 10:09 AM
>     To:   DeLap, Larry
>     Cc:   Springer, Mark A; Ammerman, Douglas K
>     Subject:    FW: BLIPS
>
>     Larry --
>
>     Have you approved this product? No.
>
>      If not, when do you expect to make a decision? Upon receipt from
> Presidio of explicit confirmation that the additional representations
> requested by Mark will be given.
>
>      << File: Representations.rtf >>
>
>     Thanks
>
>     Mike
>
>     -----Original Message-----
>     From: Mcconnachie, Barbara
>     Sent: Thursday, May 13, 1999 7:46 PM
>     To:   Lanning, John T; Stein, Jeff; Lippman, Michael H; Wiesner,
> Philip J; Watson, Mark T; DeLap, Larry
>     Subject:    FW: BLIPS
>
>     I am beginning to think that the name BLIP was selected because this
> product promises to be just a "blip" on our financial statements.  I
> wholeheartedly agree with Phil Wiesner's message this morning outlining
```

> where we are at this point and the incredible support we have received
> from WNT to craft a tax opinion that satisfies the more-likely-than-not
> standard.
>
> One week ago, I assembled a special BLIPS task force in Dallas to
> deal specifically with the following issues:
>
> 1. Educating a select group of professionals regarding
> the technical aspects of this product.
>
> 2. Review of the risk-management aspects of the
> product.
>
> 3. Review of marketing plan and the product's fee
> potential.
>
> While John Larson initially indicated that it may take Deutsche Bank
> and Sherman & Sterling up to 60 days to produce the relevant
> documentation, it is my understanding that efforts by all parties have
> been accelerated and that we are currently expecting documentation to be
> completed no later than the end of this month. In that regard, it is my
> understanding that Presidio has 2 individuals permanently housed at
> Sherman & Sterling to assist in the necessary documentation. Similarly
> Deutsche Bank is dedicating resources necessary to complete their
> documentation. In fact, at the end of this month, Jeff Eischeid will be
> attending a meeting in Frankfurt to address the issue of expanding
> capacity at Deutsche Bank given our expectation regarding the substantial
> volume expected from this product.
>
> Mark's concerns (which were based upon comments made by Presidio at
> the Dallas meeting) are being addressed both by Presidio and Deutsche
> Bank. In my opinion, Mark's comments should in no way delay or reinitiate
> our internal approval process. It is important to recognize that part of
> the agreement I made with Larry DeLap is that every BLIP transaction will
> receive the joint approval of both Mark Watson and Jeff Eischeid. To
> insure that we have proper risk-management control over this product,
> every opinion letter and every engagement letter will be subject to such
> joint approval.
>
> In short, it is my understanding that this product has been examined
> by all appropriate technical resources in WNT and that all material issues
> that have been raised are being incorporated into the documents. The
> validity of the transactions will be subject to the actual facts as Phil
> pointed out. In that regard, I am fully confident that by having Mark and
> Jeff both reviewing each transaction that we will be able to avoid some of
> the technical issues that are currently being discussed in the abstract.
>
> I concur with Jeff.
>
> Doug
>
> Doug Ammerman
> KPMG LLP
> Orange County Office
> (714) 850-4455
>
> -----Original Message-----
> From: Stein, Jeff
> Sent: Monday, May 10, 1999 11:05 AM
> To: Wiesner, Philip J; Lanning, John T; Ammerman, Douglas K
> Cc: Lippman, Michael H; Smith, Richard H (WNT); Watson, Mark T;
> Rosenthal, Steven M; DeLap, Larry
> Subject: RE: BLIPS
>
> I think it's shit OR get off the pot. I vote for shit.
>
> -----Original Message-----

> From: Wiesner, Philip J
> Sent: Monday, May 10, 1999 9:51 AM
> To: Lanning, John T; Ammerman, Douglas K
> Cc: Stein, Jeff; Lippman, Michael H; Smith, Richard H
> (WNT); Watson, Mark T; Rosenthal, Steven M; DeLap, Larry
> Subject: RE: BLIPS
>
> John/Doug: Many people have worked long and hard to craft a
> tax opinion in the BLIPS transaction that satisfies the more likely than
> not standard. I believed that we in WNT had completed our work a month ago
> when we forwarded the opinion to Larry. Based on my attendance at numerous
> technical meetings and my reading the opinion, I came to the conclusion
> that we could reach an overall more likely than not tax opinion based on
> the information provided re business purpose and potential profit and the
> representations to be provided by the investor and Presidio. We viewed our
> role as a positive one, ie, we would work very hard to achieve, if
> possible, the desired level of opinion and suggest improvements, in
> particular, to limit the risks which the Firm is assuming by issuing the
> opinion.
>
> The speed to market issue is also troubling to me, but
> perhpas for different reasons. First, this is a classic transaction where
> we can labor over the technical concerns, but the ultimate resolution - if
> challenged by the IRS - will be based on the facts (or lack thereof). In
> short, our opinion is only as good as the factual representations that it
> is based upon. As the courts did in the individual tax shelter cases of
> the 80s and in the recent ACM case, the decision will be based not on the
> techical niceties, but on the overall issues of whether in fact the
> investors approached the transaction from a business like point of view
> with a real desire to make a profit other than from tax benefits. Second,
> we have been dealing with a true prototype opinion where the facts keep
> evolving. The real "rubber meets the road" will happen when the
> transaction is sold to investors, what the investors' actual motive for
> investing the transaction is and how the transaction actually unfolds. Our
> opinion will be worth little (but we will be protected from risk if it is
> properly caveated) is the actual facts bear little relation to the assumed
> facts in the opinion. Note: This is Mark Watson's primary concern based on
> the recent Presidio discussions at a PFP meeting. Third, our reputation
> will be used to market the transaction. This is a given in these types of
> deals. Thus, we need to be concerned about who we are getting in bed with
> here. In particular, do we believe that Presidio has the integrity to sell
> the deal on the facts and representations that we have written our opinion
> on?! We have had past experience in the foreign stock redemption and the
> OPUS transactions which shows how difficult it is to keep the facts in
> line. Thus, the process has been slowed by a number of very critical
> forces which have been at work.
>
> Having said all the above, I do believe the time has come to
> shit and get off the pot. The business decisions to me are primarily two:
> (1) Have we drafted the opinion with the appropriate limiting bells and
> whistles (Yes, in my opinion), has the engagment letter been drafted with
> the right rsik limiting language (from what I have seen, Yes) and is the
> marketing of the transaction limited to very sophisticated taxpayers who
> are made aware of the risk and properly advised by their own tax and
> investment advisers (I thought that the marketing here was to be limited
> to a very small and narrow range of risk taking individuals!) and (2) Are
> we being paid enough to offset the risks of potential litigation resulting
> from the transaction? If the answers are yes to both questions, then we
> have done all we can do from a technical point of view and it is time to
> move on and decide the business case. 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. Finally, as I said above, our opinion is only as good as
> the underlying factual assumtions and actions by the investors. We cannot
> control with any certainly what they will do in fact!
>
> The way forward. In my view, the technical issues have been

> worked about as well as they can be. We should decide as a business matter
> to proceed and work to have in place controls to make sure that the
> sellers of the transaction and the investors in the transaction do not
> make a sham of our opinion.
>
> Phil
>
>
>
> -----Original Message-----
> From: Lanning, John T
> Sent: Saturday, May 08, 1999 3:32 PM
> To: Ammerman, Douglas K; Wiesner, Philip J
> Cc: Stein, Jeff; Lippman, Michael H
> Subject: FW: BLIPS
>
> I must say that I am amazed that at this late date
> (must now be six months into this process) our chief WNT PFP technical
> expert has reached this conclusion. I would have thought Mark would have
> been involved on the ground floor of this process, especially on an issue
> as critical as profit motive. What gives? This appears to be the
> antithesis of "speed to market". Is there any chance of ever getting this
> product off the launching pad, or should we simply give up???
>
> John
>
> -----Original Message-----
> From: DeLap, Larry
> Sent: Friday, May 07, 1999 7:48 AM
> To: Ammerman, Douglas K; Eischeid, Jeffrey A;
> Bickham, Randall S
> Cc: John Lanning; Jeff Stein
> Subject: FW: BLIPS
>
> Doug, Jeff, and Randy -
>
> Steve Rosenthal informed me on Tuesday afternoon
> that he had substantial concern with the "who is the borrower" issuer, and
> that he would be discussing the matter with Randy on Tuesday or Wednesday.
> I don't know what the outcome of those discussions were. I imagine Steve
> would have a concern with the second bullet in Mark Watson's message.
>
> I don't believe a PFP product should be approved
> when the top PFP technical partner in WNT believes it should not be
> approved.
>
> I will be back in the U.S. on Saturday and in the
> Silicon Valley office on Monday morning. Please give me a call on Saturday
> afternoon or Sunday at home (408-353-3309) or on Monday morning in the
> office.
>
> Larry
>
> -----Original Message-----
> From: Watson, Mark T
> Sent: Wednesday, May 05, 1999 9:21 AM
> To: Ammerman, Douglas K; Eischeid, Jeffrey A;
> Bickham, Randall S
> Subject: BLIPS
>
> Based on our meeting on April 30 and May 1, I am not
> comfortable with the BLIPS product for the following reasons:
>
> * According to Presidio, the probability of making a profit from this
> strategy is remote (possible, but remote). Thus, I don't think a client's
> representation that they thought there was a reasonable opportunity to
> make a profit is a reasonable representation. If it isn't a reasonable

```
> representation, our opinion letter is worthless.
>
> *   The bank will control, via a veto power over Presidio, how the
> "loan" proceeds are invested.  Also, it appears that the bank will require
> this "loan" to be repaid in a relatively short period of time (e.g., 60
> days) even though it is structured as a seven-year loan.  These factors
> make it difficult for me to conclude that a bona fide loan was ever made.
> If a bona-fide loan was not made, the whole transaction falls apart.
>
>                Until these issues are resolved satisfactorily, I
> don't think we should release this product.
>
>                Mark T. Watson
>                Partner
>                KPMG - Washington National Tax
>                202-467-2433 (phone)
>                202-822-8887 (fax)
>
```

Unknown

From:	Lipschultz, Brent S
Sent:	Thursday, August 05, 1999 1:35 PM
To:	Eischeid, Jeffrey A; Tendler, Neil J; Bloom, Richard J
Cc:	Ammerman, Douglas K
Subject:	BLIPS involvement in the NE - BDMs

BLIPS.DOC BLIPS SCRIPT.DOC

In an effort to obtain additional client leads for BLIPS given the short-time horizon, we would like to deploy the BDMs in the Northeast in an effort to assist us in contacting the NE area audit, tax, and consulting partners. Could you forward these documents to Larry Delap for his review as soon as possible so that we can start deployment immediately.

If you have any questions, you can contact me, Richard Bloom, or Neil Tendler.

Thank you for your prompt attention to this matter. (P.S. the introduction of the BLIPS Script will be changed depending upon who is making the introduction).

Brent Lipschultz

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #66

KPMG 0007691

BLIPS

Hi, this is ____________ from KPMG's Personal Financial Planning Practice. We have an innovative strategy that can offset the federal and state capital gains tax from your key client's/ target's asset sales. It's a substantial fee generator for the firm (minimum is $250,000 and it is a turnkey type of product). However, the strategy is extremely time sensitive. It must be initiated by September 15th. We're looking for clients or targets who have or will have realized a minimum of a $20 million capital gain. Persons who recently sold or will have sold a closely held business or individuals with highly appreciated stock positions looking to diversify are ideal candidates.

I'd appreciate a return call as soon as it is convenient at x______ to discuss this in further detail.

There is an innovative Personal Financial Planning strategy that can offset the federal and state capital gains tax from your key client's/ target's assets sales.

Benefits of the Strategy

Clients can potentially eliminate the 20% federal capital gains tax and applicable state tax liability at a maximum cost of 7% of the gain. Thus the savings are at least 13% of the total gain.

- Example – If client had a $20 million gain, he could eliminate the $4 million federal capital gains tax at a pre-tax cost of $1.4 million.

Product Profile

This is an integrated investment strategy which has the potential for economic benefit while potentially producing large tax losses. This is accomplished through the generation of tax basis beyond invested capital.

- Example – Client invests $1.4 million into strategy that has the potential for future profit while generating a $20 million tax loss upon divestiture.

Qualifiers

There are three qualifications:

- Since we are bringing this to a limited number of clients, we would like to bring this to key clients/ targets with whom we have a close relationship (e.g. KPMG client);
- Persons with a > $20 million capital gain or anticipated gain in the case of a future asset sale;
- Persons with a high tax risk tolerance.

Target Profile Examples

- Owners of closely held businesses who have or are going to sell in near future;
- Substantial shareholders of appreciated stock positions who are seeking alternative ways to diversify;
- Recent IPO Shareholders who are coming out of lock-up positions;

Pricing

KPMG's fee is 1.25% (125 basis points) of the gain to be mitigated. This fee is included as part of the 7% investment in strategy.

- Example - $250,000 fee for a $20 million gain. $20 million is the minimum transaction size with $250,000 being the minimum fee.

Key Differentiators and Deliverables

The following are the key points that we believe differentiate the strategy from other firms who may have other gain mitigation strategies:

- KPMG acts as tax advisor in the transaction and performs a detailed review of all documentation;
- The strategy includes the use of a third party skilled in execution;
- KPMG issues a "More Likely Than Not" opinion on the tax implications of the strategy or the tax issues associated with the tax rules;
- Major NY law firm offers concurring legal opinion.

We believe that the combination of our opinion along with the concurring legal opinion is a definite differentiator from other strategies in the market. We also believe this strategy is more technically sound than other offerings from Big 5 firms.

The Bonuses of Helping To Engage

The biggest bonus in helping to secure engagements with your contacts is the potential fees involved. With a minimum of $250,000 fee and with the PFP practice actively working on some multi-million dollar fees, we can generate some substantial revenue attributable to your participation on a turn key basis. Second, having our PFP experts help your clients elevates your relationship to a more "trusted advisor" status and can be the glue for a long-term partnership.

Next Step
Our next step is the identification of appropriate clients/ targets. Given the qualifications above, we're looking to quickly go to market with this strategy. There is time sensitivity to this strategy for this tax year as we need to have initiated the transaction by September 15th.

When you come up with your appropriate candidates, please contact:

Rich Bloom, PFP Senior Manager, x **6470**

Phil Dinsmore, Tax BDM, x **6716**

Neil Tendler, PFP Northeast Partner in Charge, x **6255**

francesco.piovanetti@db.com
To: william.boyle@db.com
cc:
Subject: Re: Risk and Resources Committee Paper

Sent: 07/26/1999 10:34 AM

Let's talk...

---------------------- Forwarded by Francesco Piovanetti on 07/26/99 09:33 AM ---------------------------

From: Mick Wood on 07/15/99 06:44 PM GMT

To: Francesco Piovanetti
cc:
Subject: Re: Risk and Resources Committee Paper (Document link not converted)

As discussed - we will not present this tomorrow.

In any event, I dont think this would be ready to present as is.

You need to spell out very clearly what the issue is that you feel requires input from the RRC. What you have here is an explananation of a deal structure.
If this structure involves us taking risk on private clients, then we may need to involve the Private Client Credit Unit. That may not be necessary if it involves risk on an SPV, or is structured on a limited or non recourse basis, but we may then have to involve the market risk guys to ensure we have picked up the optionality elements.
If you intend to include this deal structure paper, I would strongly suggest that it requires significant amendment and some additions. Please take this in the spirit that it is intended because it is in nobody's interests to have a paper rejected, just because people could not understand it. I personally spent some time going through it and felt it was missing a lot of quite basic bits of information without which it was impossible to address the risks (for example,. how and in what form is the client investment made! What further commitments exist!, what is the purpose of the structure (if, indeed we care!). Some of the gaps I could build in by guess work, but It is dangerous to expect people to have to do that. It also conveys a bad impression of those presenting the business. I was under no pressure when I read it, and was reading it as an interested party. Others may not be so tolerant. There are also details which I believe must be wrong, and some terminology is used which is out of context. Alone, some of these are very petty details, but combined with the other aspects, they could be the sort of thing could kill the proposal; simply because people get irritated with the presentation. Unfortunately, I cannot get involved in assisting you to draft the presentation, for a number of reasons. What I would suggest is you give it somebody else who has never seen the deal before, and ask them to describe it back to you based only on the information in this presentation.

Again, please take my comments in this last paragraph in the spirit they are intended. (one reason I have not copied anybody else).

Mick

Francesco Piovanetti@DBNA
13/07/99 17:27

Permanent Subcommittee on Investigations
EXHIBIT #67

To: Mick Wood/DMGCM/DMG UK/DeuBa@DMG UK
cc: PAUL MCHUGH; NANCY DONOHUE; William Boyle; Ivor Dunbar/DMGSF/DMG UK/DeuBa@DMG UK; Paul Glover
Subject: Risk and Resources Committee Paper

(Embedded image moved to file: pic06517.pcx) (Embedded image moved to file: pic23982.pcx)

Dear Mick,

Attached please find the paper that will be presented to the Risk and Resources Committee this coming Friday. Please call me to discuss the document before you forward it to other members of the committee.

You can reach me at 212-469-7318.

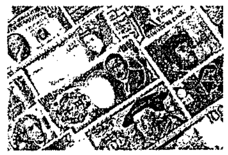
Regards,

Francesco Piovanetti
Structured Transactions Group

(See attached file: BLIPS Transaction Global.ppt)

- pic06517.pcx
- pic23982.pcx
- BLIPS Transaction Global.ppt

July 14, 1999



Bond Linked Indexed Premium Strategy "BLIPS"

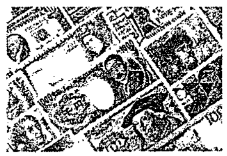
Global Markets

Structured Transactions Group
Relative Value Group

Confidential and Proprietary Product Overview for Review by the Risk & Resources Committee

Deutsche Banc Alex. Brown

Deutsche Bank



BLIPS Overview

BLIPS will be marketed to High Net Worth Individual Clients of KPMG by Presidio Advisors ("Presidio"). Presidio has structured a foreign exchange investment program with significant pre-tax profit potential for US investors.

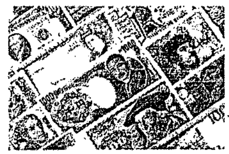
Presidio has approached Deutsche Bank Securities ("DBSI") for the execution of foreign exchange and interest rate derivative transactions, and financing of the BLIPS program.

DBSI has received a legal opinion from Shearman & Sterling that validates DBSI's role in the transaction as a lender and FX execution provider, and sees no risk to DBSI in its involvement in the BLIPS program. Furthermore, KPMG and Brown & Wood will issue opinions to the investors in the transactions attesting to the soundness of the structure from a tax perspective. At no time will DBSI provide any tax advice to any of the investors involved in the transactions; *DBSI will only execute FX and interest rate transactions, and finance the BLIPS structure*. Disclaimer letters designed to protect DBSI from any tax and reputational risk will be executed by investors to further reinforce DBSI's position.

Stringent collateral requirements are in place under the Credit Agreement. The ISDA, which will cover all foreign exchange and interest rate transactions, is cross-defaulted to the Credit Agreement.

For presentation purposes we will use the following sample trade:

- A newly created LLC will receive a seven year loan from DBSI-STG. The loan will carry a high coupon rate (16%) and will be delivered to the LLC in the form of a par amount ($100MM) and a premium amount ($60MM). The loan will be collateralized with a cash contribution of approximately 7.7% ($4.6MM) of the premium amount.



BLIPS Step 1 - Margin Account

DBSI Loan

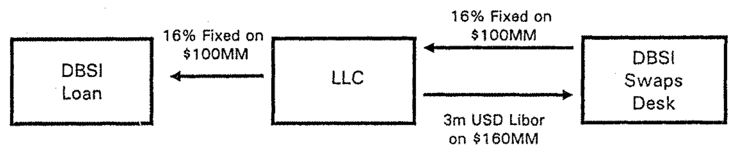
↓ $ 100MM Loan
60MM Premium
4.6MM Equity Capital

$164.6MM deposit in Global Markets

Deposit loan and premium proceeds into a DBSI Margin Account where the funds will be held-in-custody.

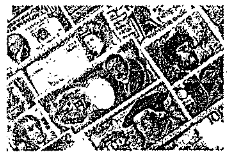
BLIPS Step 2 - Loan / Swap

The LLC will enter into an Interest Rate Swap with DBSI-NY Swaps desk to effectively convert the loan from a fixed rate into a floating rate Libor based obligation:



Loan Details	Swap Details
7yr	7yr
Fixed Rate Approximately 16%	Fixed Rate to Match Exact Loan Coupon
Quarterly Coupon Payments	Floating 3month Libor on $160MM

- The loan and swap will be priced simultaneously on the USD Libor curve.
- The loan and swap will *always* net off against each other at each point in time to value $160MM, plus Libor accrued interest.
- The swap will have two elements to create a small basis to the loan. This risk will be borne by the LLC:
  - Seven day timing mismatch on the start date
  - Cap on 3m Libor payments, at 9%, for first two years of swap
- DBSI-STG will enter into a offsetting swap with the DBSI-NY Swaps desk, creating a Libor based loan.



Strictly private and confidential

BLIPS Step 3 - FX Transactions

1. Sell HKD / Buy USD
2. Sell ARS / Buy USD
3. Sell SAR / Buy USD
4. Sell EGP / Buy USD
5. Sell DKK / Buy EUR

In compliance with the terms of the Credit Agreement, all trades must be approved by DBSI for maturity and notional size.

Trades will typically be 2 and 3 month forward trades.

Un-pegged currency forwards will typically be hedged for down-side moves with put option purchases.

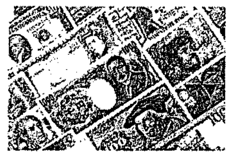
Typical Investment Program

$164.6MM in Global Markets Margin account

- Sell HKD / Buy $35MM USD
- Sell ARS / Buy $15MM USD
- Sell SAR / Buy $ 5MM USD

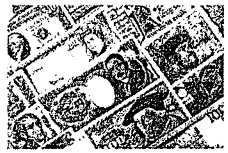
$55MM USD

- In all emerging market trades, the LLC will short the local currency and go long the USD.



BLIPS Step 4 - Synthetic USD Deposit

- A key part of Presidio's FX investment program will be to hold the loan and equity proceeds in a non-USD currency.
- This will be constructed as a synthetic USD deposit using FX spot and forward trades.
- For example:
  - Day 1: Sell $160MM USD/buy EUR for value Day 1 and buy USD/sell EUR for value Day 60
  - Day 1-60: Earn Eurolibor based deposit rate



BLIPS Summary

▪ Expected Swap/Loan/FX/Depo holding period is estimated to be 45-90 days per account.

▪ Managing the counterparty credit risk entails real time monitoring of LLC Equity Value versus two key risks:

1. Depo/Swap Basis Risk:	Interest earned in margin account/synthetic USD depo vs. interest due on interest rate swap
2. FX Market Risk:	Expected and actual MTM on fx trade

▪ Present "trial run" calculations estimate the risks as being equal to:

1. Depo/Swap Basis Risk:	25bps of premium amount
2. FX Market Risk:	25bps of premium amount

▪ 7.7% of premium amount will be held, in full, by DBSI until the LLC account is closed and DBSI has a legal claim on that amount in the Credit Agreement.
▪ The 7.7% will cover market risks, transaction costs, and DBSI fees.

Watson, Mark T

⁻rom:	Ely, Mark H
ınt:	Tuesday, September 21, 1999 9:31 AM
.o:	DeLap, Larry; Watson, Mark T; Elgin, Evelyn
Cc:	Rosenthal, Steven M; Miller Jr., Norlyn D
Subject:	RE: West

Larry is exactly right--we got to a reasonable basis not to register; this conclusion was primarily based on the definition of "tax shelter ratio," and thus, we never had to specifically reach the 5 investors issue. Note that we felt, given the examples in the Regs, that we had a weak argument to say it wasn't marketed to 5 investors.

Mark H. Ely
National Partner-in-Charge
Tax Controversy Technical Services
Washington National Tax
KPMG LLP
p-(202)467-3854; f-(202)822-8887; mhely@kpmg.com

-----Original Message-----
From: DeLap, Larry
Sent: Tuesday, September 21, 1999 9:12 AM
To: Watson, Mark T; Elgin, Evelyn
Cc: Rosenthal, Steven M; Ely, Mark H; Miller Jr., Norlyn D
Subject: RE: West

No, that is not correct. Mark Ely has concluded there is a reasonable basis not to register.

-----Original Message-----
From: Watson, Mark T
Sent: Tuesday, September 21, 1999 9:04 AM
To: DeLap, Larry; Elgin, Evelyn
Cc: Rosenthal, Steven M; Ely, Mark H; Miller Jr., Norlyn D
Subject: RE: West

Larry, just to clarify, even if we have five or more investors in a single BLIPS transaction, you don't think we need to register the transaction as a tax shelter. Is this correct?

-----Original Message-----
From: DeLap, Larry
Sent: Monday, September 20, 1999 12:57 PM
To: Elgin, Evelyn; Watson, Mark T
Cc: Rosenthal, Steven M; Ely, Mark H; Miller Jr., Norlyn D
Subject: RE: West

I see. **Each deal** rather than **all the deals.**

In any event, the BLIPS "reasonable basis not to register as a tax shelter" opinion did not consider the "substantial investment" prong (as the conclusion was based on other prongs of the test), so five-investors-in-one-BLIPS-deal would not appear to directly affect that opinion.

-----Original Message-----
From: Elgin, Evelyn
Sent: Monday, September 20, 1999 12:40 PM
To: DeLap, Larry; Watson, Mark T
Cc: Rosenthal, Steven M; Ely, Mark H; Miller Jr., Norlyn D
Subject: RE: West

Larry,

I don't think I have a copy of the opinion, but I was looking at the issue in this way --

We generally pin our conclusion on 2 things (if possible) -- lack of 2/1 ratio and lack of 5 or more investors. We usually avoid 5 or more investor requirement by showing 2 things -- not more than 5 or more investors for any given deal and law doesn't require aggregation of different deals.

Permanent Subcommittee on Investigations
EXHIBIT #68

MTW 0177

If we're in a situation where there are 5 or more investors in a given deal, then we'd have to pin our conclusion on only one thing -- lack of 2/1 ratio. The impact this turn of events would have on a conclusion about whether we have to register would turn on the strength of the foregone no duty to aggregate argument and of the remaining no tax shelter ratio argument.

In BLIPs, the remaining no 2/1 tax shelter ratio argument possibly was sufficiently tenuous that perhaps having to forego the no aggregation argument (even if not compelling) could alter the ultimate conclusion about whether to register.

ON THE OTHER HAND -- If the opinion concedes the 5 or more investor requirement is met, then having 5 or more investors at the outset wouldn't make any difference in the opinion's conclusion.

Eve

-----Original Message-----
From: DeLap, Larry
Sent: Monday, September 20, 1999 11:25 AM
To: Elgin, Evelyn; Watson, Mark T
Cc: Rosenthal, Steven M; Ely, Mark H; Miller Jr., Norlyn D
Subject: RE: West

?

Eve -

We knew at the outset that BLIPS would be taken to way more than 5 investors. Mark Ely's opinion on the matter was premised on that prong of the registration test being met.

Larry

-----Original Message-----
From: Elgin, Evelyn
Sent: Monday, September 20, 1999 10:36 AM
To: Watson, Mark T
Cc: Rosenthal, Steven M; Ely, Mark H; Miller Jr., Norlyn D; DeLap, Larry
Subject: RE: West

Mark,

You really need to touch base with WNT, as it's WNT's conclusion (not mine) that there's a reasonable basis for not registering BLIPs as a shelter. I believe that having 5 or more investors in a BLIPs deal could, but would not necessarily, change the answer. (You could still argue tax shelter ratio prong of registration requirement was not met. Still, having 5 investors at outset would seem to take away comfort previously afforded by also not meeting 5 or more investor prong.)

Eve

-----Original Message-----
From: Watson, Mark T
Sent: Saturday, September 18, 1999 11:00 AM
To: Elgin, Evelyn
Cc: Rosenthal, Steven M; Ely, Mark H; Miller Jr., Norlyn D; DeLap, Larry
Subject: RE: West

Eve, thanks for the info. By the way, was it assumed when the tax shelter registration issues wrt BLIPS were examined that there would be less than five investors in each deal? If there are more than five investors in a BLIPS deal, would that change your conclusion regarding the need not to register BLIPS as a tax shelter?

-----Original Message-----
From: Elgin, Evelyn
Sent: Wednesday, September 15, 1999 11:28 AM
To: Watson, Mark T
Cc: Rosenthal, Steven M; Ely, Mark H; Miller Jr., Norlyn D; DeLap, Larry
Subject: RE: West

Mark,

I think you, Steve or your designate needs to sit down with WNT tax controversy group (e.g., Mark Ely, Norlyn Miller) to go over the 6111(c) issue. They'll tell you what they need, but basically it's information explaining the ratio of tax benefits to investment for the investor for the first 5 years and whether there's likely to be 5 or more investors in each deal. (If there's not 5 or more investors in each deal, there's still an issue as to whether we aggregate deals, but that's a different and later issue.) I think an executive summary would be very helpful as well as a whitepaper/opinion/ICV materials, etc. if they exist. Also, a contact person for follow-up questions. (I don't really think DPP-Tax should weigh in on this issue until WNT has reached a conclusion on the strength of the requirement to register.)

Eve

-----Original Message-----
From: Watson, Mark T
Sent: Wednesday, September 15, 1999 8:03 AM
To: Elgin, Evelyn
Cc: Rosenthal, Steven M
Subject: FW: West

Eve, we are working on a new tax product -- WEST -- that may have some tax shelter registration issues. Can you assist us with determining whether we need to register this product as a tax shelter? If so, what do you need from us to make such a determination?

-----Original Message-----
From: Warley, Carol G
Sent: Tuesday, September 14, 1999 7:28 PM
To: Watson, Mark T; Baumann, Dale R; Rosenthal, Steven M
Subject: RE: West

Mark, Steve, and Dale, if this isn't rolled out until the end of September, could a client still logistically even do a leveraged deal this year? Did Larry raise the tax shelter registration issue? The registration issue is a key point for my clients.

-----Original Message-----
From: Watson, Mark T
Sent: Tuesday, September 14, 1999 4:36 PM
To: Warley, Carol G
Subject: RE: West

Carol, Larry sent Steve his first round of questions. I don't expect this product will be rolled out until the end of September.

-----Original Message-----
From: Warley, Carol G
Sent: Tuesday, September 14, 1999 2:32 PM
To: Watson, Mark T
Subject: West

Any word from Larry?

KPMG

Carol Warley
PFP
713-319-2180 *phone*
713-319-2040 *fax*
cwarley@kpmg.com *e mail*

PRESIDIO ADVISORS, LLC

333 Hayes Street, Suite 200
San Francisco, CA 94102

Telephone (415) 284-7333
Facsimile (415) 284-7284

Date	April 20, 1999		
To	John Rolfes	cc	Nancy Donohue 7888
Company	Deutsche Bank	~~Tel~~	
Tel		Fax	
Fax			
		cc	John Larson, Bob Pfaff
		Tel	
From	Amir Makov	Fax	
Subject	**BLIPS friction costs**		

John, further to our Friday phone conversation, I would like to describe the necessary financing steps the BLIPS program will require.

Day 1: Investor's LLC borrows a $100MM principal amount for 7 years at a 16% annual (or semi – lets discuss) coupon. The price of the loan (the cash amount) is to be determined after a 7 day grace period. x 7 day fwd warning including interest?

Day 7: Grace period is over and a cash value is determined ~~based on~~ the 7-year swap rate for day 7. In today's rate environment, the price is approximately $162MM. Once cash value is determined, Investor's LLC contributes cash subject to loan ~~liability~~ to Partnership. Investor is assumed to have borrowed that amount starting on day 1, and having invested the proceeds ($162MM) at an account with Deutsche Bank [see friction costs #1].

At the exact time the cash value for the loan is determined, partnership enters a fixed to floating swap with Deutsche Bank Securities, where partnership receives a fixed 16% annual (or semi, depending on the loan – lets discuss) and pays a Libor plus a spread [x] floating coupon. X is calculated such that the value of the swap is zero. The notional amount of the swap would be roughly equal to $138MM (to be discussed). The difference between the yield received on the cash deposited with Deutsche Bank Securities and the yield paid would be friction costs #2. Sig. negative carry

Exh. No. 2-1037

On day 60, Investor exits partnership and unwinds all trades in partnership. There is an amount due to the bank based on accrual interest derived from the sum of friction costs 1 and 2. On

Page 2
April 20, 1999

average these costs should be approximately 18-20 annual basis points on the cash amount ($162MM). For example, assuming the above transaction, at end of 60 days, partnership will pay $48,000 in total friction costs to Deutsche Bank and Deutsche Bank Securities.

In addition to "actual" friction costs, a loan origination fee and a breakage fee will be charged to Investor LLC and partnership. This fee should approximately be 100 basis points of the premium. In our above example, Deutsche Bank will earn a fee or $620,000.

Both Bob and I will be in New York this coming Friday. We would like to further discuss the loan / swap hedging and costs issues. I will call you tomorrow.

Amir.

New Product Committee Overview Memo: BLIPS Transaction

This product has been developed with KPMG and Presidio Advisors. In simple terms, for the Blips project, Deutsche Bank will act as lender, transaction executor, foreign exchange trader, and Know Your Customer Screener. KPMG will distribute the product to its clients. Presidio has structured the product and will act as the investment advisor.

Presidio Advisors

There are 3 main partners at Presidio

Robert Pfaff
John Larson
Amir Makov

Bob and John built their careers at KPMG as tax attorneys and members of the 6,000 person tax accounting group. Amir was recently at Sentinel, where he worked on the Dos Equis trades with DB. The Dos Equis trades, after all expenses, generated about $10-15 mm USD in fees to DB in 1998.

Amir left Sentinel to join Presidio in early 1999. Amir's original connection to Presidio was made through David Kelley and Roberto Marsella, formerly heads of the Deutsche Bank Structured Products Group. Kelley and Marsella will play no official role in the Blips transaction.

Presidio is a well-known client to DB in the Private Bank, Special Products Group and the Equity Derivatives Group (Frankfurt). Last year, through the OPIS program, which involved a large program of equity derivative trades, OPIS generated fees to DB in the excess of $35 mm, and net of expenses, the number was approx. $33 mm.

Presidio, in conjunction with ICA, has developed a new product called BLIPS. BLIPS will be marketed to client end users through KPMG mainly by John Larson and KPMG's high net worth advisory practice. Amir Makov will take responsibility for executing and managing the capital market transactions for BLIPS.

BLIPS TRANSACTION

BLIPS will be marketed to High Net Worth Individual Clients of KPMG.

It is envisioned that BLIPS will be a large program, covering over a 6 month period of time over 40 separate accounts / counterparties.

Permanent Subcommittee on Investigations
EXHIBIT #70

Loan Balances over time could be as large as $5 billion in par amounts + $3 bn in premium. Fees to DB are estimated to be in the 1.25% of premium range ($30+ mm usd).

If DB proceeds with the BLIPS program, it will involve the following:

1- HNW Individuals will be introduced to the DB Private Bank by Presidio/KPMG for Know Your Client Review.

2- The "LLC" (HNW Individual is the single member of a Delaware LLC) will receive a nominal 7 year loan from the DB Private Bank. The Loan will be a high coupon loan (16%) and the loan amount will be delivered to the HNW Individual in the form of a par amount (100) and a premium amount (estimated at 60). The loan/premium amounts will be priced by Global Markets off the US Interest Rate Swap Curve.

For tax and accounting purposes the Loan Liability for the LLC/HNW Individual will be the par amount only (100), not the premium. The LLC will also be obligated for the above market interest rate for the term of the loan. The Loan Proceeds (Par + Premium) will be held in custody in a DB Pledged Account in cash or near cash. Loan will include a prepayment clause with provisions to require repayment of unamortized premium in addition to principal. Loan conditions will be such as to enable DB to, in effect, force (p)repayment after 60 days at its option.

3- After a 7 to 10 day holding period, the LLC will transfer all Loan Proceeds to a Company/Partnership ("Company"). The Company will also have 3% of par amount Equity Capital contributed by the HNW Individual and an additional .3% Equity Capital contributed by the Manager of the Company, Presidio. (in our example here the Company will have 100 Par amount + 60 mm Premium + 3 mm HNW Equity Capital + .3 mm Presidio Equity Capital for a total of 163.3 mm USD). The entire amount of funds in the Company will be held in custody at a DB Global Markets Margin Account.

4- Monitoring of the Collateral will be handled by the Global Markets group, as it will be executing all transactions on behalf of the Company. Presidio will act as the Investment Adviser to the Company.

5- The Company will enter into an Interest Rate Swap to convert its Loan Liability from Fixed into Floating.

6- The Company will enter into a series of FX transactions, all approved by DB and all executed by DB. Typical trades will be in the 2 month forward FX market, Long USD/Short HKD, Long USD/Short Argentine Peso, Long Euro/Short Danish Krone.

7- The Company's trades will typically have negative carry and will be designed to make $ for the Company in the event of a global markets crisis. In addition there will be negative carry for the Company on the Loan Interest that it owes vs. the interest on the funds that it holds in the Global Markets Custody Account.

8- The appropriate amount of Equity Capital in the Company will be determined by Global Markets Credit.

9- The holding period / life of the Company will be 45 to 60 days. At the end of this time period, the Company will likely unwind all transactions, repay the loan par amount and premium amount. For tax and accounting purposes, repaying the premium amount will "count" like a loss for tax and accounting purposes.

10- At all times, the loan will maintain collateral of at least 101% to the loan + premium amount. If the amount goes below this limit, the loan will be unwound and the principal + premium repaid.

11- DB will have the right to terminate the Company and its activities as it will retain the right to approve/disapprove all trading activity in the Company. This will allow DB to effectively force the closure of the Company and the repayment of its loan to DB. However, it is not believed this right will be exercised due to "12" below.

12- It is imperative that the transaction be wound up after 45-60 days and the loan repaid due to the fact that the HNW individual will not receive his/her capital loss (or tax benefit) until the transaction is wound up and the loan repaid. This is in addition to the *de facto* "put" DB will have on the loan.

13- No loans are expected to go over year end 1999 due to DB constraints as well as the capital loss issue mentioned in "12" above.

14-At no time will DB Private Bank provide any tax advice to any individuals involved in the transaction. This will be further buttressed by signed disclaimers designed to protect and "hold harmless" DB.

15-DB has received a legal opinion from Shearman & Sterling which validates our envisaged role in the transaction and sees little or no risk to DB in the trade. Furthermore opinions have been issued from KPMG Central Tax department and Brown & Wood attesting to the soundness of the transaction from a tax perspective.

WHO IS INVOLVED SO FAR AT DB

The following people have been working on the transaction. Those from the Private Bank and Global Markets will be responsible for the ongoing running of the trade.

Private Bank	John Rolfes, Presidio Relationship Manager NN to come from DB/Bankers Trust Structured Credit Rick Stockfon, Account Manager
Global Markets	Nancy Donohue, global market sales Steve Cohen, structured product credit Francesco Piovanetti, structured products
Accounting	Rob Arnig, KPMG as advisor to the Bank Linnae Latessa Controlling, *for treatment to the bank's capital vis a vis loan principal and premium*
Tax	Joe Cassidy, DB NA Tax
Legal	Michèlle Cenis , DB Alvin Knott, Shearman & Sterling Gerry Rokoff, Shearman & Sterling

nb: Shearman & Sterling worked with DB on OPIS and Dos Equis transactions.

DIVISION OF RESPONSIBILITY

John Rolfes in Private Banking is presently the RM for Presidio and has taken joint responsibility with Doug Lemmonds for overseeing the BLIPS transaction. Private Banking will be responsible for:

Know Your Client for all HNW Names
Sourcing from Treasury the Loan proceeds
The Private Bank will be booking the Loans
Account Opening and maintenance of accounts
Relationship Management of the HNW customers to the deal

Nancy Donohue can act as the RM for Presidio in the Global Markets arena. Global Markets will be responsible for:

Setting up ISDAs for 40 accounts

Setting up Margin Accounts for 40 accounts
Pricing the Loan on the US Swap Curve
Executing and Settling the Interest Rate Swap and FX Trades
Monitoring, Daily, the value of the LLCs vs. Equity Balances

Approvals received already from the following DB departments/divisions:

Global Markets: Shamil Chandaria, Managing Director, Co-Head Structured Transactions Group

Audit/Accounting: Rob Arning (KPMG Partner in charge of DB Americas audit)

DBNA Tax: Joseph Cassidy, Managing Director and Head of DBNA Tax

DBNA Legal: Michelle Cenis, Responsible for DBNA Legal Structured Products

Formal Approval is expected from DBNA New Products Committee this Thursday May 20.

This Enhanced Investment Strategy release is subject to a Confidentiality Agreement. Due to the proprietary and confidential nature of information pertaining to this and any other strategies, no additional information other than what is provided below is available to First Union employees. Only a limited number of employees within First Union shall be granted permission to sign a Confidentiality Agreement to become fully informed on the details of the strategy and this must be cleared through Diane Stanford, Manager of Financial Advisory Services.

Capital Management Group
Enhanced Investment Strategy Release
February 2, 1999

STRATEGY NAME – FLIP Strategy

Target Customers:
Individuals and/or Entities
Capital Gain of $20 Million or more
Other - Focused on Income Tax Planning
Desire to sell significant stock position or selling business
Medium to high risk tolerance

Potential Benefits:
Individual Capital Gain Elimination
Corporate Capital Gain Elimination

EXAMPLE
Individual with $25 million Capital Gain from Sale of Business

Step 1	Individual enters into investment arrangement with Quadra Investments and pays 7.25% of notional amount for warrants of offshore company
Step 2	Client buys UBS stock equal to at least 5% of notional amount
Step 3	45 to 50 days later, client buys out-of –the-money call options on UBS stock (approximate cost 1.25% to 1.5% of notional amount)
Step 4	Approximately 90 days into the transaction, 90% of the client's long position is sold
Result:	The basis of the stock owned by the offshore company attaches to the client's stock. Upon sale, the additional basis generates loss. In addition to potential for investment return, the tax on the capital gain is offset by the loss on the stock.

Fees – **Internal Use Only**
Transaction Fees to First Union are $100,000 for a single investor; $75,000 per investor for multi-client strategies. Additional fees for asset management, funding loans, etc. are in addition to the above fee.

Incentive Compensation: Direct payout for Trust Specialists and PICs limited to 5% in aggregate. Commercial bankers and PCG bankers: 100% to grid (1997 partnership agreement honored).

To the extent your disclosure to the customer or anyone else exceeds the information provided in this package, your commission will be forfeited and you will be precluded from participating in any other Enhanced Investment Strategies.

CMG CONTACTS – Persons Authorized
The approved list of contacts within CMG Personal Financial Consulting Group includes: Diane Stanford, John Castrucci, Jeff Martin, Tom Newman, Lisa Rudolph Featherngill

finplan/finplan/charlot/EISR2.doc, c:\eisr2

Permanent Subcommittee on Investigations
EXHIBIT #71

SEN-009397

	A	B	C	D
1	Foreign Leveraged Investment Program			
2	Preliminary Issue and Hazard Summary			
3				
4		Issue	Hazards	Whose favor
5				
6		Primary		
7		Stock ownership (FC did not in substance own the UBS stock)	75/25	taxpayer
8				
9		Zanz	80/20	taxpayer
10				
11		Secondary		
12		Step Transaction	80/20	taxpayer
13				
14		Basis Adjustment is not a "proper adjustment" under 1.302-2	80/20	taxpayer
15				
16		Stock Loss not "bona fide" loss under section 165	50/50	even
17				
18		Stock loss disallowed under section 269	100/0	taxpayer
19				
20		Taxpayer not sufficiently "at risk" under section 465	50/50	even
21				
22		Section 482 requires reallocation of basis to FC	75/25	taxpayer
23				
24		The transaction as a whole lacks economic substance	70/30	taxpayer

KPMG 0026813

Permanent Subcommittee on Investigations
EXHIBIT #72

Proprietary Material
Confidentiality Requested

	A	B	C	D
1	Foreign Leveraged Investment Program			
2	Issue and Hazard Summary			
3				
4		Issue	Hazards	Whose favor
5				
6		Primary		
7		Stock ownership (FC did not in substance own the UBS stock)	75/25	taxpayer
8				
9		Exercise and redemption	80/20	taxpayer
10				
11		Secondary		
12		Basis Adjustment is not a "proper adjustment" under 1.302-2	80/20	taxpayer
13				
14		Stock Loss not "bona fide" loss under section 165	65/35	government
15				
16		Stock loss disallowed under section 269	100/0	taxpayer
17				
18		Taxpayer not sufficiently "at risk" under section 465	65/35	government
19				
20		Section 482 requires reallocation of basis to FC	75/25	taxpayer
21				
22		The transaction as a whole lacks economic substance	60/40	taxpayer

Watson, Mark T

From: Lanning, John T
Sent: Wednesday, February 10, 1999 9:45 PM
To: Eischeid, Jeffrey A
Cc: Ammerman, Douglas K; Watson, Mark T; DeLap, Larry; Stein, Jeff; Lippman, Michael H
Subject: RE: BLIPS

Jeff et al:

Given the marketplace potential of BLIPS, I think a month is far too long - especially in the spirit of "first to market".

I'd like for all of you, within the bounds of good professional judgement, to dramatically accelerate this timeline.

Jeff - after consulting with Mark and Larry, I'd like to know how quickly we can get this product to market.

John

-----Original Message-----
From: Eischeid, Jeffrey A
Sent: Tuesday, February 09, 1999 5:22 PM
To: Lanning, John T
Cc: Ammerman, Douglas K; Watson, Mark T; DeLap, Larry
Subject: BLIPS

John -

I am writing to update you on the status of the BLIPS as an OPIS replacement strategy. A draft KPMG more-likely-than-not opinion was sent to Mark and Jeff Zysik late this afternoon so that they can begin the Washington National Tax review. This will obviously take some time. Assuming they are comfortable with the opinion, we can take the strategy to Larry DeLap for DPP Tax review and assistance with DPP Assurance review. This will also take some time. However, I would think we can reasonably anticipate "approval" in another month or so.

The investment analysis has been completed by Presidio and Sentinel Advisors. That will be at WNT by the end of this week. Finally, we have received a letter from Brown & Wood indicating their concurrence with the more-likely-than-not conclusions in KPMG's draft opinion.

Please call me if you have any further questions.

Jeff

Permanent Subcommittee on Investigations
EXHIBIT #73

Watson, Mark T

From: Rosenthal, Steven M
Sent: Monday, February 15, 1999 8:28 AM
To: Watson, Mark T
Subject: RE: BLIPS Progress Report

Mark,

Richard and I met yesterday (Sunday) to discuss. We need some more facts before we can finish. I think we can get these facts this week. Also, we need to meet collectively (across groups) to identify responsibility for issues. Again, I think this can happen this week. We will need to do a little more research, and I expect we can sign-off (or not) by the start or middle of next week (i.e., by the 24th).

Steve

-----Original Message-----
From: Watson, Mark T
Sent: Monday, February 15, 1999 7:48 AM
To: Smith, Richard H; Rosenthal, Steven M; Sams, James K; Kelloway, Lisa A
Subject: BLIPS Progress Report

I have to give John Lanning and Doug Ammerman a progress report on our review of BLIPS. Thus, I would be grateful if you would let me know where you are in the review process, whether you have identified any technical problems, and when you think you will be finished with your review.

Thanks. . .

P.S. I don't like this pressure any more than you do.

Permanent Subcommittee on Investigations
EXHIBIT #74

KPMG Peat Marwick LLP

Washington National Tax - Tax Innovation Center

MEETING SUMMARY

Meeting called by:	Mark Springer/Mark Watson WNT - TIC/PFP	Meeting date:	Feb. 19, 1999
		Facilitator:	Mark Springer/Mark Watson
Participants:	Jeff Eischeid Eve Elgin John Gardner Richard Larkins Steve Rosenthal Jim Sams Richard Smith Mark Springer Mark Watson Phil Wiesner Jeff Zysik	Note taker:	Jeff Zysik
Purpose of meeting:	• Determine if BLIPS is viable • Discuss impact of Admin. budget proposal	Ref:	p:\users\jzysik\products\admin\02_19sum.doc
Outcomes:	• Final decision that BLIPS is/is not viable postponed • Additional responsibilities for moving BLIPS forward were assigned		

Permanent Subcommittee on Investigations
EXHIBIT #75

Items Discussed - Friday, February 19		Action Item/Resolution
1.	Agenda overview	
2.	Overview of BLIPS	
3.	Roundtable discussion of critical issues	The following issues were deemed most critical, in order of perceived importance: 1. Section 705(a)(2)(B) 2. Section 752 3. Section 465 4. Section 183/Est. of Barons 5. Economic purpose 6. Additional structuring issues
4.	Discussion - if opinion letter strengthened, transaction restructured, might there be a technically viable product?	Maybe. See issues below.
	705(a)(2)(B)	The unanimous consensus was that a technically viable product exists ***only if*** the sec. 705(a)(2)(B) issue can be resolved. Thus, resources should be focused on resolving the sec. 705(a)(2)(B) issue. The sec. 705(a)(2)(B) issue pertains to whether bond premium is a nondeductible, non-capital item for purposes of sec. 705.
	752	Even if the section 705(a)(2)(B) issue is favorably resolved, the group was not satisfied that the opinion letter has adequately addressed sec. 752. Specifically, the Rev. Rul. 95-26 discussion was deemed inadequate, and there was a consensus that the analysis of Rev. Ruls. 73-301 and 81-241 failed to adequately address the fact patterns and holdings found in those Rev. Ruls. Also, the opinion letter fails to address adequately Rev. Rul. 88-77.

Economic substance

The opinion letter attempts to establish an economic substance standard that the group does not believe is the standard articulated by the courts. In addition, the opinion letter lacks a thorough application of the expected BLIPS facts to the established standard.

Additional Structuring issues	The group had additional issues with how the transaction was structured. For example, there was a discussion as to whether there are any business situations, other than BLIPS, that can be identified were a loan would be structured in this manner. Another issue discussed was whether the bank involved was a partner in the transaction if the funds and trades all remained with the same institution. Not all issues identified are set forth here, as discussed below.
183/465/*Est. Baron*	The section 183/*Estate of Baron* discussion should be strengthened. Similar comment with respect to the section 465 analysis.

5. If yes, discuss/decide /assign responsibilities

705(a)(2)(B)	The consensus among the group was that the section 705(a)(2)(B) issue needs further analysis. Thus, the appropriate members of WNT will research sections 163 and 988 in an effort to determine how the amortization and/or repayment of bond premium should be treated for section 705 purposes. ***A second meeting of the group is planned for 2/23 at 4:00 p.m to discuss their findings. Jeff Eischeid/Randy Bickham are invited to participate in person or via phone. A call in number will be provided prior to that meeting.*** It is suggested that Randy Bickham also move forward immediately to bolster the arguments found in the opinion letter and that he supply any additional support for the conclusion reached in the opinion letter with respect to this issue.
752	Assuming the section 705 issue can be favorable resolved, Randy Bickham should then attempt to bolster the section 752 arguments made in the opinion letter.
Economic substance	The economic substance issues have been addressed by a number of white papers prepared by WNT. An excerpt that sets forth the standard established by the courts as interpreted by WNT will be forwarded to Randy Bickham, who should

incorporate the standard into the opinion letter and then apply the BLIPS facts to this standard.

183/465/*Est. Baron*

A discussion about the need to strength this analysis was held earlier between Mark Watson and Jeff Eischeid. Randy Bickham/Kevin McGarth should work on strengthening the arguments set forth in the opinion letter on these issues, assuming the section 705(a)(2)(B) is resolved favorably.

Additional Structuring issues

Although a number of other issues were identified (all of which are not set forth here), based on Jeff Eischeid's comments that the investment structure is open to wide changes, the consensus was that before these issues should be addressed, a determination should be made that the critical technical issues can be addressed favorably.

Rosenthal, Steven M

From: Rosenthal, Steven M
Sent: Tuesday, April 06, 1999 3:55 PM
To: DeLap, Larry
Cc: Springer, Mark A
Subject: RE: BLIPS

Larry,

I would not characterize my assessment of the economic substance of the "premium borrowing" in the BLIPS transaction as "positive." I had one conversation with representatives of the Presidio investment firm, and did not find their economic arguments compelling. There is a "cash-flow" difference between borrowing at a premium rate and borrowing at a market coupon rate, although, in my judgement, the difference is small (the "cash-flow" from payments under a premium borrowing arguably offsets the increasing risks from the graduated investment strategy). Also, these advantages, however small, disappear if the investment strategy is changed to require full investment from the start (which is what I now understood the transaction to require).

I summarized my understanding of the economic arguments for the premium borrowing in a short E-mail to Richard Smith (which I will forward to you). I have not been asked to evaluate the business purpose of issuing a premium bond, the economic substance of the BLIPS investment program, or the overall business purpose/economic substance of the BLIPS transaction.

Steve

-----Original Message-----
From: DeLap, Larry
Sent: Friday, April 02, 1999 1:53 PM
To: Rosenthal, Steven M
Subject: FW: BLIPS

Steve -

Is the reference to "Steve's positive assessment" accurate?

Larry

-----Original Message-----
From: Ammerman, Douglas K
Sent: Friday, April 02, 1999 12:57 PM
To: Lanning, John T
Cc: Stein, Jeff; Lippman, Michael H; DeLap, Larry; Brian Rivotto; Carolyn Branan; David Zaudtke; Dennis Ito; Glen Wright; James Duty; Jeffrey Eischeid; Mark Watson; Neil Tendler; Neil Wolfson; Robert Pedersen; Robert Perez; Tracie Henderson; William Goldberg
Subject: BLIPS

John,

I wanted to provide you with a quick update on the status of the BLIPS approval process and what we can expect over the next few days. This summary is based upon multiple conference calls throughout the last two weeks with Jeff Eischeid, Randy Bickham, Mark Watson and others. Additionally, I have spoken directly with John Raedel and have exchanged messages with John Guinan and Phil Wiesner.

Registration Issue. Larry DeLap, based upon a technical analysis by Eve Elgin, concluded that the product fell within the purview of Internal Revenue Code Section 6111(c) and must be registered as a tax shelter. Eve's conclusion was that there was no reasonable basis for not registering the product. In response to DPP's position, Randy Bickham prepared the attached memorandum to Mark Ely dated March 24, 1999, that concluded that there was a reasonable basis for not registering based upon satisfying the "tax shelter ratio" test contained in Code Section 6111. Based upon the logic contained in the memorandum and his own independent assessment, Mark agreed that there was a reasonable basis for not registering the product as a tax shelter. He is drafting a memorandum to DPP setting forth his logic for concluding that there is a reasonable basis for not registering the BLIPS product.

Technical Issues. The only remaining technical issues are the applicability of Internal Revenue Code Section 988 to the "ordinary" version of the product and Phil Wiener's final sign-off on whether the BLIPS product meets the requisite business purpose threshold.

Jim Sams could not initially get to a MLTN position with respect to the application of Code Section 988 because of the anti-abuse provision contained in the regulations under Code Section 988. The anti-abuse provision incorporates a "substance over form" analysis that allows the Commissioner to recharacterize the timing, source and character of transactions. Jeff Eischeid and Randy Bickham prepared that attached memorandum dated March 31, 1999, which concludes that on a "more-likely than-not basis" that an application Code Section 988(a) allows for ordinary income or loss treatment and the anti-abuse provision contained in

Permanent Subcommittee on Investigations
EXHIBIT #76

Rosenthal, Steven M

From: Rosenthal, Steven M
Sent: Monday, April 26, 1999 7:35 PM
To: DeLap, Larry
Subject: RE: BLIPS Analysis

Larry,

The attached write-up makes some sense to me, although it is filled with technical mumbo-jumbo that is not particularly useful. The basic argument is that the BLIPS partnership prefers a payment schedule that is front-loaded, when the partnership's investments are less risky. Sort of like you planning to make larger principal payments on your mortgage when you are a partner, and planning smaller principal payments when, in the future, you expect to give up your partner status to start up a new business (which might either be very successful or very unsuccessful). Of course, the BLIPS partnership also could structure its borrowing with market-rate coupons and more up-front principal payments, rather than borrow with above-market coupons--and achieve the same economic effect without the tax benefits.

I think the duration and convexity analysis is contrived (and largely irrelevant). The argument again is a cash flow argument: that convexity hedging is better accomplished through cash flow payments of a premium borrowing rather than a market borrowing. I think this argument is suspect. First, I suspect that the convexity effect of a premium borrowing is very small. Second, I doubt that anyone uses premium borrowings as a convexity hedge (convexity hedges generally are accomplished using options, according to my textbooks). I asked earlier for any articles that might recommend a premium borrowing as a convexity hedge and was never given any.

Call me to discuss if you like.

Steve

-----Original Message-----
From: DeLap, Larry
Sent: Friday, April 23, 1999 8:04 AM
To: Rosenthal, Steven M
Subject: FW: BLIPS Analysis
Importance: High

Steve -

I cannot figure out what this has to do with the business purpose of the investor borrowing the funds outside the partnership. However, putting aside the "who is the borrower" issue, does the attached write-up make sense to you?

Larry

-----Original Message-----
From: Bickham, Randall S
Sent: Wednesday, April 21, 1999 6:00 PM
To: DeLap, Larry
Cc: Eischeid, Jeffrey A
Subject: FW: BLIPS Analysis
Importance: High

-----Original Message-----
From: John Larson [SMTP:jlarson@presidioadv.com] <mailto:[SMTP:jlarson@presidioadv.com]>
Sent: Wednesday, April 21, 1999 10:38 AM
To: rbickham@kpmg.com
Cc: eischeid@kpmg.com; amakov@presidioadv.com
Subject: BLIPS memo revised

all changes made

<< File: BLIPS0308.doc >>

Permanent Subcommittee on Investigations
EXHIBIT #77

MTW 0026

Watson, Mark T

'rom:	Rosenthal, Steven M
›nt:	Friday, May 07, 1999 4:48 PM
.o:	Wiesner, Philip J
Cc:	Springer, Mark A; Smith, Richard H (WNT); Watson, Mark T
Subject:	Who is the Borrower in the BLIPS transaction

Phil,

As a follow-up to our meeting this morning, I wanted to outline my concerns on the "Who is the Borrower" issuer. My research suggests that this question turns on economic substance--and a "facts and circumstances" determination. My largest concern is that the BLIPS facts suggest that, in economic substance, the partnership, rather than the individual investor is the true borrower (assuming there is a debt). I believe the following facts are problematic: the investor is nominally the borrower for only a transitory period (7-10 days); the loan is non-recourse (the investor never assumes any personal liability); the investor does not control the proceeds (the proceeds are left in the bank) and the investor apparently has little investment discretion while it holds the funds; the investor presumably will earn a negative spread while it holds the proceeds; the bank--and all of the other parties to the transaction-- will look to the partnership, and not the investor, to repay the loan; the non-tax business reason for the investor to borrow the proceeds and convey the loan is not substantial (the purported reason, leverage, can be accomplished in or out of the partnership).

The case law (Plantation Patterns, NIPSCO, Aiken) emphasizes that the substance (which requires a non-tax business purpose), and not the form, of an arrangement is critical to answering the question of "Who is the Borrower." Thus, in NIPSCO, a back-to-back finance arrangement that provided the intermediary with dominion and control of the funds and a positive interest rate spread was upheld, but, in Aiken, an intermediary that earned no profit was not respected.

The S-corporation cases appear of limited value. In these cases, the individual actually borrows and enters into another loan agreement (and thereby remains liable on the original loan). In our case, the individual borrows and then conveys the ~sumed loan to the partnership (without a substantial change in its economic position). In addition, in these S corporation ses, the bank typically was unaware (and did not care) that the loan proceeds were relent (see, e.g., Bolding). In BLIPS, ..ie bank (and the other parties) contemplate that the partnership, and not the investor, will repay the loan. Likewise, in Rev. Rul. 80-240, in a structure very similar to BLIPs (but, with a corporation and not a partnership, assuming a loan borrowed by an individual), the IRS determined that the individual would be ignored for federal income tax purposes because the individual was merely an intermediate agent (and there was no plan or intention for the individual either to own the property acquired with the loan proceeds or repay the loan proceeds).

Even if we could surmount these first two issues (i.e., a non-tax business purpose and the requirement that the parties look to the investor as the borrower), there are further hurdles to relying on these S-corporation cases. In Bergman v. U.S. (decided last month by the 8th Cir.), the court emphasized that "[l]oan transactions, like all transactions, must have independent economic substance to confer tax benefits on the parties [citations omitted]. The tax benefits of creating indebtedness thus may be set aside if the taxpayer's economic situation has not actually changed [citations omitted]. Actual indebtedness is created only where there is an economically significant change in the taxpayer's wealth; in other words, there must be an actual economic outlay that leaves the taxpayer poorer in a material sense [citations omitted]." In a non-recourse situation, like BLIPS, the investor appears no poorer, or at more risk, by serving as an intermediary, as compared to his exposure if the partnership had borrowed the proceeds directly.

Steve

Permanent Subcommittee on Investigations
EXHIBIT #78

MTW 0028

Rosenthal, Steven M

From: Rosenthal, Steven M
Sent: Wednesday, August 18, 1999 8:35 AM
To: Watson, Mark T
Subject: RE: BLIPS Documents -- Acceptance of Recommended Language

I feel strongly that we should disclose all tax risks, but I think Larry DeLap needs to make the call. I know there will be "heat," but the documents are not consistent with our original understanding on this point (and, as I understand from Richard, will not be modified).

Can we get together? I am in today and Friday and most of next week. Thanks.

-----Original Message-----
From: Watson, Mark T
Sent: Sunday, August 15, 1999 1:27 PM
To: Rosenthal, Steven M
Subject: RE: BLIPS Documents -- Acceptance of Recommended Language

Steve, how strongly do you feel about this? If I raise this issue, I suspect we will get some serious push back. I am prepared to raise the issue, but we may take some more "heat" for doing so at this stage of the "game".

-----Original Message-----
From: **Rosenthal, Steven M**
Sent: Sunday, August 15, 1999 8:18 AM
To: Watson, Mark T
Cc: Schwartz, Carol A; Larkins, Richard G
Subject: RE: BLIPS Documents -- Acceptance of Recommended Language

Mark,

I think if we follow Richard's approach to rely on the representations below, we must disclose to our clients the possible downside of the transaction (i.e., that there is a possibility of discharge of indebtedness income). I think you will need to raise this issue in the marketing of the transaction (and the opinion).

Steve

-----Original Message-----
From: Larkins, Richard G
Sent: Tuesday, August 10, 1999 11:30 AM
To: Watson, Mark T
Cc: Schwartz, Carol A; Rosenthal, Steven M
Subject: BLIPS Documents -- Acceptance of Recommended Language

Mark:

If counsel/Presidio can represent (i) that all of the restrictions contained in the definition of Permitted Investments are commercial, customary, arm's length provisions for nonrecourse loans with highly-leveraged borrowers, and (ii) that, based on the Credit Agreement, the Bank is obligated to enter into any of the Permitted Investments if requested by the Borrower and that should the Bank exercise any discretion in this regard, the Borrower would have a significant cause of action against the Bank for breach of contract, then we could conclude that the Borrower more likely than not has a unilateral option as defined in Reg. sec. 1.1001-3(c)(3).

Richard

Permanent Subcommittee on Investigations
EXHIBIT #79

SMR 0045

Rosenthal, Steven M

From: Watson, Mark T
Sent: Wednesday, May 05, 1999 9:21 AM
To: Ammerman, Douglas K; Eischeid, Jeffrey A; Bickham, Randall S
Subject: BLIPS

Based on our meeting on April 30 and May 1, I am *not* comfortable with the BLIPS product for the following reasons:

- According to Presidio, the probability of making a profit from this strategy is remote (possible, but remote). Thus, I don't think a client's representation that they thought there was a reasonable opportunity to make a profit is a reasonable representation. If it isn't a reasonable representation, our opinion letter is worthless.
- The bank will control, via a veto power over Presidio, how the "loan" proceeds are invested. Also, it appears that the bank will require this "loan" to be repaid in a relatively short period of time (e.g., 60 days) even though it is structured as a seven-year loan. These factors make it difficult for me to conclude that a bona fide loan was ever made. If a bona-fide loan was not made, the whole transaction falls apart.

Until these issues are resolved satisfactorily, I don't think we should release this product.

Mark T. Watson
Partner
KPMG - Washington National Tax
202-467-2433 (phone)
202-822-8887 (fax)

Permanent Subcommittee on Investigations
EXHIBIT #80

Watson, Mark T

~rom:	Lanning, John T
:nt:	Monday, May 10, 1999 6:02 PM
·, o:	Watson, Mark T
Cc:	Wiesner, Philip J; Ammerman, Douglas K
Subject:	RE: BLIPS

Mark:

I hear you, but still wonder why someone wasn't asking these questions of Presidio months ago?

John

-----Original Message-----
From: Watson, Mark T
Sent: Monday, May 10, 1999 10:29 AM
To: Lanning, John T
Cc: Wiesner, Philip J; Ammerman, Douglas K
Subject: FW: BLIPS

John, in my defense, my change in heart about BLIPS was based on information Presidio disclosed to me at a meeting on *May 1*. This information raised serious concerns in my mind about the viability of the transaction, and indicated that WNT had not been given complete information about how the transaction would be structured when we were asked to review the model opinion letter.

I want to make money as much as you do, but I cannot ignore information that raises questions as to whether the subject strategy even works. Nonetheless, I have sent Randy Bickham four representations that I think need to be added to our opinion letter. Assuming these representations are made, I am prepared to move forward with the strategy.

-----Original Message-----
From: Wiesner, Philip J
Sent: Monday, May 10, 1999 9:51 AM
To: Lanning, John T; Ammerman, Douglas K
Cc: Stein, Jeff; Lippman, Michael H; Smith, Richard H (WNT); Watson, Mark T; Rosenthal, Steven M; DeLap, Larry
Subject: RE: BLIPS

John/Doug: Many people have worked long and hard to craft a tax opinion in the BLIPS transaction that satisfies the more likely than not standard. I believed that we in WNT had completed our work a month ago when we forwarded the opinion to Larry. Based on my attendance at numerous technical meetings and my reading the opinion, I came to the conclusion that we could reach an overall more likely than not tax opinion based on the information provided re business purpose and potential profit and the representations to be provided by the investor and Presidio. We viewed our role as a positive one, ie, we would work very hard to achieve, if possible, the desired level of opinion and suggest improvements, in particular, to limit the risks which the Firm is assuming by issuing the opinion.

The speed to market issue is also troubling to me, but perhpas for different reasons. First, this is a classic transaction where we can labor over the technical concerns, but the ultimate resolution - if challenged by the IRS - will be based on the facts (or lack thereof). In short, our opinion is only as good as the factual representations that it is based upon. As the courts did in the individual tax shelter cases of the 80s and in the recent ACM case, the decision will be based not on the techical niceties, but on the overall issues of whether in fact the investors approached the transaction from a business like point of view with a real desire to make a profit other than from tax benefits. Second, we have been dealing with a true prototype opinion where the facts keep evolving. The real "rubber meets the road" will happen when the transaction is sold to investors, what the investors' actual motive for investing the transaction is and how the transaction actually unfolds. Our opinion will be worth little (but we will be protected from risk if it is properly caveated) is the actual facts bear little relation to the assumed facts in the opinion. Note: This is Mark Watson's primary concern based on the recent Presidio discussions at a PFP meeting. Third, our reputation will be used to market the transaction. This is a given in these types of deals. Thus, we need to be concerned about who we are getting in bed with here. In particular, do we believe that Presidio has the integrity to sell the deal on the facts and representations that we have written our opinion on?! We have had past experience in the foreign stock redemption and the OPUS transactions which shows how difficult it is to keep the facts in line. Thus, the process has been slowed by a number of very critical forces which have been at work.

Permanent Subcommittee on Investigations
EXHIBIT #81

MTW 0039

Watson, Mark T

From: Watson, Mark T
Sent: Wednesday, August 04, 1999 9:25 AM
To: Brockway, David H; Springer, Mark A; Ammerman, Douglas K
Subject: BLIPS

Gentlemen, we are almost finished with our second review of the loan documents and LLC agreement related to BLIPS, and I anticipate that we will submit our final comments on these documents by the end of business today. The PFP practice will then begin implementing the BLIPS transaction, and we anticipate that approximately 80 transactions will be implemented before 12/31/99.

However, before engagement letters are signed and revenue is collected, I feel it is important to again note that I and several other WNT partners remain skeptical that the tax results purportedly generated by a BLIPS transaction would actually be sustained by a court if challenged by the IRS. We are particularly concerned about the economic substance of the BLIPS transaction, and our review of the BLIPS loan documents has increased our level of concern.

Nonetheless, since Richard Smith and Phil Wiesner -- the WNT partners assigned with the responsibility of addressing the economic substance issues associated with BLIPS -- have concluded that they think BLIPS is a "more-likely-than-not" strategy, I am prepared to release the strategy once we complete our second review of the loan documents and LLC agreement and our comments thereon (if any) have been incorporated.

Permanent Subcommittee on Investigations
EXHIBIT #82

MTW 0083

Rosenthal, Steven M

From: Stein, Jeff (US/Vice Chairman)
Sent: Monday, January 17, 2000 9:43 PM
To: Rosenthal, Steven M
Cc: Smith, Richard H (WNT); Lanning, John T
Subject: BLIPS 2000

Steve - The PFP guys really need your help on the BLIPS 2000 strategy. I understand you have uncovered some issues that need to be dealt with. They need your help not only in spotting the issues but also in helping them resolve them favorably so we can take this to market. Your attention on this over the next few days would be most appreciated. If you need additional resources please let me or Richard know. Thanks for you help.

Permanent Subcommittee on Investigations
EXHIBIT #83

SMR 0050

Rosenthal, Steven M

From: Rosenthal, Steven M
Sent: Monday, March 06, 2000 7:13 PM
To: Brockway, David H
Subject: Blips I, Grandfathered Blips, and Blips 2000

David,

As you asked this morning, I am writing to communicate my views on the economic substance of the Blips, Grandfathered Blips, and Blips 2000 strategies. Throughout this process, I have been troubled by the application of economic substance doctrines (i.e., is there a debt? who is the borrower? what is the amount of the liability? is there a sufficient non-tax business motivation for the investor) to these strategies, and have raised my concerns repeatedly in internal meetings. The facts as I now know them, and the law that has developed, has not reduced my level of concern.

In short, in my view, I do not believe that KPMG can reasonably issue a more-likely-than-not opinion on these issues. I know there is some dispute, for instance, on the proper standard for non-tax business purpose (which, I believe, is the higher standard, the "primary" test). However, regardless of which standard is applied, I do not believe that KPMG can reasonably issue a more-likely-than-not opinion on the economic substance issues for the Blips (or the Grandfathered Blips) strategies. Because Blips 2000 is still being designed, there is some ability to improve the substance of the strategy. In my view, however, even after any potential improvements, Blips 2000 is also unlikely to satisfy a more-likely-than-not standard on the issues.

Steve

Permanent Subcommittee on Investigations
EXHIBIT #84

SMR 0056

KPMG Peat Marwick LLP

Washington National Tax

To Distribution List

Date February 11, 1999

From Jeffrey C Zysik
Washington National Tax - Tax Innovation Center

Steno jcz
Ref c:\windows\temp\blop_lp.doc

BLIPS

As each of you is by now aware, a product with a very high profile with the tax leadership recently was submitted to WNT/Tax Innovation Center. We are charged with sheparding this product through the WNT "productization" and review process as rapidly as possible. The product is perceived to have a very high value. Following is a grid that identifies the different code sections/technical areas that we know impact the strategy, and the name of the partner who has agreed to take lead responsibility for reviewing the pro-forma opinion letter with respect to the area.

Should you identify issues not in your area of responsibility that you believe are not identified in the grid or which you wish to comment on, please forward your observation to the appropriate lead professional or his or her designee. We would like to conclude WNT review by COB Wednesday, Feb. 17. Thanks for everyone's assistance.

Technical Area/Code Section	Lead Professional
Subchapter K	Richard Smith
At-risk (Sec. 465)	Richard Smith
Passive activity rules (Sec. 469)	Richard Smith
Anti-abuse (Regs. Sec. 1.701-2)	Richard Smith
OID issues (Secs. 1271-1275)	Steve Rosenthal
Anti-abuse (Sec. 1.1275-2)	Steve Rosenthal
Foreign currency transaction (Secs. 985-988)	Jim Sams
Sec. 269	Lisa Kelloway
Penalties (6662-6664)	Eve Elgin/Larry DeLap
Business Purpose/Economic Substance	Eve Elgin/Larry DeLap

Distribution List:
Larry DeLap
Eve Elgin
Lisa Kelloway
Steve Rosenthal
Jim Sams
Richard Smith
Mark Springer
Mark Watson

Permanent Subcommittee on Investigations
EXHIBIT #85

March 28, 2000

Memorandum for David Brockway

Subject: Talking points on significant tax issues for BLIPS 2000

General facts

In the BLIPS 2000 transaction, an investor enters into a $100 million face-amount fixed rate nonrecourse loan from Deutsche bank. Under the terms of the loan, the $100 million must be repaid in 7 years, and interest is payable at an annual rate of 16% on the $100 million face amount. If the loan is terminated prior to the 7-year maturity date (by an "event of default"), there is a prepayment penalty (which may vary based on interest rates at the time of termination). The investor receives $160 million in loan proceeds for entering this loan, which may be invested pursuant to limitations under the loan documents (which includes certain foreign currency investments). After some period of time (most likely 60 days), the investor intends to exit from the investment program by transferring any and all investment assets to an off-shore entity in exchange for the assumption of the $100 million loan.

Intended tax results

Investor expects to deduct a $60 million ordinary loss from the transfer of the investment assets to the off-shore entity (the loss is equal to the amount received--arguably $100 million from the assumption of the liability--minus the basis in the investment assets, $160 million).

Significant tax issues

1. Is the amount realized from transferring the investment assets only $100 million (which results in a $60 million loss)? How does Tufts affect this determination?

Pro: The amount realized is the amount of liability that has been assumed, $100 million. The loan may ultimately be repaid for $100 million, and any prepayment penalty is speculative. Tufts is limited to its facts.

Con: Economically, the amount of the liability is $160 million. The $60 million "premium" is, in effect, an additional liability, which is expected to be repaid over the 7 years or, if the loan is terminated early, at the time of termination. Under the principles of Tufts, an amount should be realized on the relief of a loan if no income has been recognized on the original entering of the loan. Also, under the principles of Tufts, an amount should be realized on the relief of a loan if the taxpayer created basis by applying the loan proceeds to the purchase of property used to secure the loan.

Permanent Subcommittee on Investigations
EXHIBIT #86

2. Is the $60 million loss deductible under section 165(c)(2)?

Pro: A "rational argument can be made" that the standard for a deduction under section 165(c)(2) is only a reasonable expectation of profit, which can be satisfied by relying on representations. A "bona fide" loss is determined by income tax accounting principals, not economic principles.

Con: The standard for a deduction under section 165(c)(2) is a "primary" purpose test (i.e., a predominant non-tax purpose), which is unlikely to be found. Also, the regulations provide, that "[s]ubstance and not mere form shall govern in determining a deductible loss."

3. Will the investor's loss be limited by the Section 465 "at risk" rules?

Pro: No, neither section 465 nor the corresponding regulations establish parameters for aggregating and/or segregating activities related to the production of income (i.e., investment activities). As a result, an investor should be permitted to combine all directly-held investment activities into one activity (and, thus, include all of his other investment assets in computing the at-risk amount in the BLIPS 2000 strategy).

Con: Yes, neither section 465 nor the corresponding regulations permit an investor to aggregate all activities engaged in for the production of income. In fact, since Section 465(c)(3) specifically aggregates trade or business activities (but not investment activities), Congress apparently intended that taxpayers not aggregate investment activities when determining their "at-risk" amount with respect to a particular investment asset. Since an investor who participates in the BLIPS 2000 transaction will purchase assets using proceeds from a nonrecourse loan (which, pursuant to section 465(b)(2), will not give the investor an "at-risk" amount), if the investor cannot aggregate his investment activities, he could not deduct his $60 million loss on the subsequent sale of the assets purchased pursuant to the section 465 limitations.

4. Is there a loan?

Pro: The documents will be stylized as a loan.

Con: The investor will have very little control over the proceeds of the "loan," and cannot incur any liability apart from fees, etc.

5. What is the amount of the loan?

Pro: The amount of the loan is $100 million, the face amount.

Con: In substance, the amount of the loan is $160 million, in light of the prepayment obligations, and the expectation that the loan will not be outstanding until maturity.

6. Is the business purpose for the loan, the investment, and the subsequent exchange of the investment assets, sufficient to permit the deduction for the loss?

Pro: Yes, the investor will represent that he expects to make a profit, and the subsequent exchange is a reasonable exit strategy after the investment program is completed.

Con: No, the $60 million loss is independent of any profit expectation (that is, the investor expects to take a $60 million loss regardless of whether he makes or loses money on the investment strategy).

7. Is Notice 99-59 a new barrier to a BLIPS-2000 strategy?

Pro: No, Notice 99-59 applies to different facts and creates no new law.

Con: Yes, Notice 99-59 applies to arrangements where "[t]hrough a series of contrived steps, taxpayers claim tax losses for capital outlays that they have in fact recovered." In addition, the IRS litigation position now is stated clearly for "artificial" losses.

8. Is the avoidance of the interest offset attributable to the premium an abuse of the OID anti-abuse regulation that provides that "[i]f a principal purpose in structuring a debt instrument or engaging in a transaction is to achieve a result that is unreasonable in light of the purposes of section 163(e), sections 1271 through 1275, or any related section of the Code, the Commissioner can apply or depart from the regulations under the applicable sections as necessary or appropriate to achieve a reasonable result."

Pro: No, a premium is treated symmetrically on the assumption of a loan (i.e., the original borrower avoids the offset to interest expense, but the new borrower must include the offset). Also, the anti-abuse rule only permits the Commissioner to apply or depart from his regulations, and not to create new rules. As a result, because there is no regulation to force a recapture of a premium, the Commisioner cannot create a new rule on audit. (Under reg. sec. 1.61-12(c), a premium is excluded from income and, under reg. sec. 1.163-13, the premium is included as an offset to interest as the loan matures).

Con: Yes, the purpose of reg. sec. 163-13 is to ensure that a borrower that is able to exclude a premium under reg. sec. 1.61-12 includes the premium in a subsequent period. Also, the investor intends, in the BLIPS 2000 strategy to shift the premium offshore, and prevent its inclusion in the U.S. tax base.

9. Is the loss attributable to the investment in nonfunctional currency forward, futures, options or similar financial instruments an ordinary loss?

Pro: The statute and regulations state clearly that "any" loss from a disposition of such instruments is foreign currency loss. The legislative history discusses the issue briefly and notes general concern of seeking to avoid administrative burdens associated with separating market and currency components of gain or loss in respect of such instruments.

Con: In general, Congress intended ordinary treatment only for foreign currency gain or loss, to be determined separately from "market" gain or loss. Two anti-abuse rules are contained in the section 988 regulations. Section 1.988-1(a)(11) authorizes the commissioner to include or exclude a transaction from section 988 -- e.g., to exclude if "it is not properly considered a section 988 transaction." An example parallels the facts of BLIPS (but in the opposite direction, as it involves gain instruments). Section 1.988-2(f), while arguably more tangential to the issue in BLIPS, authorizes the Commissioner to recharacterize a transaction in accordance with its substance (including to integrate transactions). Finally, common law substance/form cases arguably also militate against characterizing BLIPS loss as foreign currency gain or loss.

10. Other design issues

a) The loan is a non-recourse loan, with the investment assets as the collateral. Under the regulations for nonrecourse loans, if a substantial amount of the collateral is released, substituted, added to or otherwise modified, there is a possibility of a significant modification of the loan, and a deemed reissuance (with the possibility of discharge of indebtedness income). In BLIPS 2000, if the investor chooses not to leave substantially all of his investments in a time deposit, he may be viewed as modifying the collateral by changing his investment assets and, if these modifications are substantial, there may be a deemed reissuance. Other arguments exist (i.e., that the collateral changes occur automatically under the loan or pursuant to a unilateral option of the investor) not to treat the making of investments as a modification of a loan, but more weight now would be placed on these arguments.

b) The loan, at origination, may have either a fixed or floating interest rate. If, after entering a fixed-rate loan, the investor enters into a fixed-for-floating swap to hedge the interest rate exposure, there is the potential that the loan and the swap could be integrated to create a floating-rate loan, under either reg. sec. 1275-6 or the common law. If the loan and the swap are integrated from the start, the loan may be treated as a floating-rate loan from the start, and there may not be any loan premium (depending on how the loan is recast). If the loan is a fixed rate instrument, and there are not any significant contingent payments, the IRS likely cannot integrate under sec. 1275-6. If, however, there are not any significant contingent payments with respect to the premium, there, arguably, may be additional pressure not to treat the premium as a liability.

c) What is the non-tax justification for the premium loan? How much premium can be created? In an earlier transaction, the non-tax justification for a premium loan has been that the investor prefers the cash flow payments on a premium borrowing to the cash flow payments on a borrowing with market-rate coupons. (That is because the cash flow on a premium borrowing is higher at the start of the borrowing and lower later on, which, Presidio contends, matches the investor's risk profile as the stages of the investment strategy progresses, and the riskiness of the investments increase). If the investor intends to exit the BLIPS 2000 strategy after the first stage (i.e., after 60 days), the purported justification for the premium bond is absent.

PRIVATE AND CONFIDENTIAL

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S Corporation Charitable Contribution Strategy

Summary of Certain Risks

As with most other tax planning strategies, the S Corporation Charitable Contribution Strategy presents a certain level of risk. The purpose of this Risk Analysis is to help you assess those risks in deciding whether to enter into this strategy.

Risks associated with the S Corporation Charitable Contribution Strategy include:

- Income reallocation. The Internal Revenue Service ("IRS") or a state taxing authority could assert that some or all of the income allocated to the tax-exempt organization should be reallocated to the other shareholders of the corporation. If the IRS were to succeed in reallocating the income, the other shareholders would be required to pay the tax on the income that was originally allocated to the tax-exempt entity, plus interest. Essentially, the other shareholders would be reallocated the income that they would have recognized absent the strategy.

- Disallowance or reduction of charitable contribution deduction. The IRS or a state taxing authority could assert that some or all of the charitable contribution deduction should be disallowed, on the basis that the tax-exempt organization did not acquire equitable ownership of the stock or that the valuation of the contributed stock was overstated. It is particularly important that you meet the detailed substantiation requirements of the regulations and that you select a reputable independent valuation firm to provide a qualified appraisal to support the charitable contribution deduction.

- Second class of stock. The IRS or a state taxing authority could assert that the strategy creates a second class of stock. Under the Internal Revenue Code, subchapter S corporations are not permitted to have a second class of stock. If the IRS or a state taxing authority were successful in asserting that the strategy creates a second class of stock, the corporation would lose its subchapter S status and would be treated as a C corporation. The effect of being considered a C corporation is that the corporation would be subject to a corporate level tax on its income and distributions to the shareholders would be subject to a second level of tax.

- Penalties. The IRS. or a state taxing authority could attempt to assess an accuracy-related penalty against the current shareholders of the business. The amount of this penalty could be 20% of the understatement of tax due to the implementation of the strategy.

The understatement penalty is not applicable where two requirements are satisfied. First, the taxpayer must reasonably believe, at the time the return is filed, that the positions on the return are more likely than not the proper positions. Second, there must be substantial authority for the position.

The reasonable belief test can be satisfied either by a taxpayer's own analysis or by the taxpayer's good faith reliance on an opinion of a professional tax advisor. If the taxpayer seeks to establish its reasonable belief by reliance on a tax opinion, the opinion must unambiguously state that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment will be upheld if challenged by the IRS. The opinion also must be based on all pertinent facts and the law as it relates to those facts; must not be based upon inaccurate legal or factual assumptions; and must not unreasonably rely upon the representations, statements, findings, or agreements of the taxpayer or any other person.

As part of this strategy, KPMG will provide you an opinion letter covering the various parts of the strategy. Based on current tax authorities, we expect to be able to conclude that it is more likely than not that the intended benefits of the strategy will be allowed if challenged and that there is substantial authority for the positions being claimed. We also expect to be able to conclude that the taxpayer should prevail (70% or greater probability of success) if the IRS should raise the second class of stock issue.

Our opinion will be based on the tax law and other authorities in effect on the date we issue our opinion. There can be no assurance that there will no change in the relevant tax authorities between now and the date we issue our opinion or the date you file your tax return reporting benefits of the strategy.

The IRS or a court might discount an opinion provided by the promoter of a strategy. Accordingly, it may be advisable to consider requesting a concurring opinion from an independent tax advisor.

- Disputes with the tax-exempt organization. Disputes could develop with the tax-exempt organization over such matters as the valuation of the stock contributed to it or redeemed by it, as well as whether or when to present the stock for redemption. We suggest that you consult with your legal adviser on means to mitigate any such potential disputes.

If you have questions about any of the issues raised in this summary or have any other concerns, please contact us.

Watson, Mark T

~rom:	Lanning, John T
:nt:	Monday, May 10, 1999 6:29 PM
.:o:	Watson, Mark T
Subject:	RE: BLIPS

Mark:

Thanks for the reply. I know this one has been frustrating for all of us. We learn more with each new deal. Let's move forward and get this done, as long as we're protecting the interests of the firm.

John

-----Original Message-----
From: Watson, Mark T
Sent: Monday, May 10, 1999 6:11 PM
To: Lanning, John T
Cc: Wiesner, Philip J; Ammerman, Douglas K; Springer, Mark A
Subject: RE: BLIPS

John, the draft opinion letter we were asked to review purportedly set forth accurate facts as to how the transaction was going to be structured. Given the parties involved, I did not think we needed to question the facts that they provided us. It was not until I heard conflicting information that I questioned the original facts. In the future, I will question everything Presidio and Randy Bickham represent to me.

-----Original Message-----
From: Lanning, John T
Sent: Monday, May 10, 1999 6:02 PM
To: Watson, Mark T
Cc: Wiesner, Philip J; Ammerman, Douglas K
Subject: RE: BLIPS

Mark:

I hear you, but still wonder why someone wasn't asking these questions of Presidio months ago?

John

-----Original Message-----
From: Watson, Mark T
Sent: Monday, May 10, 1999 10:29 AM
To: Lanning, John T
Cc: Wiesner, Philip J; Ammerman, Douglas K
Subject: FW: BLIPS

John, in my defense, my change in heart about BLIPS was based on information Presidio disclosed to me at a meeting on *May 1*. This information raised serious concerns in my mind about the viability of the transaction, and indicated that WNT had not been given complete information about how the transaction would be structured when we were asked to review the model opinion letter.

I want to make money as much as you do, but I cannot ignore information that raises questions as to whether the subject strategy even works. Nonetheless, I have sent Randy Bickham four representations that I think need to be added to our opinion letter. Assuming these representations are made, I am prepared to move forward with the strategy.

-----Original Message-----
From: Wiesner, Philip J
Sent: Monday, May 10, 1999 9:51 AM
To: Lanning, John T; Ammerman, Douglas K
Cc: Stein, Jeff; Lippman, Michael H; Smith, Richard H (WNT); Watson, Mark T; Rosenthal, Steven M; DeLap, Larry
Subject: RE: BLIPS

John/Doug: Many people have worked long and hard to craft a tax opinion in the BLIPS transaction that satisfies the more likely than not standard. I believed that we in WNT had completed our work a month

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ago when we forwarded the opinion to Larry. Based on my attendance at numerous technical meetings and my reading the opinion, I came to the conclusion that we could reach an overall more likely than not tax opinion based on the information provided re business purpose and potential profit and the representations to be provided by the investor and Presidio. We viewed our role as a positive one, ie, we would work very hard to achieve, if possible, the desired level of opinion and suggest improvements, in particular, to limit the risks which the Firm is assuming by issuing the opinion.

The speed to market issue is also troubling to me, but perhpas for different reasons. First, this is a classic transaction where we can labor over the technical concerns, but the ultimate resolution - if challenged by the IRS - will be based on the facts (or lack thereof). In short, our opinion is only as good as the factual representations that it is based upon. As the courts did in the individual tax shelter cases of the 80s and in the recent ACM case, the decision will be based not on the techical niceties, but on the overall issues of whether in fact the investors approached the transaction from a business like point of view with a real desire to make a profit other than from tax benefits. Second, we have been dealing with a true prototype opinion where the facts keep evolving. The real "rubber meets the road" will happen when the transaction is sold to investors, what the investors' actual motive for investing the transaction is and how the transaction actually unfolds. Our opinion will be worth little (but we will be protected from risk if it is properly caveated) is the actual facts bear little relation to the assumed facts in the opinion. Note: This is Mark Watson's primary concern based on the recent Presidio discussions at a PFP meeting. Third, our reputation will be used to market the transaction. This is a given in these types of deals. Thus, we need to be concerned about who we are getting in bed with here. In particular, do we believe that Presidio has the integrity to sell the deal on the facts and representations that we have written our opinion on?! We have had past experience in the foreign stock redemption and the OPUS transactions which shows how difficult it is to keep the facts in line. Thus, the process has been slowed by a number of very critical forces which have been at work.

Having said all the above, I do believe the time has come to shit and get off the pot. The business decisions to me are primarily two: (1) Have we drafted the opinion with the appropriate limiting bells and whistles (Yes, in my opinion), has the engagment letter been drafted with the right rsik limiting language (from what I have seen, Yes) and is the marketing of the transaction limited to very sophisticated taxpayers who are made aware of the risk and properly advised by their own tax and investment advisers (I thought that the marketing here was to be limited to a very small and narrow range of risk taking individuals!) and (2) Are we being paid enough to offset the risks of potential litigation resulting from the transaction? If the answers are yes to both questions, then we have done all we can do from a technical point of view and it is time to move on and decide the business case. 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. Finally, as I said above, our opinion is only as good as the underlying factual assumtions and actions by the investors. We cannot control with any certainly what they will do in fact!

The way forward. In my view, the technical issues have been worked about as well as they can be. We should decide as a business matter to proceed and work to have in place controls to make sure that the sellers of the transaction and the investors in the transaction do not make a sham of our opinion.

Phil

-----Original Message-----
From: Lanning, John T
Sent: Saturday, May 08, 1999 3:32 PM
To: Ammerman, Douglas K; Wiesner, Philip J
Cc: Stein, Jeff; Lippman, Michael H
Subject: FW: BLIPS

I must say that I am amazed that at this late date (must now be six months into this process) our chief WNT PFP technical expert has reached this conclusion. I would have thought Mark would have been involved on the ground floor of this process, especially on an issue as critical as profit motive. What gives? This appears to be the antithesis of "speed to market". Is there any chance of ever getting this product off the launching pad, or should we simply give up???

John

-----Original Message-----
From: DeLap, Larry

Sent: Friday, May 07, 1999 7:48 AM
To: Ammerman, Douglas K; Eischeid, Jeffrey A; Bickham, Randall S
Cc: John Lanning; Jeff Stein
Subject: FW: BLIPS

Doug, Jeff, and Randy -

Steve Rosenthal informed me on Tuesday afternoon that he had substantial concern with the "who is the borrower" issuer, and that he would be discussing the matter with Randy on Tuesday or Wednesday. I don't know what the outcome of those discussions were. I imagine Steve would have a concern with the second bullet in Mark Watson's message.

I don't believe a PFP product should be approved when the top PFP technical partner in WNT believes it should not be approved.

I will be back in the U.S. on Saturday and in the Silicon Valley office on Monday morning. Please give me a call on Saturday afternoon or Sunday at home (408-353-3309) or on Monday morning in the office.

Larry

-----Original Message-----
From: Watson, Mark T
Sent: Wednesday, May 05, 1999 9:21 AM
To: Ammerman, Douglas K; Eischeid, Jeffrey A; Bickham, Randall S
Subject: BLIPS

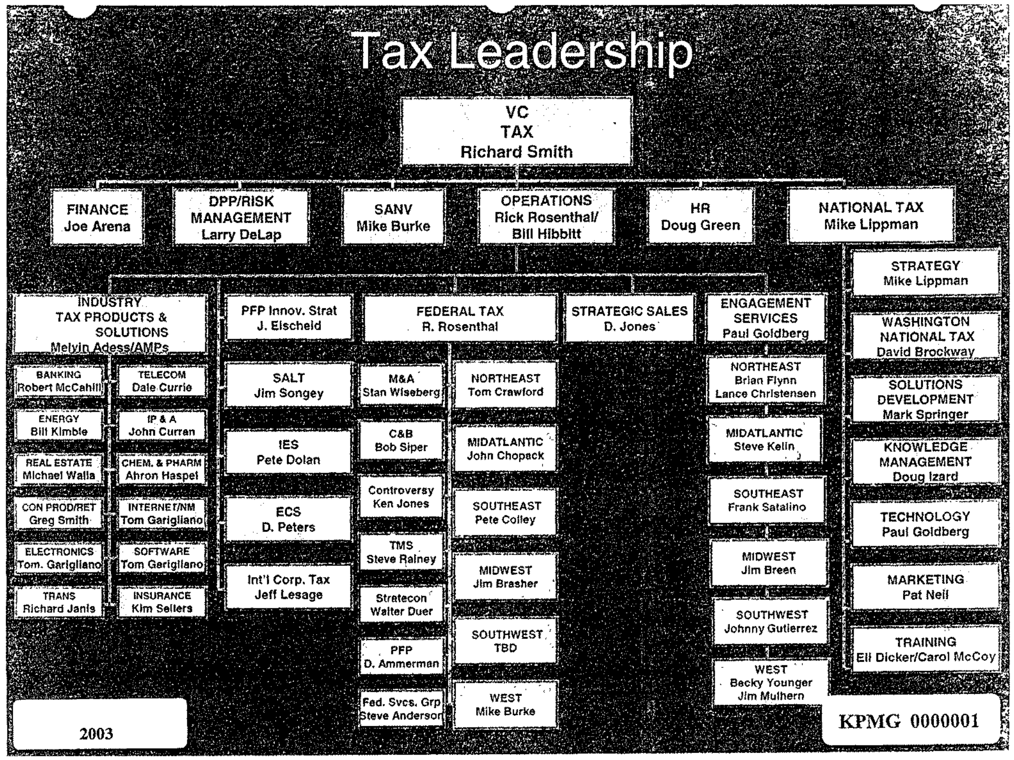
Based on our meeting on April 30 and May 1, I am *not* comfortable with the BLIPS product for the following reasons:

- According to Presidio, the probability of making a profit from this strategy is remote (possible, but remote). Thus, I don't think a client's representation that they thought there was a reasonable opportunity to make a profit is a reasonable representation. If it isn't a reasonable representation, our opinion letter is worthless.

- The bank will control, via a veto power over Presidio, how the "loan" proceeds are invested. Also, it appears that the bank will require this "loan" to be repaid in a relatively short period of time (e.g., 60 days) even though it is structured as a seven-year loan. These factors make it difficult for me to conclude that a bona fide loan was ever made. If a bona-fide loan was not made, the whole transaction falls apart.

Until these issues are resolved satisfactorily, I don't think we should release this product.

Mark T. Watson
Partner
KPMG - Washington National Tax
202-467-2433 (phone)
202-822-8887 (fax)



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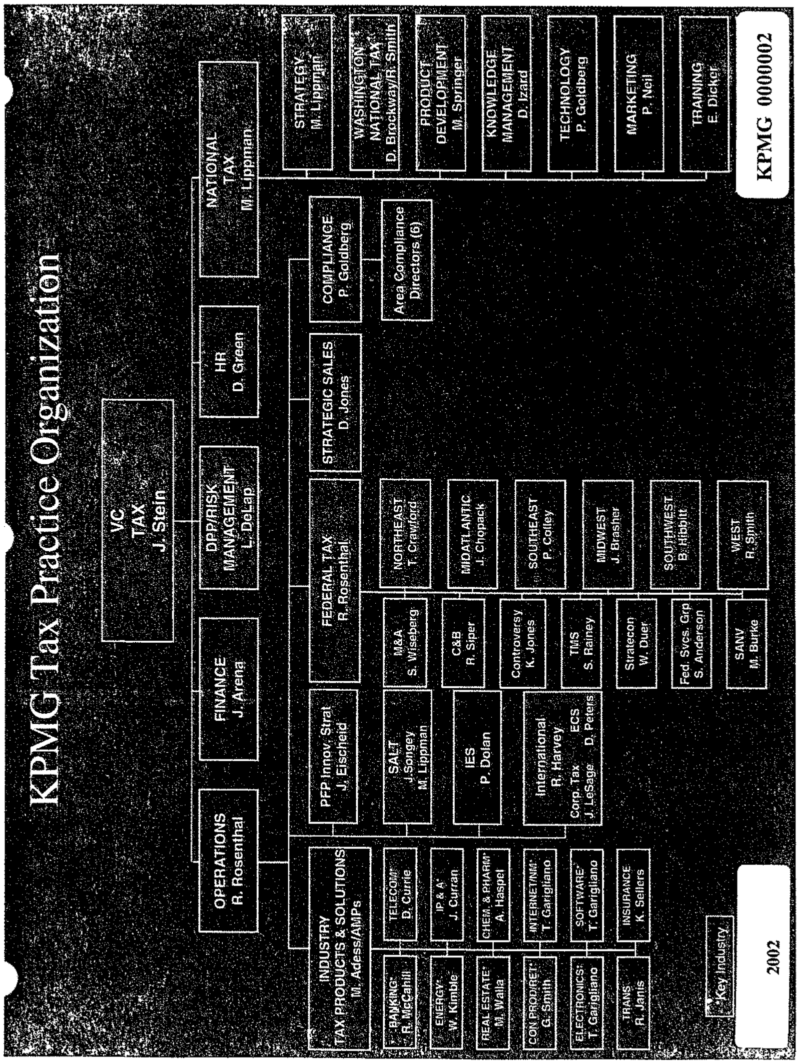
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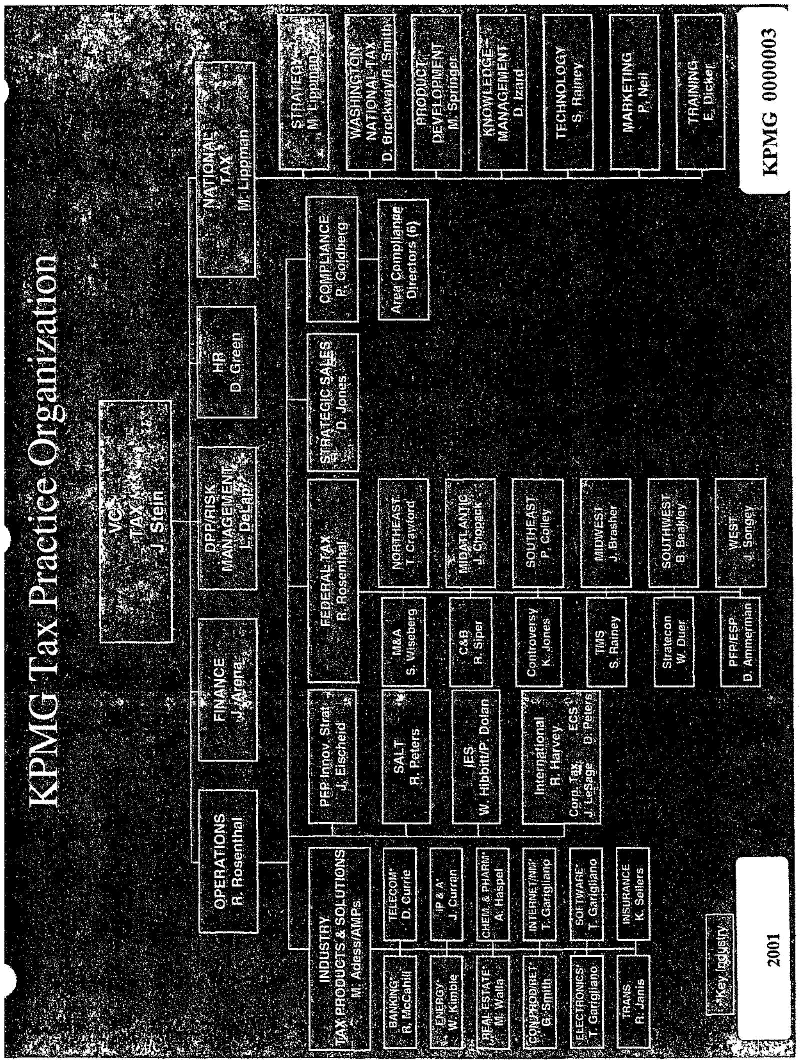
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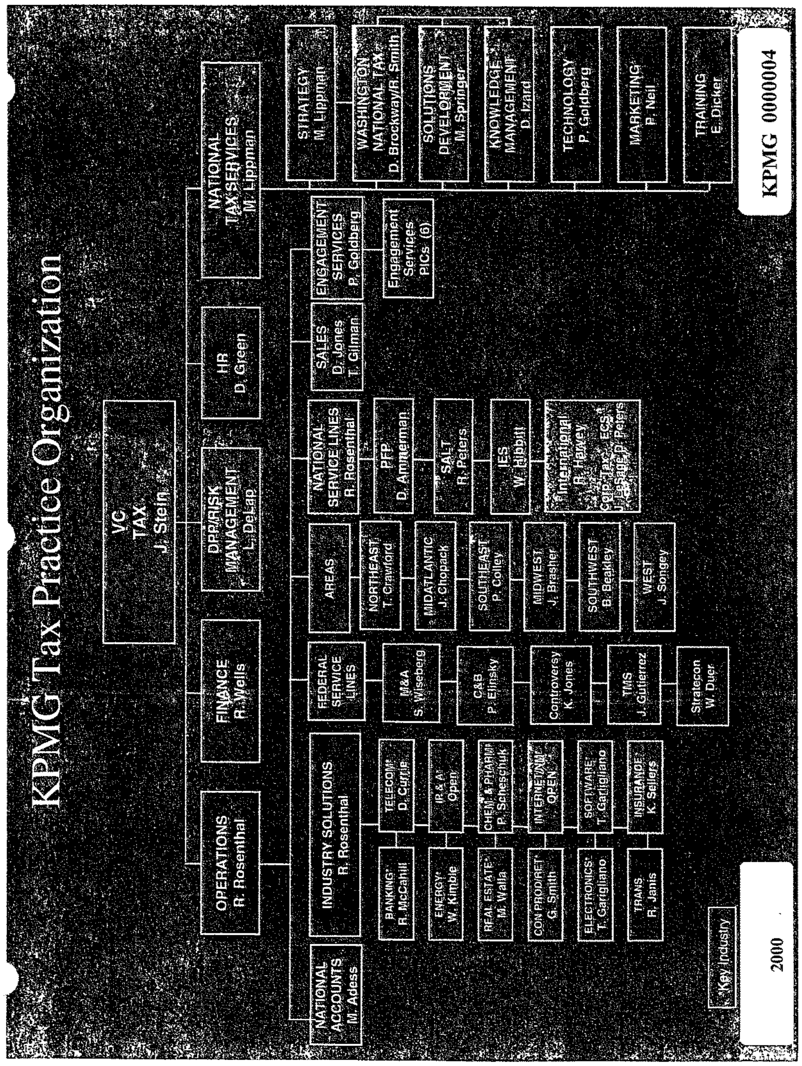
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December 31, 1999

Permanent Subcommittee on Investigations
Markings on Exhibits 90a and 90b were made by the Permanent Subcommittee on Investigations to draw attention to virtually identical language in the two purportedly independent tax opinions.

You have requested our opinion regarding the U.S. federal income tax consequences of certain investment transactions that have been concluded by LLC ("Investor"), a Delaware single-member limited liability company. As more fully described below, Investor participated in a series of transactions involving investments in foreign currency-based securities and derivative contracts through an investment fund. The investment transactions were structured through an investment program (the "Investment Fund") designed by Presidio Growth LLC ("Presidio"). Presidio is an independent investment advisor registered under the Investment Advisers Act of 1940 that specializes in structured financial products and the execution of associated investment and derivative-based trading strategies.

Presidio acted as investment advisor and managing member (the "Managing Member") with respect to Investor's participation in the Investment Fund. Prior to its entry into the Investment Fund, Presidio provided to Investor the attached Strategic Investment Fund Confidential Memorandum that sets forth the potential financial returns and risks from participation in the investment program. Based upon Investor's independent assessment of the Strategic Investment Fund Confidential Memorandum, Investor has represented that Investor believed that there was a reasonable expectation of earning a reasonable pre-tax profit from the investment transactions described that would be in excess of all associated fees and costs, without regard to any tax benefits that might occur.

Our opinion and supporting analysis are based upon the following description of the facts and representations associated with the investment transactions undertaken by Investor. In rendering our opinion, we have reviewed the applicable provisions of the Internal Revenue Code of 1986, as amended ("Code"), and the final, temporary, and proposed Treasury Regulations (hereinafter "Treas. Reg." or "regulations") promulgated

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thereunder; relevant decisions of the U.S. federal courts; published Revenue Rulings ("Rev. Rul.") and Revenue Procedures ("Rev. Proc.") of the Internal Revenue Service ("Service") and other materials as we have considered relevant.[1]

Our opinion is limited to the conclusions expressed below in the sections entitled "*Summary of Opinion*" and "*Conclusion.*" In various sections of the opinion, for ease of understanding and as a stylistic matter, we may use language such as "will" or "should" which could suggest that we reached a conclusion on an issue at a standard different from "more likely than not."[2] Such language should not be so construed. Our conclusions on any issue discussed in this opinion letter do not exceed a "more likely than not" standard.

I. Description of Investment Transactions

A. Overview of Investment Program

The following describes the investment program entered into by Investor and the investment structure utilized based upon information provided to us by Presidio. A more detailed explanation of the underlying investment strategy devised by Presidio is contained in the attached Strategic Investment Fund Confidential Memorandum.

Presidio has represented the following relative to the investment program entered into by Investor:

> Since inception of floating exchange rates in 1973, all currencies have been subject to wide swings in value. The general consensus by the international financial community is that exchange rate volatility is undesirable because of the adverse impact these swings have on international capital flows. Consequently, many governments influence the level of their currency by intervening in foreign exchange markets.

[1] Code Section 6110(j)(3) provides that a written determination, (e.g., a private ruling, determination letter, or technical advice memorandum), may not be used or cited as precedent. However, in Xerox Corp. v. U.S., 656 F.2d 659, 660 (Ct. Cl. 1981), the court noted that although private letter rulings have no precedential value, "they are helpful, in general, in ascertaining the scope of the...doctrine adopted by the Service and in showing that the doctrine has been regularly considered and applied by the Service."

[2] Under a "more likely than not" standard, we are of the opinion that under current U.S. federal income tax law there is a greater than 50 percent likelihood (i.e., it is "more likely than not") that the positions taken will be upheld if challenged by the Internal Revenue Service.

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Emerging market governments are typically more active participants in their respective currency markets because emerging market currency levels are more easily controlled and the benefits to the emerging market nations are more significant. By controlling the level of their currency, emerging market nations encouraged capital inflows by mitigating the risk of currency devaluation. In addition, by entering into a managed currency regime, the emerging market nation can curb hyperinflation, a problem faced by many emerging market nations due to a combination of rapid growth and imprudent fiscal management common to many of these countries.

The Investment Fund entered into by Investor was established by Presidio as an investment that sought to provide investors with a high total return. To obtain this objective, the Investment Fund invested in U.S. dollar and foreign currency denominated debt securities of corporate and governmental issuers and entered into forward foreign currency contracts, options on currencies and securities and other investments selected by Presidio, as Managing Member of the Investment Fund.[3]

It was Presidio's belief that successful implementation of its investment strategy could best be achieved through a relatively long-term investment horizon. Accordingly, the Investment Fund was structured as a three stage, seven year investment program. The core investment strategy underlying all three stages was to maintain long or short positions in debt securities and currency exchange contracts. Through such investments, the Investment Fund sought to profit from changes that Presidio anticipated would occur in the value of the currencies in which such securities were denominated or quoted or to which the forward currency exchange contracts related.[4]

[3] An investment in the Investment Fund increased or declined in value as a result of changes in the value of the securities in which the Investment Fund invested and the currencies and securities underlying the forward foreign currency contracts and options.

[4] These profit opportunities were primarily based upon selectively selling ("shorting") overvalued emerging market currencies and selectively buying ("going long") undervalued emerging market currencies. The investment strategy effectively sought to obtain high risk-adjusted returns for its investors by exploiting opportunities to short currencies under unsustainable managed currency regimes and going long currencies previously subject to managed currency regimes that were considered fundamentally undervalued by Presidio due to political or economic upheaval. By monitoring the economic conditions in

The three investment stages were differentiated by the degree of risk assumed by the Investment Fund. In each successive stage, Presidio was to allocate a greater percentage of the Investment Fund's assets to securities and currency positions that allowed a greater opportunity for profit but also correspondingly greater risk. Reflecting the greater degree of risk, Presidio could require investors to make additional capital contributions. However, the aggregate contributions of an investor could not exceed the amount to which such investor agreed at the time of subscription to the Investment Fund. The obligation to make additional capital contributions terminated if the investor notified Presidio of its election to withdraw its entire capital account balance from the Investment Fund.

The anticipated time horizons and associated investment strategies for the three stages at the time Investor entered into the Investment Fund were as follows:

- ***Stage I:*** The first stage was expected to last 60 days, during which time the Investment Fund would engage in strategies that the Managing Member believed entailed relatively low levels of risk compared to later investment stages. An example of a strategy that could be used during this stage was for the Investment Fund to sell short currencies under managed currency regimes ("pegged currencies") that the Managing Member believed were likely to depreciate in the short term.

- ***Stage II:*** The second stage of the investment strategy was expected to last approximately 120 days. During stage two, the Investment Fund would pursue similar investment strategies as during stage one. However, the degree of risk taken by the Investment Fund would increase. More of the Investment Fund's capital was to be was to allocate to riskier positions, resulting in higher potential profit but also higher potential losses and volatility. Due to the increase in risk

emerging market countries and the direction of the currency markets, Presidio sought to identify and profit from, those currency devaluations which were most likely to occur over the life of the Investment Fund.

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during investment stage two, the members could be required to increase their capital contributions to the Investment Fund.

- *Stage III:* The third stage of the investment strategy was expected to last approximately 6.5 years. During the third investment stage, the Investment Fund would pursue investment strategies that had the potential for greater rewards but also would entail substantially greater risk. For example, in addition to maintaining short positions in pegged currencies which the Managing Member believed to be overvalued, the Investment Fund could establish long positions in emerging market currencies that have recently been devalued. By buying debt securities denominated in recently devalued currencies or entering into forward currency exchange contracts after a devaluation, the risk profile of the Investment Fund would be higher than during the first two stages; however, the potential returns were expected to be commensurately higher.[5]

The minimum investment for an investor in the Investment Fund was $10 million in return for a Class A interest. Contributions to the Investment Fund had to be in cash. At the discretion of Presidio, as the Managing Member, the Investment Fund allowed a Class A Member to contribute cash subject to indebtedness at the time of subscription. If an investor funded its investment capital through a loan, the Managing Member required investors to arrange at least seven-year financing in order to cover the expected term of the program.[6] In addition to one or more Class A Members and the Managing Member, the Investment Fund allowed for one or more holders of Class B interests. The Class B Member(s) were affiliates of the Managing Member.

Class A Members had the right to withdraw all (but not part) of their capital account balances upon written request to the Managing Member beginning on the 60th day following the Class A Member's initial investment and each 60 day

[5] Presidio believed that currencies which had recently been devalued typically were undervalued due to economic upheaval and abnormally high interest rates. The value of these currencies may, however, be particularly volatile.
[6] Presidio effectively allowed an investor a choice of funding its participation in the Investment Fund on either a non-leveraged basis or a leveraged basis by contributing cash subject to an outstanding loan to the Investment Fund.

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anniversary thereafter provided that the Managing Member received the written request at least 10 business days prior to such date. Unless the Managing Member otherwise agreed, Class B Members could only withdraw their capital account balances following the withdrawal by all of the Class A Members. In lieu of accepting a Class A Member's withdrawal request, the Managing Member could have elected either to liquidate the Investment Fund or to arrange for the purchase of the Class A Member's interest at a price equal to the withdrawal proceeds that the Class A Member would otherwise have received.

B. The Investment Structure

On September 30, 1999 Investor obtained a $33,300,000 fixed rate nonrecourse loan[7] from Deutsche Bank AG. Under the terms of the credit agreement (the "Credit Agreement")[8] between Deutsche Bank AG and Investor, the $33,300,000 principal amount of the loan was payable on the seventh anniversary of the borrowing date.[9] Interest on the loan was payable quarterly at a rate of 17.557 percent per annum. The loan proceeds were initially transferred to Investor's personal bank account at Deutsche Bank AG and then immediately transferred to Investor's trading account at Deutsche Bank AG.

Presidio has represented to us that Investor opted to repay the loan at a 17.557 percent interest rate in return for a premium payment of $20,000,000 in order to lessen the financial risks associated with participation in the Investment Fund. As discussed, the Investment Fund uses a three stage approach with increasing levels of investment risk in each subsequent stage. Presidio further represented to us that Investor entered into a financing arrangement whereby higher levels of financing risks were incurred early in the program, with such risks declining as the loan premium amount was amortized over the term of the loan. According to Presidio, the structure of Investor's loan results in an integrated investment strategy whereby there are complementary levels of investment risks and financing risks at all times during the term of the Investment Fund. By having

[7] Section 9.14 of the Credit Agreement states that Deutsche Bank AG agrees and acknowledges that neither it (nor any of its affiliates) shall have any recourse against the Investor or any of its assets or property other than the pledged collateral.

[8] Any future references to the Credit Agreement incorporating terms defined within the Credit Agreement will use the convention of capitalizing such terms.

[9] Under the terms of the Credit Agreement (Section 3.01), Investor had the ability to prepay the loan subject to any applicable prepayment penalties and breakage fees. Pursuant to Section 3.02 of the Credit Agreement, the amount of any prepayment penalty is a function of interest rates at the time of prepayment.

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the loan premium structure, it is the view of Presidio that it is possible to match investment risks with financing risks.[10]

The investment program entered into by Investor was structured through Longs Strategic Investment Fund, LLC, a Delaware limited liability company ("Partnership") that was treated as a partnership for U.S. federal income tax purposes.[11] Presidio, through two limited liability companies, contributed $155,554 to Partnership for a 1% interest as Managing Member and a 9% Class B interest.[12] Investor contributed $54,700,000[13] subject to the $33,300,000 nonrecourse loan to Partnership for a 90 percent Class A interest on October 12, 1999.[14] The assumption of the loan by Partnership was approved by Deutsche Bank AG pursuant to the Assignment and Assumption Agreement dated October 12, 1999. To mitigate its risk position with respect to interest rate changes during the term of the loan, Partnership entered into a fixed-for-floating rate interest rate swap with Deutsche Bank AG for a term of approximately seven years.[15]

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[10] Presidio has represented to us that over the seven-year term of the loan, an investor would be exposed to several types of financial risks resulting from potential changes in interest rates. Of particular concern to an investor is residual interest rate risk (the "convexity" effect). According to Presidio, Investor has managed residual interest rate risk through the structuring of a financing package with a loan premium as its integral economic component. *See* the attached discussion of the underlying financial theory in the "Analysis of Financing Alternatives" prepared by Presidio. In the analysis, Presidio recommends the use of the loan premium structure to mitigate residual interest rate risk.

[11] A limited liability company with multiple members can elect to be classified as a partnership or as an association taxable as a corporation. Absent an election, a domestic multi-member limited liability company will automatically be classified as a partnership pursuant to Treas. Reg. Sec. 301.7701-3(b)(1)(i).

[12] Presidio Growth LLC was the Managing Member with a 1% interest in Partnership and Presidio Resources LLC had the 9% interest.

[13] The capital contribution stated in this opinion letter does not reflect a de minimis amount of accrued interest earned by Investor during the period between the time of entering into the loan and the contribution of the proceeds to Partnership. Accordingly, future references in this Opinion to the capital contribution by Investor and Investor's adjusted basis in Partnership or any distributed asset do not reflect such accrued interest. Such references are merely made to illustrate the operation of applicable tax laws to Investor's transactions, and do not imply that we are opining on the precise amount of Investor's capital contribution or adjusted basis.

[14] Deutsche Bank AG represented to us that there was no plan or intention to require Investor to convey the loan proceeds or assign the loan obligation to Partnership.

[15] Partnership entered into the fixed-to-floating rate swap to hedge interest duration risk. Duration risk (or more precisely "modified" duration) is a measure of the price sensitivity of a bond to interest rate movements. It is used to measure the sensitivity of a bond's price (i.e., the present value of its cash flows) to interest rate movements. A swap from fixed-to-floating can be used to hedge interest rate duration risk. *See* attached discussion of the underlying financial theory in the "Analysis of Financing Alternatives" prepared by Presidio.

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The Limited Liability Company Agreement of the Partnership required that capital accounts be maintained pursuant to Code Section 704(b) and the Regulations promulgated thereunder. In general, Partnership net profits and losses were allocated among the Members as follows: 90% to the Class A Members, 9% to the Class B Members and 1% to the Managing Member except for a management fee, which was allocated to the Class A and Class B Members on the basis of their capital account balances. The Class B Members were entitled to a preferred return equal to 12% per year (or any portion thereof) of their capital account balances before any allocation of profit was made to the Class A Members or the Managing Member.

C. Subsequent Events and Investment Results

On December 13, 1999, upon completion of Stage I of the Investment Fund, Investor opted to terminate its participation in the Investment Fund. As a result of Investor not opting to participate in Stage II of the Investment Fund, Investor elected to have its partnership interest redeemed. On December 13, 1999 Investor's Partnership interest was liquidated. Investor's liquidating distribution consisted of the following Partnership assets:

• Cash	$348,733
• 425 shares of Microsoft Corp.	$39,897

Subsequent to Investor's withdrawal from Partnership, Partnership continued making investments with the remaining partnership assets utilizing the $33,300,000 loan for financing. The covenants contained in the Credit Agreement allowed Deutsche Bank AG to call the $33,300,000 loan if the Investor ceased to own directly or indirectly at least a majority of the outstanding membership units in Partnership (an "Event of Default") upon giving written notice to Partnership.

II. Representations

A. Representations Made to KPMG by Investor

In connection with the transactions described above, Investor has represented to KPMG LLP ("KPMG") the following:

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- Investor's single member invests directly in marketable securities and other financial instruments on his own account.

- Investor acted independently of, and at arm's length from, the Managing Member, the Class B Member and Deutsche Bank AG with respect to the transactions described herein.

- There was no legally binding agreement, written or otherwise, that compelled Investor to complete the transactions in the way described herein. The duration of Investor's participation in the Investment Fund was dependent upon the performance of the program relative to alternative investments.

- There were no written agency agreements or arrangements (apart from Presidio's role as Managing Member of Partnership) consummated with respect to the transactions undertaken pursuant to the Investment Fund and neither Investor, nor to the best of Investor's knowledge, any parties involved held themselves out to a third party as agents of any of the others with respect to these transactions.

- Investor independently reviewed the economics underlying the Investment Fund before entering into the program and believed there was a reasonable opportunity to earn a reasonable pre-tax profit from the transactions described herein (not including any tax benefits that may occur), in excess of all associated fees and costs.

- Investor's sole member[16] sold a portion of the financial instruments received as Partnership liquidating distributions.

- Investor has provided KPMG with all facts and circumstances that Investor knows, or has reason to know, are pertinent to this opinion letter and believes that all its representations on which this opinion relies are reasonable.

[16] As a single member limited liability company for which no check-the-box election was made, Investor is disregarded as an entity separate from its owner. Accordingly, for tax purposes, any transactions entered into by Investor are treated as entered into directly by Investor's sole member. For stylistic purposes, references may be made in this opinion to transactions entered into by (or to the tax consequences of such transactions) "Investor's sole member." Such references to "Investor's sole member" are made to indicate that the resulting tax consequences are borne by Investor's sole member, whereas the actual transaction at issue may have been entered into by Investor.

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- Investor and Investor's sole member each use the U.S. dollar as its functional currency.
- The capital contribution, made by Investor's sole member, was made from Investor's sole member's separate property.

B. Representations Made to KPMG by Presidio

In connection with the transactions described above, Presidio has represented to KPMG the following:

- Presidio believed there was a reasonable opportunity for Investor to earn a reasonable pre-tax profit, in excess of all associated fees and costs, and without regard to any tax benefits that may occur, by participating in the Investment Fund. Presidio communicated this belief to Investor.
- Presidio acted independently of, and at arm's length from, Investor and Deutsche Bank AG with respect to the transactions described herein.
- Deutsche Bank AG did not, directly or indirectly, control or participate in the management or operations of Partnership.
- Deutsche Bank AG did not, directly or indirectly, control or direct the investments of Partnership apart from its rights under a Pledge and Security Agreement, Credit Agreement, and Account Control Agreement.
- All of Partnership's foreign currency transactions were conducted over the counter. Therefore, Partnership did not undertake transactions on a national securities exchange registered with the Securities and Exchange Commission. Furthermore, Partnership did not undertake transactions on a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission.
- There did not exist at the time Investor or any assignee entered into trading strategies, within the range of Permitted Investments, an Event of Default under the terms of the Credit Agreement.

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- Neither the Investor nor any assignee entered into trading strategies, within the range of Permitted Investments, in a manner that results in or causes an Event of Default under the terms of the Credit Agreement.

- The loan collateral and covenants were not altered or amended upon assumption of the loan by Partnership.

- The descriptions of the Investment Fund and the economics of the financing arrangement used by Investor, as set forth in the Overview of Investment Program and The Investment Structure sections of this opinion letter, and in the attachments hereto, are accurate.

- Any amount due under the Note, other than the aggregate outstanding principal amount, any accrued but unpaid interest, and the unamortized premium is expected to be incidental (i.e., under all reasonably expected market conditions on the date of issuance of the Note, the potential amount of any such payment would be insignificant relative to the total expected amount of the remaining payments on the Note).

C. Representations Made to KPMG by Deutsche Bank AG

In connection with the transactions described above, and in addition to any representations described in any other section of this opinion letter, Deutsche Bank AG has represented to KPMG the following:

- The Credit Agreement and associated exhibits contained therein (i.e., the Pledge and Security Agreement and the Account Control Agreement) and the Assignment and Assumption Agreement entered into between Investors and Deutsche Bank AG have been approved in the ordinary course of business by the competent authorities within Deutsche Bank AG as consistent, in the light of all the circumstances such authorities consider relevant, with Deutsche Bank AG credit and documentation standards which Deutsche Bank AG believes are consistent with industry standards.

- Deutsche Bank AG acted independently of, and at arm's length from, Investor and the other participants in the Investment Program.

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- Deutsche Bank AG recorded for U.S. GAAP accounting purposes and U.S. regulatory purposes the Stated Principal Amount and the Initial Unamortized Premium Amount of the loan made pursuant to the Credit Agreement as follows: a $33,300,000, seven year loan and a $20,000,000, unamortized premium amount, respectively.

- The Credit Agreement provides that the Maturity Date of the loan made thereunder is the seventh anniversary of the applicable Borrowing Date. Furthermore, Section 8 of the Credit Agreement sets forth the conditions upon which the principal of and any accrued interest in respect of the applicable Note, the applicable Prepayment Amount, if any, the applicable Breakage Fee, if any, and all other obligations owing under such Credit Agreement and the applicable Note may be declared to be, or become, due and payable prior to the applicable Maturity Date. Except as provided in such Credit Agreement, Deutsche Bank AG will not accelerate any stated principal or interest payment due under the Credit Agreement.

- While as part of the negotiation of the form of the Credit Agreement a form of Assignment and Assumption Agreement was negotiated and it was the expectation of Deutsche Bank AG that the Bank (as defined in the Credit Agreement) would be requested to give its consent to an assignment of the applicable Borrower's rights and obligations under the Credit Agreement pursuant thereto to the Presidio limited liability company used to effectuate the Investment Program, the Credit Agreement would not require the Borrower to assign the loan made thereunder to any Person and Deutsche Bank AG had no plan or intention to require such assignment.

III. Summary of Opinion

Based on and subject to the facts, documentation and representations described above and the discussion and analysis of the relevant statutory provisions, judicial doctrines, and other authorities below, we are of the opinion that under current U.S. federal income tax law there is a greater than 50 percent likelihood (i.e., it is "more likely than not") that the following positions will be upheld if challenged by the Internal Revenue Service:

- The $20,000,000 loan premium will not constitute a liability of Investor or Partnership for purposes of Code Section 752, but represents an addition to the $33,300,000 loan to be amortized under Treas. Reg. Section 1.163-13 against the issuer's interest expense over the life of the loan;

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- Investor will recognize no gain or loss upon receipt of the loan proceeds of $33,300,000, including the loan premium of $20,000,000;

- Investor will be recognized as the true borrower of the loan for U.S. federal income tax purposes;

- Investor will recognize no gain or loss with respect to its capital contribution of $54,700,000 to Partnership subject to the $33,300,000 loan;

- The fixed rate debt instrument and interest rate swap will not be integrated under Treas. Reg. Section 1.1275-6(c)(2);

- Upon liquidation of Investor's Partnership interest, Investor's adjusted basis of $21,400,000,[17] plus or minus its allocable share of Partnership income or loss, in its Partnership interest is first reduced by actual cash received of $348,733 and the residual amount is allocated to the financial instruments distributed;

- The difference between the basis allocated to the financial instruments received in a liquidating distribution and the proceeds received upon disposition of such financial instruments will be deductible by Investor's sole member as a capital loss under Code Section 165(a) subject to Code Section 165(f) which provides that losses from sales or exchanges of capital assets are allowed only to the extent allowed in Code Sections 1211 and 1212;

- Investor's sole member's Code Section 465 "at risk" amount for its taxable year ending on December 31, 1999, includes the cash and the adjusted basis of the assets distributed to Investor as liquidating distributions by Partnership;

- Partnership income (or loss) and the loss upon disposition of the assets received by Investor upon liquidation of its interest in Partnership will not be subject to limitation under the Code Section 469 passive activity loss rules;

- Investor's issuance of the debt instrument will not have a substantial effect on Investor's U.S. federal income tax liability that could be construed as unreasonable in light of the purposes of Code Sections 163(e), 1271 through 1275, or 701-777.

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[17] See Footnote 13.

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IV. Analysis of Investment Transactions

A. Investor's Receipt of Loan Proceeds

1. Debt Instruments – The General Rules

The value of a debt instrument is equal to the present value of its future cash flows, which consist of interest and principal. The rate used to compute the present value of these cash flows is the interest rate that provides an acceptable return on an investment commensurate with the issuer's risk characteristics (the "market rate of interest"). If the market rate of interest differs from the stated interest rate, the present value of the debt instrument will differ from the face value of the debt instrument. The difference between the face value and the present value of the debt instrument is either a discount or premium. For example, if a debt instrument is issued with a premium, the effective interest rate will be lower than the stated interest rate. In the instant case, the calculation is as follows:

Present value of the principal = principal x discount factor at the market rate of interest

- $33,300,000 x 62.3581% = $20,765,243

Present value of interest payments = the sum of (quarterly payments x appropriate discount factors at the market rate of interest)

- $1,461,620 x appropriate discount factors at the market rate of interest = $32,522,088

Present value of debt = Present value of principal + Present value of interest payments

- $20,765,243 + $32,522,088 = $53,287,331

From a financial accounting perspective, a debt instrument must be recorded at its present value to properly measure the associated interest expense for financial statement purposes. The resulting $20,000,000 premium in the above example is not a liability because it does not result in any future net economic loss to the issuer. The lower effective rate of interest merely results because the proceeds from the borrowing exceed

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the face or maturity amount of the debt. The same logic would apply to a discount. A discount on a debt instrument does not represent prepaid interest and is not an asset for financial accounting purposes. Such amount is not an asset because it does not provide any future economic benefit. A loan discount or premium is not an asset or liability separate from the note giving rise to it, but is reported as a direct deduction from, or addition to, the face amount of the loan for financial accounting purposes. Conceptually, a premium on debt payable is a liability valuation account that has no existence apart from the related debt. For financial accounting purposes, based upon U.S. generally accepted accounting principles, the premium account is referred to as an adjunct account.[18]

The "OID rules" were introduced to conform the Code provisions relating to the measurement and timing of interest with the methods developed in the financial marketplace and applied under generally accepted accounting principles. OID stands for original issue discount, and generally refers to the tax accounting methods developed since 1982 for the measurement and timing of interest income and expense arising with respect to debt instruments. The Code and Regulations refer to all forms of indebtedness as "debt instruments." The term "bond" has the same meaning as the term "debt instrument" in Treas. Reg. Section 1.1275-1(d).[19] Thus, the terms will be used interchangeably for purposes of this opinion.

Under the OID rules, a debt instrument issued with a stated interest rate in excess of prevailing market rates for instruments of the same credit quality and maturity results in receipt of a bond premium to the issuer. Bond premium generally can be viewed as the mirror image of OID. From an income tax perspective, amortization of a premium results in the proper timing of recognizing interest income on the part of the holder and deducting interest expense on the part of the issuer of a debt instrument. Thus, for OID purposes, consistent with the financial accounting rules, the amount of premium is not considered a liability separate from the debt instrument that gave rise to it.

As further discussed herein and consistent with financial accounting rules, the amount of loan premium for tax purposes is calculated by subtracting from the loan's issue price all amounts payable under the debt instrument other than stated interest. In the instant case, Investor borrowed $33,300,000. The $33,300,000 loan is due on the seventh anniversary of the borrowing date and bears interest payable quarterly at an annual interest rate of

[18] Opinions of the Accounting Principles Board No. 21 (New York: AICPA, 1971).
[19] Treas. Reg. Section 1.171-1(b)(1).

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17.557 percent. The present value and issue price of the loan is $53,300,000. Subtracting the $33,300,000 face amount from the loan's $53,300,000 issue price results in a loan premium of $20,000,000. The loan premium is not an additional liability, but is reported as a separate item for the purpose of properly measuring interest consistent with both the financial accounting rules and the OID provisions. The premium is effectively a valuation account that is an addition to the $33,300,000 face amount of the loan giving rise to it.

Bond issuance premium is the excess of a debt instrument's issue price over its stated redemption price at maturity ("SRPM"). Code Section 1273(a)(2) defines SRPM to include all amounts payable under the debt instrument (other than interest based on a fixed rate or an objective interest index, and payable unconditionally at fixed intervals of one year or less during the entire term of the debt instrument).

Under Code Sections 1273(b)(1) - (5) and 1274, the issue price of a debt instrument depends on the circumstances surrounding its issuance. The following general rules apply:

- For publicly offered debt instruments not issued for property, the issue price is the initial offering price at which a substantial amount of the debt was sold.
- For debt instruments issued for property when either the debt or the property is publicly traded, the issue price is the fair market value of the property.
- For debt instruments issued for property when neither the debt nor the property is publicly traded, the issue price under Code Section 1274 is the stated principal amount of the debt, or a lower imputed amount.
- For other debt instruments not issued for property, including those issued in a bank's lending transactions, the issue price under Code Section 1273(b)(2) is the amount paid by the first purchaser.
- For transactions not subject to any of the above rules, the issue price generally will be the SRPM.

For purposes of applying the above rules, the term "property" includes services and the right to use property, but does not include money. In transactions to which Code Section

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1273(b)(2) applies, a payment from the borrower to the lender (other than a payment for property or for services provided by the lender such as commitment fees or loan processing costs) reduces the issue price of the debt instrument evidencing the loan. Solely for purposes of determining the tax consequences to the borrower, the issue price is not reduced if the payment is deductible under Code Section 461(g)(2).[20] Thus, the bond issuance premium is $20,000,000, measured by the excess of the obligation's issue price under Code Section 1273(b)(2) of $53,300,000 over the SRPM of $33,300,000.

Under Treas. Reg. Section 1.163-13, the issuer amortizes bond issuance premium by offsetting the qualified stated interest[21] allocable to an accrual period[22] with the bond issuance premium. Thus, the interest deduction otherwise allowable under Code Section 163 is reduced by the amount of bond issuance premium allocable to the period. The interest deduction amount and amortization of bond issuance premium are determined on a constant yield method and accrue ratably within an accrual period. The amount of bond issuance premium allocable to an accrual period is the product of the debt instrument's adjusted issue price[23] at the beginning of each period and its yield to maturity[24] as adjusted to reflect the length of the period. In the instant case, the loan premium will be amortized ratably as an offset to Investor's and Partnership's interest expense deductions for each accrual period.[25]

Under Treas. Reg. Section 1.61-12(c), prior to amendment by the final regulations, the issuer of a premium debt instrument took the premium into account as a separate item of income over the life of the debt instrument and interest payable was also a separate deductible item. Treas. Reg. Section 1.163-13 clarifies that the issuer determines its interest deduction by offsetting the interest allocable to an accrual period with the bond issuance premium allocable to that period. This change effectively makes the tax accounting rules consistent with the financial accounting rules by recognizing that premium and discounts are merely valuation accounts, not discrete liabilities or assets.

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[20] Treas. Reg. Section 1.1273-2(g)(2).
[21] As defined in Treas. Reg. Section 1.1273-1(c).
[22] Treas. Reg. Section 1.446-2(b) determines the accrual period to which qualified stated interest is allocable and the qualified stated interest allocable to an accrual period.
[23] Determined under Treas. Reg. Section 1.1275-1(b).
[24] Determined under Treas. Reg. Section 1.1272-1(b)(1)(i).
[25] With respect to Partnership's assumption of the nonrecourse loan, the terms "issuer" and "obligor" are interchangeable and refer to the issuer of a debt instrument or a successor obligor. Treas. Reg. Section 1.1001-3(f)(5)(i).

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Under Treas. Reg. Section 1.61-12(c)(1), an issuer does not recognize gain or loss upon the issuance of a debt instrument. Accordingly, we are of the opinion that it is more likely than not that Investor will recognize no gain or loss upon receipt of the loan proceeds of $33,300,000, including the loan premium of $20,000,000.

2. Investor as the True Borrower

Investor entered into the $33,300,000 loan on September 30, 1999 and Investor then contributed $54,700,000 subject to the $33,300,000 loan to Partnership for a 90 percent interest on October 12, 1999. Upon the contribution, the loan was assumed by Partnership. The loan was entered into by Investor in contemplation of participating in the Investment Fund. Thus, the issue arises as to whether Investor is the true borrower of the loan proceeds for U.S. income tax purposes. The Service could assert that Partnership should be considered the true borrower based upon an application of the "substance over form" doctrine. A corollary issue is whether Investor should be viewed as having "tax ownership" of the $53,300,000 in cash received from the loan.

The question of who is the true borrower arises as a result of Investor's contribution of the loan proceeds to Partnership and Partnership's subsequent assumption of the loan. Investor contributed the proceeds subject to the loan for the business purpose of leveraging its capital contribution. By leveraging its capital contribution outside the Partnership, Investor was able to guarantee a minimum initial amount of financial leverage. This leveraging effect would be particularly important during the first two stages of the Investment Fund where investment returns are premised upon investments in low and moderate risks positions.

In Bolding v. Commissioner,[26] the Tax Court found that the taxpayer, and not his wholly owned S corporation, was the true borrower on a line of credit, the proceeds of which taxpayer loaned to his S corporation. Taxpayer's share of flow-through S corporation losses were denied, however, on the basis that the taxpayer was unable to prove that he loaned the proceeds to his S corporation. As a result, the taxpayer was found not to have substantiated sufficient basis in his S corporation stock to deduct the losses.

On appeal, the Fifth Circuit agreed with the Tax Court's holding regarding the taxpayer being the true borrower on the line of credit, but found that the Tax Court had erred in concluding the taxpayer could not substantiate his stock basis.

[26] 117 F.3d 270 (5th Cir. 1997).

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The facts the Fifth Circuit considered in determining that the taxpayer was the true borrower were as follows:

- The promissory note was signed by the taxpayer, as an individual borrower;
- No documents associated with the line of credit were signed by taxpayer in his capacity as "President" of the S corporation;
- The bank did not include the S corporation's tax identification number on the note (a practice it would have followed if the S corporation had been borrower), but included only the taxpayer's social security number;
- The bank testified it intended taxpayer to be the obligor, and it requested financial information only from taxpayer.

Although on appeal the Fifth Circuit ultimately sustained the taxpayer's position, the taxpayer's failure to rigorously respect the form of his loans to the corporation was used against him. Examples of the taxpayer's disregard of proper form included the deposit of loan proceeds from the bank into the S corporation's account, the S corporation's payment of principal and interest directly to the bank, and the taxpayer failing to report interest income on the loan.

There is also a line of cases in which the issue was whether the true borrower was a corporation that, in form, issued a debt instrument to a shareholder of the corporation which guaranteed the debt. The leading case in this area is Plantation Patterns v. Commissioner.[27] In Plantation Patterns, the court held that the shareholder-guarantor was the true borrower rather than the corporation for purposes of determining which party was entitled to an interest deduction. The court determined that based on the meager capital position of the nominal borrower, the corporation, the lender was in substance looking to the shareholder-guarantor for payment. As a result, the court treated the guaranteed debt as an indirect capital contribution to the corporation by the shareholder-guarantor, treating the shareholder-guarantor as, in substance, the true borrower. A key fact in this case was the court's determination that the corporation's assets were wholly inadequate to sustain the debt.

[27] 462 F.2d 712 (5th Cir. 1972).

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An additional line of cases deal with loans by one party to an intermediary party who re-lends to another party (a so-called back-to-back loan). The principal case is Northern Indiana Public Service Co. v. Commissioner[28] where the court held that a finance subsidiary engaged in a back-to-back loan arrangement was not treated as a conduit merely because it was thinly capitalized. Most importantly, the court focused on the fact that the finance subsidiary earned a positive spread on its lending activity. The court also emphasized that the intermediary was not merely transitory and that the intermediary exercised dominion and control over interest proceeds. By contrast, in Aiken Industries, Inc. v. Commissioner,[29] the intermediary was a mere conduit because it earned no profit (and, thus, was not respected as the borrower).

The Tax Court looked at the question of whether a taxpayer was a true borrower in determining the deductibility of interest expense in Goodstein v. Commissioner.[30] In Goodstein, the court held that the taxpayer's purchase of Treasury notes and a loan to finance the purchase were shams. The facts of the case were that the taxpayer ordered his broker to purchase $10 million in face value of 1-3/8% Treasury notes. The taxpayer then executed a promissory note with a finance company for $9.9 million secured by the Treasury notes. The taxpayer directed the finance company to transfer the funds for the promissory note to his broker. Under the agreement with the finance company, the finance company could sell the Treasury notes.

When the broker purchased the Treasury notes for the taxpayer, the finance company did not have sufficient cash to pay the broker, so the finance company had the broker sell the Treasury notes. The Treasury notes were held by the broker for approximately half an hour. The taxpayer issued checks to the finance company for interest on the note; shortly after the finance company received the checks, the finance company loaned the taxpayer an amount equal to the interest paid. On his tax return, the taxpayer deducted the interest paid with the checks as well as the interest on the Treasury notes the finance company credited to his account.

The court determined that no indebtedness existed between the taxpayer and the finance company. The court found that the transitory possession of the Treasury notes was not sufficient to provide substance to the purchase of the Treasury notes or the loan of the funds to purchase the notes. While the court recognized the transactions did create a

[28] 115 F.3d 506 (7th Cir. 1997).
[29] 56 TC 925 (1971).
[30] 267 F.2d 127 (1st Cir. 1959), *affg.* 30 T.C. 1178 (1958).

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legal relationship between the taxpayer and the finance company, the relationship was not one of borrower and lender. The court determined the transaction was an exchange of promises for future performances. Because the promissory note lacked substance as indebtedness, the court denied the taxpayer's interest deductions.

The facts in the instant case can be distinguished from the aforementioned cases due to the existence of a business purpose for Investor entering into the loan and the bona fide nature of the debt. Investor was able to effectively guarantee a minimum initial amount of financial leverage by borrowing prior to the contribution to Partnership. In addition, we believe that the bona fide nature of the debt as evidenced by the underlying Credit Agreement and the existence of economic risk and reward with respect to holding the $53,300,000 during the thirteen day period between the time of entering into the loan and the contribution of the proceeds to Partnership is a key determinant with respect to Investor being recognized as the true borrower.

The underlying loan documentation clearly establishes that Investor was the true borrower:

- The loan was entered into by Investor in its individual capacity, not as a representative (or member) of Partnership.
- Investor signed the Credit Agreement in its individual capacity.
- The cash proceeds were initially transferred to Investor's personal bank account and then immediately transferred to its securities trading account, not the account of Partnership.

Upon assumption of the loan by Partnership, the Assignment and Assumption Agreement provided that the loan was originally entered into by Investor and assumed by Partnership on October 12, 1999. The assumption of the loan had to be approved by Deutsche Bank AG and was subject to a significant number of condition precedents. Deutsche Bank AG has represented to us that there was no plan or intention to require Investor to convey the loan proceeds or assign the loan obligation to Partnership.

With respect to economic risk and reward, during the thirteen day period before the cash was contributed to Partnership, Investor had "dominion and control" of the cash proceeds in that Investor could decide how to invest the cash, subject to the loan covenants. In addition, Investor had the economic "benefits and burdens" associated with tax ownership of such proceeds. The income derived from investing the proceeds was income to Investor and the interest associated with carrying the loan was an expense to Investor. Accordingly, we are of the opinion that it is more likely than not that Investor will be recognized as the true borrower of the loan.

3. The Amount of the "Liability" for Code Section 752 Purposes

In 1988, Treasury promulgated Proposed and Temporary Regulations under Code Section 752. In 1991, Treasury issued a new set of Final Regulations under Code Section 752 in an attempt to simplify the rules. While the current Regulations under Code Section 752 do not define the term "liability,"[31] the 1988 Regulations defined an "obligation" as a "liability" only to the extent that incurring or holding the obligation gave rise to:

- The creation of, or an increase in, the basis of any property owned by the obligor (including cash attributable to borrowings);

- A deduction that is taken into account in computing the taxable income of the obligor; or

- An expenditure that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital.[32]

The Service's rulings defining the term "liability" tend to be consistent with the definition in the 1988 Regulations. In Revenue Ruling 88-77,[33] the Service ruled that accrued, unpaid expenses and accounts payable of a cash method partnership are not partnership liabilities. The Service's conclusion was based upon the view that "liabilities" include only those obligations that either create basis (including cash from the borrowings) or give rise to an immediate deduction.

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[31] Although Temporary Regulations issued in 1988 provided a definition, the definition was deleted without specific comment in the Final Regulations as part of Treasury's efforts to simplify the regulations.
[32] Treas. Reg. Section 1.752-1T(g).
[33] 1988-2 C.B. 128.

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In Revenue Ruling 73-301,[34] the Service ruled that interim payments received by a partnership for services rendered in connection with a long-term contract reported on the completed contract method do not constitute liabilities for purposes of Code Section 752. Instead, the ruling characterizes such payments as "unrealized receivables" within the meaning of Code Section 751(c). The income or loss from performance of the contract would affect the basis of the partnership interests of the partners, as provided for in Code Section 705(a), only when such income or loss is recognized for U.S. income tax purposes. Accordingly, no increase in the adjusted basis of the partnership interests of the partners is made as a result of the receipt by the partnership of the advance payments. The ruling emphasized that the partnership had fully earned the payments and was under no obligation to return them or perform additional services to retain them.

In Helmer v. Commissioner,[35] a partnership gave an option on property to a prospective buyer in exchange for consideration. Even though the option resulted in the partnership receiving money (and increasing the basis of its property), without a correlative increase in the partner's bases, the court held that the option agreement did not create a liability because it created no liability on the part of the partnership to repay the funds paid or to perform any services in the future. Accordingly, the obligation to deliver the property upon exercise of the option did not create a liability.

In Revenue Ruling 95-26,[36] the Service ruled that a partnership obligation to return securities sold "short" creates a partnership liability for purposes of Code Section 752. The reasoning in the revenue ruling is twofold. First, it maintains that a short sale creates an obligation to return the securities borrowed to effect the sale. However, the ruling cites in support of this proposition Deputy v. du Pont,[37] a Supreme Court case that expressly held that a short-sale obligation does not create "indebtedness" for purposes of the interest deduction under the 1928 predecessor of Code Section 163 because "although an indebtedness is an obligation, an obligation is not necessarily an indebtedness[.]"[38] Second, the ruling maintains that the cash proceeds of the short sale create a partnership asset, thereby increasing basis and bringing the obligation within the definition of liability based upon the logic of Revenue Ruling 88-77.[39]

[34] 1973-2 C.B. 215.
[35] 34 T.C.M. (CCH) 727 (1975).
[36] 1995-1 C.B. 131.
[37] 308 U.S. 488 (1940).
[38] Deputy, 308 U.S. at 497.
[39] An obligation is a liability to the extent that it creates or increases the basis to the partnership of any partnership asset (including cash attributable to borrowings).

Revenue Ruling 95-45[40] applies a similar analysis to characterize the short-sale obligation of a shareholder who contributes its interest in the sales proceeds, in conjunction with a Code Section 351 incorporation of a going business, as a liability for purposes of Code Section 357 (which treats liabilities transferred in incorporations as taxable "boot" to the extent in excess of the basis of the transferred property) and Code Section 358 (which treats transferred liabilities as money received in calculating the basis of the transferor's stock). Applying the same reasoning as in Revenue Ruling 95-26, Revenue Ruling 95-45 cites Deputy for the proposition that a short sale creates an obligation to return the borrowed securities. Because that obligation results in an increase in asset basis, the ruling concludes that the obligation constitutes a "liability," even though acknowledging that the sales proceeds are not currently taxable. In contrast, Revenue Ruling 95-8,[41] although issued in conjunction with the other two rulings, holds that an exempt organization's income from a short sale does not result in unrelated business taxable income under Code Section 511 from "debt-financed property" under Code Sections 512(b)(4) and 514(a) and (b). Its rationale is that there is no "acquisition indebtedness" within the meaning of Code Section 514(c) because under Deputy, a short-sale obligation creates an "obligation" but not an "indebtedness."

The above short-sale revenue rulings collectively hold that the requirement to replace or return the securities borrowed to effect a short sale constitutes an "obligation," which in turn constitutes a "liability" for purposes of Code Sections 752, 357, and 358, even though not an "indebtedness" for purposes of Code Section 514. These rulings' rationale seems to be that, because the sales proceeds create basis, they constitute a "liability" even though, as Revenue Ruling 95-45 expressly acknowledges, such proceeds remain untaxed in the recipient's hands until closure of the sale. The Service's view in these rulings is that, at the point the obligation is incurred, the amount of the obligation can be determined "with reasonable accuracy." Accordingly, the "all events" test specified for the accrual of a deduction by Code Section 461(h) and Treas. Reg. Section 1.461-1(a)(2) is satisfied.[42] This capacity to measure the amount of the obligation, in turn, supposedly

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[40] 1995-1 C.B. 53.
[41] 1995-1 C.B. 107.
[42] Under the Regulation, the all events test traditionally permitted the accrual of an expense when "all events have occurred which determine the fact of the liability, and the amount of such liability can be determined with reasonable accuracy." *See* Code Section 461(h)(4) (restating traditional test). Since 1984, however, Code Section 461(h) generally has required that the test not be treated as having been satisfied until the occurrence of economic performance, such as the provision of required goods or services. Pub. L. No. 98-369 section 91(a), 98th Cong., 2d Sess. (1984).

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makes the obligation sufficiently "choate" to permit its characterization as a Code Section 752 liability.

The conclusions reached by the Service in these rulings are subject to question because the rulings confuse the sale, which produces the proceeds, with the securities borrowing. Because it is the sale, not the borrowing, that gives rise to the cash and creates additional basis, there is no liability to which Code Section 752 status can attach.[43]

In the instant case, Investor obtained a $33,300,000 loan from Deutsche Bank AG that included a premium payment of $20,000,000 in addition to the principal amount of $33,300,000. Investor contributed $54,700,000 in cash subject to the loan of $33,300,000 to Partnership. Investor's basis in its interest in Partnership is a function of the amount of the cash contributed and the treatment of the loan as a liability under Code Section 752. As discussed, a liability for Code Section 752 purposes generally includes any obligation of the partnership or partner to the extent that incurring or holding it results in the creation of, or an increase in, the basis of any property owned by the obligor (including cash); a deduction taken into account in computing taxable income; or a nondeductible, noncapitalizable expenditure.[44] In the context of Code Section 752, the OID concepts discussed above are not generally applied (except as discussed below in two defined situations). Accordingly, the amount of the debt assumed is $33,300,000, the principal amount of the debt contributed to Partnership, because such amount constitutes the amount of the loan assumed based upon the 17.557 percent coupon rate of interest.

The application of the time-value-of money concepts in the context of Code Section 752 parallels how the rules are applied for purposes of Code Section 465.[45] In Follender v. Commissioner,[46] the Tax Court rejected the Service's position that present value concepts should be imposed on the "at risk" rules under Code Section 465. Based upon the lack of support in the legislative history and the statutory language of Code Section 465, the Tax Court refused to find an "implied limitation of the borrowed amount to

[43] *See* McKee, Nelson, and Whitmore, Federal Taxation of Partnerships and Partners, Chapter 7.01, for a further discussion of the inconsistencies contained in these rulings.
[44] *See* the Revenue Rulings discussed above, as well as McKee, Nelson, and Whitmire, Federal Taxation of Partnerships and Partners, Chapter 7. As previously noted, Code Section 752 and the Treasury Regulations thereunder do not define the term "liability."
[45] *See* S. Rep. No. 938, 94th Cong., 2d Sess. 50 n.8 (1976).
[46] 89 T.C. 943 (1987).

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present value,"[47] observing that "Congress has been explicit in the areas it has chosen to require present value calculations."[48] The court further stated that "the statute does not allow for present value calculation, expressly or implicitly."[49] In the context of Code Section 752, time-value-of money concepts are applied in two defined situations: (1) a special rule for non-recourse liabilities with interest guaranteed by a partner,[50] and (2) with respect to an unreasonable delay of a partner's obligation to make payments to the partnership.[51] Neither fact pattern applies to the instant case. As to the instant case, there is no requirement in the Code or Regulations that a taxpayer apply a present value approach in the context where the applicable interest rate with respect to a debt instrument gives rise to a loan premium amount. Accordingly, the amount of the debt assumed by Partnership is the "face," or principal amount, of $33,300,000.

With respect to the interest paid on the loan, all interest paid or accrued within the taxable year on indebtedness is deductible under Code Section 163. A liability (as defined in Treas. Reg. Section 1.446-1(c)(1)(ii)(B)) is incurred, and generally is taken into account for U.S. income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.[52] Treas. Reg. Section 1.461-4(e) provides that economic performance with respect to interest occurs as the interest cost economically accrues in accordance with the principles of the relevant provisions of the Code. This is consistent with the approach taken by the Service in Revenue Ruling 83-84[53] dealing with the continuing viability of the "Rule of 78's" method. In the ruling, the Service stated that "no deduction will be allowed to the extent that the debtor's liability or payment is for

[47] Follender, 89 T.C. at 953.
[48] Follender, 89 T.C. at 952.
[49] *Id.*
[50] Treas. Reg. Section 1.752-2(e) treats a nonrecourse obligation as a recourse obligation if a partner guarantees a substantial portion of the interest that will accrue under the obligation. If the rule applies, the partner that has guaranteed the payment of interest is treated as bearing the economic risk of loss for the partnership liability to the extent of the present value of the guaranteed future interest payments.
[51] Treas. Reg. Section 1.752-2(g) provides that if a *partner's* obligation to make a payment or contribution is unreasonably delayed, the obligation is adjusted to reflect the time value of money of the deferral. The result of failing to satisfy an obligation on a "timely" basis is to effectively cause the obligation to be valued at less than its "face" amount. If an obligation does not bear interest at a rate at least equal to the applicable federal rate at the time of valuation, the value of the obligation is the discounted present value of all payments due from the partner.
[52] Treas. Reg. Section 1.461-1(a)(2).
[53] 1983-1 C.B.97.

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interest that does not economically accrue in the current year." Accordingly, interest payable on the loan would constitute a liability to Partnership in the year payable. The accrued interest payable as a Code Section 752 liability will increase Investor's basis in Partnership upon accrual and there will be a corresponding decrease in basis under Code Section 705 when the interest is paid.

Based on its reasoning in the short sale rulings that the amount of the Code Section 752 liability is a function of the amount of basis resulting from the short sale, the Service could argue that the amount of the liability, for Code Section 752 purposes, is $53,300,000 because the $33,300,000 loan gave rise to $53,300,000 in Partnership assets. Such position by the Service would be inconsistent with the logic that a liability is not recognized for purposes of Code Section 752 until such time as the all events and economic performance rules are satisfied pursuant to the regulations under Code Section 461.

In the instant case, the $20,000,000 incremental amount that relates to the premium is repayable though interest payments. In the event of early repayment, a prepayment penalty could arise that is determined based upon prevailing economic factors, primarily then existing interest rates. Accordingly, the all events and economic performance rules are not satisfied upon the Investor's contribution of the cash subject to the loan.[54] To the extent there is a prepayment penalty, it is effectively contingent at the time the loan is contributed to Partnership because the cost of repaying the loan cannot be determined with reasonable accuracy. In LaRue v. Commissioner,[55] the Tax Court held that an obligation is not incurred and taken into account by an accrual basis taxpayer until the year in which all events have occurred to fix the amount of the obligation and economic performance has occurred with respect to the obligation. The Tax Court in LaRue relied on Long v. Commissioner,[56] for its conclusion that contingent liabilities could not be included in a partner's basis until such time as those liabilities are made definite or fixed. Accordingly, we are of the opinion that it is more likely than not that the face amount of the loan, $33,300,000, should constitute the amount of the "liability" for purposes of Code Section 752.

[54] The all events and economic performance rules were not satisfied during the term of Investor's participation in Partnership. The $33,300,000 loan remained outstanding after Investor terminated its interest in Partnership.
[55] 90 T.C. 465 (1988).
[56] 71 T.C. 1 (1978).

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B. Investor's Capital Contribution to Partnership

1. Entity Classification as a Partnership

Treas. Reg. Section 301.7701-2(b) describes certain entities that are classified as *per se* corporations for U.S. income tax purposes. None of the categories of entities defined in the Regulations as *per se* corporations would apply to Partnership. Treas. Reg. Section 301.7701-3 provides that an entity not described in Treas. Reg. Sections 301.7701-2(b)(1), (3), (4), (5), (6), (7) or (8) is considered an "eligible entity," which may elect to be classified as a corporation or, if it has 2 or more members, a partnership. Treas. Reg. Section 301.7701-3(b)(1) provides that a domestic eligible entity that has two or more members and does not choose to elect to be classified as a corporation will be classified as a partnership for U.S. income tax purposes.

Based on the facts set forth, Partnership will constitute a domestic eligible entity. Consequently, because an affirmative election to be treated as a corporation was not made, we are of the opinion that it is more likely than not that Partnership will be classified as a partnership for U.S. income tax purposes.

2. Investor's Capital Contribution - The General Rules

The Limited Liability Company Agreement provides that the members' respective capital accounts are maintained based upon the capital account maintenance rules of Code Section 704. The regulations under Code Section 704(b)[57] provide that a partner's capital account must be credited with the following:

- The amount of money the partner contributes to the partnership.
- The fair market value of property the partner contributes to the partnership net of any liabilities secured by such property that the partnership is considered to assume or to which the property remains subject to in the partnership's hands.[58]

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[57] See Treas. Reg. Section 1.704-1(b)(2)(iv)(b) for the basic rules associated with maintaining capital accounts.
[58] Unlike the Code Section 721 provisions discussed below which look to the adjusted basis of the property contributed, the Code Section 704 capital account maintenance rules look to the fair market value of the property.

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- Allocations to the partner of partnership income and gain, including income and gain exempt from taxation.

A partner's capital account is decreased by the following:

- The money distributed to the partner by the partnership.
- The fair market value of property distributed to the partner by the partnership net of liabilities that the partner is considered to assume or to which the property remains subject to in the partner's hands.
- Allocations to the partner of partnership expenditures that are not deductible in computing the partnership's taxable income or not properly chargeable to capital account.
- Allocations to the partner of partnership losses and deductions, including financial losses and deductions, but excluding the nondeductible items immediately above.

Code Section 721(a) provides the general rule that no gain or loss is recognized by a partnership or any of its partners as a result of a contribution of "property" in exchange for an interest in the partnership. Money constitutes "property" for purposes of Code Section 721(a).[59] Generally, there are three circumstances where the Code Section 721(a) nonrecognition rule would not apply:

- A contributing partner can realize gain on the contribution of property to a partnership if the contributing partner is relieved of liabilities in the transaction in an amount in excess of the basis of that partner's partnership interest. Consequently, if property contributed to a partnership is subject to an encumbrance that is less than the adjusted basis of the property to the contributing partner, the existence of the encumbrance should not cause the recognition of gain on contribution.
- Code Section 721(a) does not apply to contributions to "investment partnerships" that are considered "investment companies" under Code Section 721(b).
- The contribution must not be part of a "disguised sale" taxable under Code Section 707(a).

[59] *See* Treas. Reg. Section 1.721-1(b)(1) which refers to "contributions of money or other property."

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None of the above circumstances should be applicable to Investor's cash contribution of $54,700,000 subject to the $33,300,000 loan because:

- The amount of the loan assumed by Partnership was less than the amount of cash contributed.

- Under Code Section 721(b), the non-recognition rule of Code Section 721(a) does not apply to gain realized upon a contribution of property to a partnership "investment company." Generally, this rule applies if the contribution results in diversification of the transferor's assets. The intent of Code Section 721(b) is to prevent tax-free diversification of securities portfolios. In the instant case, both Investor and Presidio's LLCs are contributing only cash to Partnership. Accordingly, there is no diversification and Section 721(b) should not apply.

- Under Code Section 707(a)(2)(B), a contribution of property by a partner to a partnership may be recharacterized as a sale if the partnership distributes to the contributing partner cash or other property that is consideration for the contribution. Code Section 707(a)(2)(B), by definition, only applies to transactions deemed to be sales. In the instant case, Investor is contributing cash where there is no inherent gain or loss potential.[60]

Accordingly, based upon the Code Section 721(a) general rule of nonrecognition of gain or loss and the non-application of exceptions to that rule, we are of the opinion that it is more likely than not that Investor will not recognize gain or loss with respect to its contribution of cash subject to the loan to Partnership.

3. Investor's Capital Contribution - Code Section 1274

Code Section 1274(c) provides that if any person in connection with the sale or exchange of property assumes any debt instrument, or acquires any property subject to any debt instrument, Code Sections 1274 and 483[61] do not apply to the debt instrument unless the terms and conditions of the debt instrument are modified in connection with the assumption or acquisition. Treas. Reg. Section 1.1274-5(a) further addresses the

[60] Treas. Reg. Section 1.707-3(b)(1) specifically excludes money or the obligation to contribute money from the definition of what constitutes "property transferred by a partner."
[61] Code Sections 1274 and 483 generally apply to ensure adequate interest is charged and paid on an obligation whenever a sale or exchange of property occurs involving the issuance of a debt instrument.

application of Code Section 1274 to an assumption of a debt instrument. The Regulation states that Code Section 1274 does not apply to a debt instrument if the debt instrument is assumed, or property is taken subject to the debt instrument, in connection with a sale or exchange of property, unless the terms of the debt instrument, as part of the sale or exchange, are modified in a manner that would constitute an exchange under Code Section 1001. The same rule applies under Treas. Reg. Section 1.483-1(d).

The Code Section 1001 Regulations employ a two-step analysis to determine whether there has been a deemed exchange of a debt instrument. Any alteration to the terms of a debt instrument must be first tested to determine if a "modification" of the debt instrument has occurred. If so, the modification must then be tested to determine whether it is "significant." A significant modification results in a deemed exchange of the original debt instrument for a modified instrument. The deemed exchange will be a realization event under Treas. Reg. Section 1.1001-1(a) and could potentially give rise to gain or loss, to cancellation of indebtedness income for the issuer, and/or to a change in accounting for interest on the new instrument.[62]

The Treas. Reg. Section 1.1001-3 regulations initially define the term "modification" in an extremely broad, all-encompassing manner. A modification is defined as any alteration, addition, or deletion of a legal right or obligation of the issuer or holder of a debt instrument whether evidenced by an amendment of the instrument, conduct of the parties, or otherwise.[63] The focal point of the definition is "changes or alterations" to the original debt instrument that were not agreed upon at the time of the instrument's issuance.

On the other hand, changes or alterations occurring by operation of the original terms of a debt instrument do not generally result in a modification. Treas. Reg. Section 1.1001-3(c)(1)(ii) provides that an alteration of a legal right or obligation that occurs by operation of the original terms of a debt instrument is not a modification. The Regulations contemplate two scenarios whereby such changes could arise -- an alteration that occurs automatically and an alteration resulting from the exercise of an option provided to an issuer or holder.

[62] If an assumption of a debt instrument involves a modification that triggers an exchange under Code Section 1001, Treas. Reg. Section 1.1274-5(b)(1) provides that the modification is treated as a separate transaction taking place immediately before the sale or exchange.
[63] Treas. Reg. Section 1.1001-3(c).

An example of an alteration which could occur automatically (and, as a result, would not constitute a modification) is an annual resetting of the interest rate based on the value of an index.[64] With respect to collateral, a specified increase in the interest rate if the value of collateral declines from a specified level or alternatively the substitution of collateral to maintain required value thresholds would not constitute modifications if the actions are pursuant to the original terms of the agreement.[65] Example 2 contained in Treas. Reg. Section 1.1001-3(d) sets forth a fact pattern whereby the original terms of a bond provide that the bond must be secured by a certain type of collateral having a specified value. The terms also require the issuer to substitute collateral if the value of the original collateral decreases. Any substitution of collateral that is required to maintain the value of the collateral occurs by operation of the terms of the bond and, as a consequence, does not constitute a modification.

The only exceptions to the general rule that changes or alterations occurring by operation of the terms of a debt instrument do not constitute a modification are set forth in Treas. Reg. Section 1.1001-3(c)(2):

- An alteration that results in a new obligor, the addition or deletion of a co-obligor, or a change to any extent in the recourse nature of a debt instrument.

- An alteration that transforms a debt instrument to an instrument or property right that is not a debt instrument unless pursuant to the holder's option to convert the debt instrument into equity of the issuer.

- An alteration resulting from the exercise of an option to change a term of a debt instrument unless the option is unilateral.[66]

Once it is determined that an alteration constitutes a modification, its significance is tested under the general and specific rules in Treas. Reg. Section 1.1001-3(e). Treas.

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[64] Treas. Reg. Section 1.1001-3(c)(ii).
[65] Treas. Reg. Sections 1.1001-3(c)(ii) and 1.1001-3(d), Example 2.
[66] An option is unilateral only if under the debt instrument's terms or applicable law there is, at the time of exercise, no right of the other party to alter or terminate the instrument or to put it to a person related to the issuer; exercise does not require consent of the other party or any person related to the other party or of a court or arbitrator; and exercise does not require consideration unless on the issue date it is de minimis or an amount specified in the debt instrument or based on a formula that uses objective financial information. Treas. Reg. Section 1.1001-3(c)(2)(iii).

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Reg. Section 1.1001-3(f)(4) provides that each modification is independently tested as to whether such modification constitutes a significant modification.

As discussed, an alteration that results in a new obligor, an addition or deletion of a co-obligor, or a change (in whole or in part) in the recourse nature of the debt is treated as a modification, even if allowed by the terms of the original debt instrument.[67] Accordingly, Partnership's assumption of the nonrecourse liability results in a modification of the debt instrument under Code Section 1001.[68] However, Treas. Reg. Section 1.1001-3(e)(4)(ii) specifically states that the substitution of a new obligor on a nonrecourse debt instrument is not a significant modification.

Apart from the alteration resulting from the substitution of a new obligor upon assumption of the loan by Partnership, no additional alterations occurred during the timeframe in which Investor had an ownership interest in Partnership that were not pursuant to the original terms of the debt agreement or that did not occur pursuant to the exercise of a unilateral option.[69] Accordingly, there were no modifications as defined in Treas. Reg. Section 1.1001-3(c) that would be deemed significant under Treas. Reg. Section 1.1001-3(e) so as to result in a deemed exchange. For example, in satisfying the collateral requirements under the Credit Agreement, Investor (and subsequently Partnership) was required to enter into investment transactions that constituted Permitted Investments. The Credit Agreement contained alternative categories of investments that constituted Permitted Investments. Investor and Partnership had the option to change from a Permitted Investment category to another Permitted Investment category under the terms of the Credit Agreement. Such option was a unilateral option (and, as a consequence, did not result in a modification) because there did not exist a right of the other party to alter or terminate the loan and there was no consent required.[70]

Based upon the foregoing analysis, we are of the opinion that it is more likely than not that Partnership's assumption of Investor's non-recourse debt instrument will not result in application of Code Section 1274 or Code Section 483 since the assumption will not

[67] Treas. Reg. Section 1.1001-3(c)(2)(i).
[68] Treas. Reg. Section 1.1001-3(f)(5)(i) provides that for purposes of testing whether an assumption is an exchange under Code Section 1001, the terms "issuer" and "obligor" are interchangeable and refer to the issuer of a debt instrument or a successor obligor.
[69] No additional changes were made to the original terms of the Credit Agreement nor was there any additional alterations described in Treas. Reg. Section 1.1001-3(c)(2).
[70] Treas. Reg. Section 1.1001-3(c)(3).

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constitute an exchange under Code Section 1001. In addition, we are of the opinion that it is more likely than not that there were no subsequent modifications to the Credit Agreement so as to result in an exchange for purposes of Treas. Reg. Section 1.1001-1(a).

4. Investor's Capital Contribution - Treas. Reg. Section 1.61-12(c)(2)

Treas. Reg. Section 1.61-12(c)(2) provides that an issuer generally does not realize gain or loss upon the "repurchase" of a debt instrument. The term "repurchase" includes the retirement of a debt instrument; the conversion of a debt instrument into stock of the issuer; and the exchange (including an exchange under Code Section 1001) of a newly issued debt instrument for an existing debt instrument.

Investor's contribution of the $54,700,000 cash subject to the debt of $33,300,000 should not constitute a repurchase of a debt instrument under Treas. Reg. Section 1.61-12(c)(2) for the following reasons:

- The debt instrument has not been retired;
- The debt instrument has not been converted into stock of the issuer; and
- The debt instrument has not been exchanged for purposes of Code Section 1001 (see above discussion related to determination of whether a modification constitutes an exchange).

Accordingly, we are of the opinion that it is more likely than not that Investor will not recognize income under Treas. Reg. Section 1.61-12(c)(2) upon contribution of the loan proceeds to Partnership.

C. Characterization of Debt Instrument

Investor entered into the $33,300,000 loan to partially fund its participation in the Investment Fund. As discussed, the loan was a fixed rate debt instrument with a seven-year term and interest payable quarterly at a rate of 17.557 percent per annum. Investor subsequently contributed the loan proceeds subject to the loan to Partnership.

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Partnership then entered into a fixed-for-floating rate interest swap for a seven-year term to reduce its risks related to a change in interest rates.

Prior to the release of Treas. Reg. Section 1.1275-6, the integration of a debt instrument and a hedge was permitted only in limited situations,[71] and generally was considered to be a favorable result by taxpayers and commentators. On June 14, 1996, the Service released Final Regulations concerning debt instruments with original issue discount, contingent payment debt instruments, and the anti-abuse rule for OID.[72] The purpose of the Regulations under Treas. Reg. Section 1.1275-6 was to extend the integration treatment to financial instruments that perfectly hedge a qualifying debt instrument into a synthetic fixed or floating rate obligation. Although the integration rules are taxpayer elective, an anti-abuse rule allows the Service relatively broad powers to force integration.

1. Qualifying Debt Instruments and "Section 1.1275-6 Hedges"

Treas. Reg. Section 1.1275-6(a) applies to either issuers or holders of qualifying debt instruments. This Regulation provides for the integration of a qualifying debt instrument and "Section 1.1275-6 hedges" if certain requirements are met and if the combined cash flows of the components are substantially equivalent to those of a fixed or variable rate debt instrument. The purpose of the Regulations is to "permit a more appropriate determination of the character and timing of income, deductions, gains or losses than would be permitted by separate treatment of the components."[73]

Treas. Reg. Section 1.1275-6(b)(4) provides that if its provisions apply to a qualifying debt instrument and hedge, the integrated transaction is deemed to create a synthetic debt instrument with the same cash flows as the combined cash flows of the qualifying debt instrument and hedge. This integrated instrument generally is subject to the Treas. Reg. Section 1.1275-6 Regulations rather than the rules to which each component of the transaction would be subject on a separate basis.

Under Treas. Reg. Section 1.1275-6(b), a qualifying debt instrument is any debt instrument other than:

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[71] Examples included integration under Treas. Reg. Sections 1.988-5, 1.446-4, and 1.1221-2.
[72] T.D. 8674, 61 Fed. Reg. 30133 (June 14, 1996).
[73] Treas. Reg. Section 1.1275-6(a).

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- A tax-exempt obligation as defined in Code Section 1275(a)(3);

- A debt instrument to which Code Section 1272(a)(2)(6) (pertaining to certain interests in or mortgages held by a REMIC, and certain other debt instruments with payments subject to acceleration) applies; or

- A debt instrument that is subject to Treas. Reg. Sections 1.483-4 or 1.1275-4(c) (pertaining to certain contingent payment debt instruments issued for non-publicly traded property).

A Section 1.1275-6 hedge is any financial instrument if the combined cash flows of the financial instrument and the qualifying debt instrument permit the calculation of a yield to maturity under the principles of Code Section 1272, or the right to the combined cash flows would qualify under Treas. Reg. Section 1.1275-5 as a variable-rate debt instrument that pays interest at a floating rate or rates (except for the requirement that the interest payments be stated as interest). A financial instrument can be a Section 1.1275-6 hedge only if it is issued substantially contemporaneously with, and has the same maturity as, the qualifying debt instrument. In addition, a financial instrument that hedges currency risk is not a Section 1.1275-6 hedge.

For purposes of determining what constitutes a Section 1.1275-6 hedge, Treas. Reg. Section 1.1275-6(b)(3) defines a financial instrument as a spot, forward, or futures contract; an option; a notional principal contract; a debt instrument, or a similar instrument, or a combination or series of financial instruments. Stock is not a financial instrument for purposes of this Regulation.

2. Requirements for Integration by Taxpayer

A taxpayer may integrate a qualifying debt instrument and a Treas. Reg. Section 1.1275-6 hedge if the taxpayer meets all of the following requirements provided in Treas. Reg. Sections 1.1275-6(c)(1)(i) through (vii):

- The taxpayer must adequately satisfy the identification requirements of Treas. Reg. Section 1.1275-6(e) by entering and retaining as part of its books and records information related to issuance and acquisition of the qualifying debt instrument and the Section 1.1275-6 hedge;

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- None of the parties to the hedge may be related unless the related party uses a mark-to-market tax accounting method;

- Both the qualifying debt instrument and the Section 1.1275-6 hedge are entered into by the same individual, partnership, trust, estate, or corporation;

- If the taxpayer is a foreign person engaged in a U.S. trade or business, all items of income and expense associated with the integrated transaction (other than interest expense subject to Treas. Reg. Section 1.882-5) would, in the absence of the integration rules, be effectively connected income during the synthetic debt instrument's term;

- Within 30 days immediately preceding the issue date of the synthetic debt instrument, the taxpayer did not terminate, or "leg out"[74] of, an integrated transaction containing the qualifying debt instrument, any other debt instrument that is part of the same issue, or the Section 1.1275-6 hedge;

- The qualifying debt instrument must be issued on or before, or substantially contemporaneously with, the date of first payment on the Section 1.1275-6 hedge, regardless of whether the payment is made or received by the taxpayer; and

- The taxpayer cannot have entered into a straddle[75] prior to the issue date of the synthetic debt instrument containing the Section 1.1275-6 hedge or the qualifying debt instrument.

3. Integration by Commissioner

Even if a taxpayer does not integrate a qualifying debt instrument and a Treas. Reg. Section 1.1275-6 hedge, the Commissioner may do so if the combined cash flows on the qualifying debt instrument and financial instrument are substantially the same as the combined cash flows required for the financial instrument to be a Section 1.1275-6 hedge. Treas. Reg. Section 1.1275-6(c)(2) provides that the Commissioner may not integrate a transaction unless the qualifying debt instrument is subject to Treas. Reg.

[74] "Legging" into and out of integrated transactions is described in Treas. Reg. Sections 1.1275-6(d).
[75] For this purpose, "straddle" is defined under Code Section 1092(c).

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Section 1.1275-4 (related to "contingent payment debt instruments")[76] or Section 1.1275-5 (related to "variable rate debt instruments") and pays interest at an objective rate. Under Treas. Reg. Section 1.1275-5, a "variable rate debt instrument" is a debt instrument that meets all of the following conditions:

- The issue price of the debt instrument must not exceed the total noncontingent principal payments by more than an amount equal to the lesser of:
  - ⇒ .015 multiplied by the product of the total noncontingent principal payments and the number of complete years to maturity from the issue date, or
  - ⇒ 15 percent of the total noncontingent principal payments.
- The debt instrument must only provide for stated interest (compounded or paid at least annually), at:
  - ⇒ one or more qualified floating rates,
  - ⇒ a single fixed rate and one or more qualified floating rates,
  - ⇒ a single objective rate, or
  - ⇒ a single fixed rate and a single objective rate that is a qualified inverse floating rate.
- The debt instrument must provide that a qualified floating rate or objective rate in effect at any time during the term of the instrument is set at a current value of that rate.
- The debt instrument must not provide for any contingent principal payments.

Because, under the facts in the instant case, the qualifying debt instrument is a fixed rate debt instrument, Treas. Reg. Section 1.1275-6(c)(2) does not provide the Commissioner with authority to integrate the loan and interest rate swap. Furthermore, the inability of the Commissioner to integrate a hedge with a fixed rate debt instrument was specified in

[76] A "contingent payment debt instrument" is defined under Treas. Reg. Section 1.1275-4 as any debt instrument that provides for one or more contingent payments.

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the preamble to the Final Regulations[77] concerning the anti-abuse rule for original issue discount, as follows:

> Section 1.1275-6 INTEGRATION RULES:
>
> Commentators generally approved of the integration rules in the proposed Regulations, and those rules are adopted with only two significant changes. First, the final Regulations allow (but do not require) the integration of a hedge with a fixed-rate debt instrument. For example, a taxpayer may integrate a fixed-rate debt instrument and a swap into a VRDI. Although the hedging transaction Regulations (Section 1.446-4) cover many of these transactions, the integration rules provide more certain treatment. The final Regulations, however, do not allow the Commissioner to integrate a hedge with either a fixed rate debt instrument or a VRDI that provides for interest at a qualified floating rate. In these cases, treating the hedge and the debt instrument separately is a longstanding rule that generally clearly reflects income.

Based upon the foregoing, we are of the opinion that it is more likely than not that the fixed-rate debt instrument and interest rate swap will not be integrated under Treas. Reg. Section 1.1275-6(c)(2).

D. Liquidation of Investor's Interest in Partnership: Basis in Distributed Property

On December 13, 1999, at the end of Stage I of the Investment Fund, Investor opted not to enter into Stage II of the investment program. As a consequence, Investor's interest in Partnership was liquidated on December 13, 1999.[78] Code Sections 731(a) and 731(b) generally provide for both partner and partnership non-recognition treatment for liquidating distributions. However, a partner recognizes gain under Code Section

[77] T.D. 8674, 61 Fed. Reg. 30133 (June 14, 1996).

[78] Partnership will not terminate as a result of the liquidation of Investor's Partnership interest. See Treas. Reg. Section 1.708-1(b)(1)(ii). Under Code Section 708(a), an existing partnership is considered as continuing if it is not terminated. Since there were two remaining partners, Presidio's two LLCs, there was no termination under Code Section 708(b)(1)(A). In addition, there was no "sale or exchange" of 50 percent or more of total partnership capital and profits as a result of the liquidation of Investor's 90 percent interest because a liquidation is not considered a "sale or exchange" for purposes of Code Section 708(b)(1)(B). Treas. Reg. Section 1.708-1(b)(1)(ii).

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731(a)(1) to the extent that "money" distributed exceeds the partner's basis in its interest in the partnership. Losses are not recognized by a partner with respect to a liquidating distribution except as provided for in Code Section 731(a)(2). Treas. Reg. Section 1.731-1(a)(2) denies loss treatment if "any property" other than money, inventory, or unrealized receivables is distributed.

The liquidating distribution to Investor consisted of $348,733 in cash (money) and $39,897 in financial instruments. Code Section 731(c)(1)(A) defines "money" to include "marketable securities," and the term "marketable securities" is defined in Code Section 731(c)(2) as including financial instruments.[79] However, Code Section 731(c)(3) provides that the inclusion of marketable securities as money under Code Section 731(c)(1) shall not apply if the partnership is an "investment partnership" and each partner is an "eligible partner."

An "investment partnership" is defined in Code Section 731(c)(3)(C) as any partnership that is not engaged in a trade or business and substantially all of the assets of which have always consisted of money; corporate stocks; notes, bonds, or other evidences of indebtedness; foreign currencies; notional principal contracts; and interests in or derivative financial instruments in any of the listed assets. An "eligible partner" is any partner who has not contributed to the partnership any property other than the aforementioned.

Code Section 731(c)(3)(C)(ii) states that any activity undertaken as an investor, trader, or dealer in any of the listed assets is not a trade or business activity. Treas. Reg. Section 1.731-2(e) further provides that a partnership is not engaged in a trade or business as a result of the receipt of commitment fees, break-up fees, guarantee fees, director's fees, or similar fees that are customary in and incidental to activities of a partnership as an investor, trader, or dealer. Accordingly, based upon the activities undertaken, Partnership is not engaged in a trade or business for purposes of applying the Code Section 731(c) rules. The sole asset contributed by the members to Partnership was cash. Accordingly, each partner should qualify as an eligible partner for purposes of

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[79] Pursuant to Code Section 731(c)(2)(A), marketable securities are financial instruments and foreign currency which are, as of the date of distribution, actively traded within the meaning of Code Section 1092(d)(1). Treas. Reg. Section 1.1092(d)-1(a) provides that actively traded personal property "includes any property for which there is an established financial market." "Financial instruments" include stocks and other equity interests, evidences of indebtedness, options, forward or future contracts, notional principal contracts, and derivatives.

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Code Section 731(c)(3)(C)(i) and Partnership is not engaged in a trade or business as defined in Code Section 731(c)(3)(C)(ii). The financial instruments, therefore, should not constitute money for purposes of Code Section 731(a). Consequently, because as discussed below, Investor's adjusted basis in its Partnership interest exceeded the amount of cash distributed, Investor will recognize no gain with respect to the liquidating distribution.[80]

Upon a complete liquidation of a partner's partnership interest, Code Section 732(b) provides that the basis of any distributed property is equal to the partner's basis in its partnership interest immediately prior to the distribution, reduced by any actual cash received. Under Code Section 732(c), if the basis of the distributee's partnership interest after reduction for any money received exceeds the partnership's basis in distributed unrealized receivables and inventory, each of these assets is allocated a basis equal to its basis to the partnership and the balance of the partner's basis in its partnership interest is allocated to other distributed assets as follows:

- First, each other distributed asset is provisionally assigned a basis equal to its pre-distribution partnership basis.
- If the provisional bases so assigned are less than the remaining basis to be allocated, the excess basis is allocated first to increase the bases of any appreciated assets so as to reduce all differences between values and bases proportionately, with any remaining excess basis allocated to all other distributed assets in proportion to their respective fair market values.

Accordingly, Investor's adjusted basis in its partnership interest is first reduced by actual cash received of $348,733 and the residual amount is allocated to the financial instruments distributed in accordance with the above methodology.

Since Investor contributed cash to Partnership, the initial basis to Investor of the partnership interest is the amount of money contributed, $54,700,000.[81] However,

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[80] Because Investor's adjusted basis in its partnership interest exceeded the amount of all assets distributed in liquidation, there was no gain recognized in any event.
[81] Code Section 722 provides that the basis of an interest in a partnership acquired by a contribution of property, *including money*, to the partnership shall be the amount of such money and the adjusted basis of

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Investor contributed the $54,700,000 subject to a nonrecourse loan of $33,300,000. Code Section 752(b) provides that any decrease in a partner's individual liabilities by reason of assumption by the partnership of such liabilities shall be considered as a distribution of money to the partner by the partnership which, under Code Section 733, reduces the basis of the partner's partnership interest.[82] The basis of Investor's partnership interest is effectively the amount of the money contributed to the partnership reduced by the net liability relief (the difference between Investor's entire loan liability transferred to the partnership[83] and Investor's share of the liability as a partner).[84] Treas. Reg. Section 1.752-3 provides that a partner's share of nonrecourse liabilities equals the sum of: (1) the partner's share of the partnership's Code Section 704(b) taxable gain; (2) the partner's Code Section 704(c) minimum gain; and (3) the partner's share of the partnership's excess nonrecourse liabilities. Accordingly, Investor's basis of $54,700,000 from its cash contribution is reduced by the $3,330,000 net amount of the Code Sections 752(a) and 752(b) adjustments.[85]

All changes in Partnership "liabilities" result in constructive cash contributions and distributions. Accordingly, Investor's share of partnership liabilities decreased by $29,970,000 as a result of Investor liquidating its Partnership interest. As a consequence, under Code Section 752(b) the $29,970,000 decrease is treated as a cash distribution to Investor thereby reducing its basis in its partnership interest to $21,400,000.[86]

Upon liquidation of Investor's Partnership interest, we are of the opinion that it is more likely than not that Investor's adjusted basis amount of $21,400,000, plus or minus its allocable share of Partnership income or loss in its Partnership interest is first reduced by

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such property to the contributing partner at the time of the contribution increased by the amount of gain recognized under Section 721(b) to the contributing partner.

[82] Treas. Reg. Section 1.752-1(f).

[83] Code Section 752(b).

[84] Code Section 752(a).

[85] The $33,300,000 debt assumed by Partnership less the $29,970,000 (90%) share allocated to Investor pursuant to Treas. Reg. Section 1.752-3.

[86] Under Code Section 705(a)(2), a partner's basis is decreased (but not below zero) by the amount of cash distributed to him; the basis of any property distributed to him by the partnership; and his distributive share of partnership losses and nondeductible expenditures of the partnership not properly chargeable to capital account. Treas. Reg. Section 1.752-1(c) provides that any decrease in a partner's share of partnership liabilities is treated as a distribution of money by the partnership to that partner.

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actual cash received of $348,733 and the residual amount is allocated to the financial instruments distributed.

E. Applicability of the Code Section 465 "At Risk" Rules and Code Section 469

Generally, the "at risk" provisions limit the ability of certain taxpayers to currently deduct the losses attributable to certain activities to the extent those losses exceed the taxpayer's "amount at risk" in the "activity." Code Section 465(a) provides that in the case of an individual engaged in an "activity" to which the section applies, any "loss from such activity" for the taxable year shall be allowed only to the extent of the aggregate amount with respect to which the taxpayer is "at risk for such activity" *at the close of the taxable year.*

The Code Section 465 "at risk" rules apply to individuals directly and to individuals in their capacity as partners in a partnership.[87] The "at risk limitation" of Code Section 465 does not apply to a partnership; rather, it applies to the partners.[88] Consequently, the Code Section 465 "at risk" rules have potential applicability to Investor both with respect to its direct investments and its investments through Partnership.

The determination of the extent to which the taxpayer is "at risk" is made on the basis of the facts existing as of the close of the taxable year.[89] Prop. Treas. Reg. Section 1.465-1(a) provides that a loss is allowed as a deduction only to the extent that the taxpayer is "at risk" *with respect to the activity at the close of the taxable year.* The determination of the amount the taxpayer is "at risk" in cases where the activity is engaged in by an entity separate from the taxpayer is made as of the close of the taxable year of the entity unless otherwise stated.

Accordingly, the analysis with respect to activities undertaken by a partnership is based upon viewing the partnership as a separate entity and making the determination of the amount "at risk" at the partner level. Prop. Treas. Reg. Section 1.465-41 uses the

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[87] The "at risk" rules apply to trusts and estates as well. *See* Code Section 542(a)(2) and S. Rep. No. 94-938, 94th Cong., 2d Sess. 48 (1976), 1976-3 C.B. at 86 (the "Senate Report"); *see also* Code Section 641(b) (the taxable income of an estate or trust is computed in the same manner as an individual).
[88] HR Rep. No. 432, 98th Cong., 2d Sess. 1597 (1984).
[89] Prop. Treas. Reg. Section 1.465-1(a).

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following example of a calendar year individual taxpayer and a partnership with a taxable year ending on June 30 to demonstrate the application of this concept:

Example (5): On July 1, 1976, C, along with many other persons, forms partnership W. C is a calendar year taxpayer and partnership W is on a taxable year ending June 30. On July 1, 1976, C contributes $3,000 to W. On August 1, 1976, W borrows a sum of money for which C's allocable share of personal liability is $7,500. On October 1, 1976, W borrows a sum of money under a nonrecourse financing arrangement with respect to which C's allocable share is $10,000. On March 1, 1977, W repays a portion of the loan for which C is personally liable, thereby reducing C's personal liability to $6,000. C's allocable share of W's losses for the taxable year ending June 30, 1977, is $13,000. On September 1, 1977, C contributes unencumbered personal assets with an adjusted basis of $6,000 to W. On November 1, 1977, W repays another portion of the loan for which C is personally liable, reducing C's personal liability to $5,000. On December 1, 1977, W repays part of the nonrecourse loan thereby reducing C's allocable portion of the amount outstanding to $8,000. The amount of loss deduction which C is allowed for 1977 is determined as follows:

Amount at risk in activity as of 7/1/76 (prior to contribution)	$ 0
Plus:	
Contribution -- 7/1/76	$3,000
Allocable share of loan	$7,500
	$10,500
Less:	
Allocable share of net reduction in personal liability	$1,500
Amount at risk in activity as of 6/30/77	$9,000

Although C's allocable share of W's losses for the taxable year ending June 30, 1977, is $13,000, *C's allowable loss deduction is limited to the amount at risk as of the close of the partnership's taxable year.* Thus, C's loss deduction for the taxable year ending December 31, 1977, is $9,000. The $4,000 not allowed as a loss deduction in 1977 will be treated as a deduction in 1978. The fact that prior to December 31, 1977, but after the

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close of W's taxable year on June 30, 1977, C made a contribution to W does not increase the amount of loss which C may deduct for 1977. That amount is limited to the amount C was at risk in the activity as of the close of W's taxable year.

Prop. Treas. Reg. Section 1.465-39(c) further provides that the amount a taxpayer is "at risk" in an activity "at the close of a taxable year of the taxpayer" is determined by:

- Increasing the amount "at risk" in the activity by all factors occurring during the taxable year which increase the amount at risk; and

- Decreasing the amount "at risk" in the activity by all factors occurring during the taxable year which decrease the amount "at risk".

In the above example, the "loss from the activity" was a loss generated by a partnership with a June 30 taxable year that overlapped the taxable year of the individual. In the instant case, Investor liquidated its interest in Partnership during the taxable year of Investor. Furthermore, Partnership generated a loss from its activity. The assets distributed by Partnership to Investor as non-taxable liquidating distributions[90] were contributed by Investor to its existing portfolio of investments. As discussed below, such contribution should constitute a contribution to an "activity" under Code Section 465(b)(1). Accordingly, the determination of whether there is a "loss from the activity" would be based upon the income or loss derived from Investor's investment portfolio during the taxable year. The investment portfolio for such purposes would consist of the investment assets distributed to Investor as liquidating distributions and contributed by Investor to its "activity" and the pre-existing marketable securities and other financial instruments.[91] To the extent that a loss was generated from the activity of the Partnership, the Partnership's activities will be treated as a separate activity for purposes of Code Section 465.

[90] The liquidating distributions made to Investor were effectively non-taxable distributions because there was no gain or loss recognized under Code Section 731.
[91] The "activity" being undertaken by Investor through a separate legal entity (as the concept of separate legal entity is used in Prop. Reg. Section 1.465-1(a)) effectively terminated at the date of Partnership's liquidation.

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From a Code Section 465 perspective, the assets distributed to Investor[92] upon liquidation in a non-taxable transaction were withdrawn from the "old activity" being undertaken by Partnership and contributed to a separate existing "activity" being undertaken by Investor. Accordingly, the determination of the extent to which the taxpayer is "at risk" with respect to his investment portfolio is made on the basis of the facts existing as of the close of the taxable year of Investor. Consequently, the activity undertaken through a separate entity, Partnership, during the taxable year is not impacted by the Code Section 465 "at risk" limitation rules, unless Partnership itself generated a loss on its investment activities.

1. Activities Subject to the Code Section 465 Rules

Code Section 465 originally applied to four types of activities: holding, producing, or distributing motion picture films or video tapes; farming; leasing certain tangible personal property; or exploring for, or exploiting, oil and gas resources.[93] Congress extended the application of the "at risk" rules in 1978 to exploring for, or exploiting, geothermal deposits and to each activity engaged in by the taxpayer in carrying on a trade or business or for the production of income not described in Code Section 465(c)(1).[94] In 1986, the "at risk" rules were extended to cover real estate.[95]

In applying the "at risk" rules, a two-step analysis is required. The scope of an activity first must be defined and then it must be determined whether separate activities should be aggregated or segregated for purposes of applying the "at risk" rules. The Code Section 465 Proposed Regulations provide only limited guidance regarding how to determine the scope of the activities in which a taxpayer is engaged. If two activities are interrelated, it is not clear whether there are two activities or only one.

Code Section 465 applies to each activity engaged in by the taxpayer in carrying on a trade or business or for the production of income.[96] Although a partnership itself is not subject to the "at risk" rules, the nature of any activity involving a partner is determined at the partnership level. Investor engages in its activity with respect to the investments

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[92] Since Investor is a disregarded entity for federal tax purposes, references to Investor shall include its single member for purposes of this section of the opinion.
[93] Code Section 465(c)(1).
[94] Code Section 465(c)(1)(E); Code Section 465(c)(3).
[95] P.L. 99-514, Section 503(a).
[96] Code Section 465(c)(3).

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made by Partnership for the production of income. Thus, the "at risk" activity of Investor includes its investments through Partnership. In addition, Investor invests directly in marketable securities and other financial instruments on its own account. Investor's direct investments in marketable securities and other financial instruments also constitute an "at risk" activity. Accordingly, Investor's investment portfolio consists of a combination of Investor's direct investments and investments through Partnership. By design, Investor's investment strategy necessitates an integration of risk positions with respect to all the investments composing the portfolio in order to optimize investment returns. Accordingly, in an economic sense, Investor's investment activities are interdependent and integrated.

However, for purposes of Code Section 465, Investor's direct investment activity and its investment through Partnership would constitute two separate "at risk" activities. With respect to carrying on a trade or business under the Code Section 465(c)(3) rules, if a taxpayer actively participates in the management of such trade or business, then all activities comprising the trade or business are aggregated for purposes of the "at risk" rules.[97] No such rules are provided for the production of income. In addition, Code Section 465(c)(3)(C) provides that activities are aggregated or treated as separate activities to the extent prescribed by the Treasury regulations. No such Treasury regulations have been proposed or adopted since the enactment of the provision in 1978.

Until Treasury regulations are released defining parameters for aggregation and segregation of activities relating to the production of income, Investor should be permitted to combine all directly-held investment activities undertaken pursuant to an integrated investment portfolio strategy into one activity. Because Prop. Treas. Reg. Section 1.465-1(a) treats partnerships as a separate entity for purposes of applying the "at risk" rules, we believe that the intended treatment of activities undertaken by partnerships is to view such activities as separate from related activities undertaken directly by the individual partner. Accordingly, to the extent that Partnership incurred a loss in its investment activities, Investor's allocable share of such loss will be allowed to the extent of Investor's at-risk amount with respect to the Partnership. Furthermore, Investor's interest in Partnership was liquidated before the end of its taxable year. The assets withdrawn from that activity upon liquidation were contributed to the investment activity being undertaken by Investor on its own account. Accordingly, because Investor is now engaged in only one activity, investment activities on its own account, we believe that it is more likely than not that Investor's at-risk amount with respect to its directly

[97] Code Section 465(c)(3)(B).

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held investments is determined by aggregating all of its directly held investment activities.

2. The Amount "At Risk"

For purposes of Code Section 465, a taxpayer is considered "at risk" for an activity with respect to the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity and the amount borrowed for use in an activity to the extent that the taxpayer is personally liable for repayment of such amount or has pledged property, other than property used in the activity, as security for such borrowed amount (to the extent of the net fair market value of the taxpayer's interest in such property).[98] A taxpayer is not considered "at risk," however, with respect to amounts protected against loss through nonrecourse financing, guarantees, stop/loss agreements, or other similar arrangements.[99]

An amount borrowed is not "at risk" with respect to an activity if the amount is borrowed from any person who has an interest in the activity (other than an interest as a creditor in the activity) or from a related person to a person (other than the taxpayer) having such an interest.[100] This rule applies with respect to any activity engaged in by the taxpayer in carrying on a trade or business or for the production of income only to the extent provided in Treasury regulations.[101] No such regulations have been proposed or issued.

A taxpayer's amount "at risk" in a partnership is increased by the amount of the partner's distributive share of taxable and tax-exempt income generated from the activity.[102] Code Section 465(b)(5) provides that if, in any taxable year, the taxpayer has a loss from an

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[98] Code Sections 465(b)(1) and (2).
[99] Code Section 465(b)(4).
[100] Code Section 465(b)(3).
[101] Code Section 465(c)(3)(D); Alexander v. Commissioner, 95 T.C. 467 (1990), *rev'g on motion for reconsideration*, 59 T.C.M. (CCH) 121.
[102] Prop. Treas. Reg. Sections 1.465-22, 1.465-23, and 1.465-66. *See also* Lansburgh v. Commissioner, 92 T.C. 448 (1989), (taxpayer's "at risk" amount increased to extent the taxpayer recognizes income with respect to the activity) and Allen v. Commissioner, 55 T.C.M. (CCH) at 688 (1988), (gain recognized on the disposition of the activity or an interest in the activity increases the taxpayer's amount "at risk"). These adjustments reflect the fact that the "at risk" amount is determined in a manner consistent with the determination of the taxpayer's adjusted basis, except that certain nonrecourse debt amounts and amounts protected against loss are not included. *See* the Senate Report at 50.

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activity to which Code Section 465 applies, the amount with respect to which a taxpayer is considered to be "at risk" in subsequent taxable years with respect to that activity is reduced by that portion of the loss which is allowable as a deduction.

The legislative history underlying the enactment of Code Section 465 provides that the "at risk" amount for a partner is computed with reference to the basis of the partner's partnership interest.[103] The link between the partnership rules and Code Section 465 is corroborated by Private Letter Ruling 9036013 where the Service stated that the economic risk of loss analysis of Code Section 752 applied to determine a partner's "at risk" amounts.

The "at risk" rules were interpreted in a similar manner to Code Section 752 in Follender, supra, where the Tax Court rejected the Service's position that present value concepts are to be imposed on the "at risk" rules under Code Section 465. Based upon the lack of support in the legislative history or the statutory language of Code Section 465, the Tax Court refused to find an "implied limitation of the borrowed amount to present value,"[104] observing that "Congress has been explicit in the areas it has chosen to require present value calculations."[105] The court further stated that "the statute does not allow for present value calculation, expressly or implicitly."[106] Accordingly, the amount of debt contributed to an activity is the "face" amount of the debt, the principal payable.[107]

There are two general areas of divergence in the application of the principles of the Code Section 465 "at risk" rules and the Code Section 704(d) partnership loss allowance rules. The first difference is that a partner can acquire basis through nonrecourse financing for Code Section 704(d) purposes; whereas, under Code Section 465(b)(4), nonrecourse financing is generally insufficient to create an amount at risk for Code Section 465 purposes. Accordingly, in the instant case, Investor's initial basis in its Partnership interest after contribution of cash subject to the loan is $51,370,000 and Investor's Code

[103] S. Rep. No. 938, 94th Cong., 2d Sess. 50 n.8 (1976).
[104] 89 T.C. at 953.
[105] 89 T.C. at 952.
[106] *Id.*
[107] As previously discussed, the application of the time-value-of-money concepts in the Code Section 465 context parallels the base Code Section 752 logic. In the Code Section 752 context, time-value-of money concepts are only applied in two defined situations: (1) a special rule for nonrecourse liabilities with interest guaranteed by a partner and (2) an unreasonable delay of a partner's obligation to make payments to the partnership.

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Section 465 "at risk" amount is $21,400,000. However, because Investor's adjusted basis in its Partnership interest is reduced by its portion of Partnership's nonrecourse financing upon termination of Investor's interest in Partnership, the difference between Investor's initial adjusted basis and at-risk amount described above will disappear, and Investor's at-risk amount will again track Investor's adjusted basis in Partnership.

Second, in the event a partnership interest is sold and the selling partner has suspended, unallowed Code Section 704(d) losses, subsequent gain on the sale of the partnership interest cannot be used to free-up the Code Section 704(d) loss carryover amount. The partnership's taxable year closes with respect to the selling partner under Code Section 706(c)(2)(A) and the basis for the partner's partnership interest at that date is zero.[108] This can be contrasted with the Code Section 465 rules which allow an offset of losses suspended under Code Section 465 against income from the sale of a partnership interest, as such income is treated as "income from the activity."[109] In effect, the Code Section 465 limitation applies at the partner level, while the Code Section 704(d) limitation isolates the disallowed loss at the partnership level.[110]

With respect to the instant case, the determination of the extent to which Investor is "at risk" is made on the basis of the facts existing as of the close of Investor's taxable year. At the close of Investor's taxable year, Investor had liquidated its interest in Partnership in a non-taxable transaction and the investment assets distributed to Investor were contributed to its existing activity consisting of directly-held investment assets. Accordingly, in determining the amount "at risk," the analysis should effectively track the assets distributed to Investor as liquidating distributions. Such assets were contributed to the investment activity being undertaken by Investor on its own account. Based on the foregoing analysis, we believe that it is more likely than not that Investor's Code Section 465 "at risk" amount for its taxable year ending December 31, 1999, includes Investor's cash contribution to Partnership reduced by the amount of nonrecourse debt as described above, $21,400,000, plus or minus its allocable share of Partnership income or loss.

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[108] In Sennett v. Commissioner, 80 T.C. 825 (1983), *aff'd per curiam*, 752 F2d 428 (9th Cir. 1985), the Tax Court concluded that a partner's suspended Code Section 704(d) deductions expire upon the sale of his partnership interest.

[109] Prop. Treas. Reg. Section 1.465-66(a).

[110] The underlying logic is that at the point that an investor terminates his entire interest in an investment, Code Section 465 should not preclude deduction of any suspended losses.

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3. Application of Code Section 469

Conceptually similar to the application of the Code Section 465 "at risk" rules, the passive activity loss rules of Code Section 469 do not apply directly to partnerships or S corporations, but (as a result of the entity's flow-through nature) apply to the partners or shareholders.[111]

The aggregate amount of deductions disallowed for the taxable year under Code Section 469 is generally equal to a net amount designated as the "passive activity loss." A taxpayer's passive activity loss for any taxable year is the excess of the taxpayer's passive activity deductions for the taxable year over the taxpayer's passive activity gross income for the taxable year.[112] Under the regulations, in order to compute a taxpayer's passive activity gross income and passive activity deductions, the taxpayer must first determine the items of gross income "from a passive activity" and the items of deduction that "arise in connection with a passive activity."[113]

Code Section 469(c) states that for purposes of this section the term "passive activity" means any activity which involves the conduct of any trade or business in which the taxpayer does not materially participate.[114] Code Section 469(c)(6) further provides that, *to the extent provided in the regulations*, the term "trade or business" includes any activity in connection with a trade or business or any activity with respect to which expenses are allowable as a deduction under Code Section 212. Treas. Reg. Sections 1.469-1(e)(2) and 1.469-4(b)(1)(i) provide that the term "trade or business activity" includes any activity that involves the conduct of a trade or business within the meaning of Code Section 162.

To date, no regulations have been issued defining the phrase "any activity with respect to which expenses are allowable as a deduction under Code Section 212." However, Treas. Reg. Section 1.469-1T(e)(6) provides that the activity of trading personal property for the account of owners of interests in the activity is not a passive activity, regardless of whether the activity is a trade or business and regardless of a partner's level of participation. Treas. Reg. Section 1.469-1T(e)(6) provides an example of "trading for

[111] Code Section 469(a)(2).
[112] Treas. Reg. Section 1.469-2T(b)(1).
[113] Treas. Reg. Sections 1.469-2T(c)(1) and 1.469-2T(d)(1).
[114] Under Code Section 469(h)(2), a limited partner is presumed not to materially participate in a limited partnership.

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the account of owners of interests in the activity." This example indicates that a partnership's trading activities consist of "trading for the account of its partners" where the capital employed by the partnership in the trading activity consists of amounts contributed by the partners in exchange for their partnership interests.

The term "personal property" is defined in the regulations to have the same meaning as under Code Section 1092(d), but without regard to Code Section 1092(d)(3) which generally excludes stock from the definition. Under Code Section 1092(d), personal property means any personal property of a type which is "actively traded." Treas. Reg. Section 1.1092(d)-1(a) further provides that actively traded personal property includes any personal property for which there is an established financial market. An established financial market includes an interdealer market. The regulations define an interdealer market as being characterized by a system of general circulation that provides a reasonable basis for determining current fair market value (Reuters screen quotations of indicative terms). Presidio has represented that the contracts entered into by Partnership would be considered actively-traded based upon the above definition of established financial market.

With respect to the instant case, Investor's participation in the Investment Fund will constitute an activity that is not a passive activity based upon the exception for the "activity of trading personal property for the account of owners of interests in the activity" described in Treas. Reg. Section 1.469-1T(e)(6). Accordingly, the income (or loss) generated by Partnership should not be subject to the limitations under Code Section 469. Such conclusion should extend to the losses from the disposition of any property received upon liquidation of Investor's partnership interest since the assets were not used in a passive activity. Accordingly, we believe that it is more likely than not that Partnership income (or loss) and the loss upon disposition of the assets received by Investor upon redemption of its Partnership interest will not be subject to the limitations under Code Section 469.

F. Other Tax Provisions and Judicial Doctrines

In arriving at our conclusions, we have considered several other Code provisions, as well as certain judicial doctrines that, if applicable, could impact the tax results of this transaction. These other Code provisions and doctrines are the application of the anti-abuse rules under Treas. Reg. Section 1.1275-2(g) and Treas. Reg. Section 1.701-2 and

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the application of the business purpose/economic substance/step transaction/substance over form doctrines.

1. Application of Anti-abuse Rule under Treas. Reg. Section 1.1275-2(g)

The anti-abuse rule of Treas. Reg. Section 1.1275-2(g) provides that if a principal purpose of engaging in a transaction is to achieve a result that is unreasonable under Code Sections 163(e), 1271 through 1275, or any related Code Section, the Commissioner can apply or depart from the regulations to achieve a reasonable result. Whether a result is considered unreasonable will depend upon the facts and circumstances surrounding the transaction. A significant fact in making this determination will be whether the treatment of a debt instrument is expected to have a substantial effect on the issuer's or holder's U.S. tax liability. A result will not be considered unreasonable, however, in the absence of an expected substantial effect on the present value of the taxpayer's U.S. tax liability.

The anti-abuse rule provides three examples of the application of its principles. The examples illustrating the anti-abuse rule focus on the following situations:

- Use of the option rules in Treas. Reg. Section 1.1272-1(c)(5) to limit the holder's interest income includible in the period prior to the call date;
- Use of a contingent payment debt instrument to substantially reduce the holder's interest income by virtue of the application of Treas. Reg. Section 1.1275-4(c); and
- Use of a convertible debt instrument to avoid original issue discount.

None of the examples are on point with the facts in the instant case. The facts of the instant case can be distinguished from the examples illustrating abuse since the issuer properly amortizes the loan issuance premium into income as an offset to its otherwise allowable interest expense deductions, and, similarly, upon repayment of the loan, income or deduction is properly computed under the provisions of Treas. Reg. Section 1.163-13 and Treas. Reg. Section 1.61-12, respectively.

We are not aware of any authority applying the anti-abuse provisions to a case outside of the examples provided in the regulations, such as to a case similar to the instant case. In

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analyzing whether the tax consequences contained herein are unreasonable under Code Sections 163(e), 1271 through 1275, or any related Code Section, it is useful to determine how a different application of the rules might result in a more reasonable calculation of the present value of the issuer's U.S. tax liability. For example, the Service may apply the anti-abuse rule to change the manner in which the issuer computes:

- The issue price of the loan;
- The accrual of interest expense and amortization of loan premium; and
- The income or deduction upon retirement of the loan.

It is unlikely the Service could apply the anti-abuse rule to change the issue price of the loan since the issue price is a statutory determination under Code Section 1273(b)(2), and the Service has no authority under the anti-abuse regulations to depart from the statute. However, if the Service were to change the issue price of the loan, such change would have the effect of understating or overstating the proper measurement of taxpayer's interest expense under the constant yield method prescribed under the OID rules and regulations. This misstatement would occur due to the difference in the loan's stated interest rate and prevailing market rates.

Furthermore, any increase or decrease in the issue price would impact the calculation of income from the discharge of indebtedness or repurchase premium deduction upon retirement of the loan. An increase by the Service in the loan's issue price would increase the accrued interest expense during the loan term, but decrease the repurchase premium in the year paid. Similarly, a decrease in the loan's issue price by the Service would decrease the accrued interest expense during the loan term, and increase the Partnership's repurchase premium deduction in the year the loan is paid. As a result, it appears unlikely that the Service could apply the anti-abuse rules to the facts of the instant case to achieve a more reasonable tax result.

Based on the existing authority, and the facts and circumstances of the existing case, we believe that it is more likely than not that the described tax consequences of Investor's issuance of the debt instrument will not have a substantial effect on the Investor's U.S. tax liability that could be construed as unreasonable in light of the purposes of Code Sections 163(e), 1271 through 1275, or any related Code section.

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2. **Application of Anti-Abuse Rules under Treas. Reg. Section 1.701-2**

The partnership anti-abuse regulations articulate two broad rules. The first, which we refer to as the "intent of subchapter K" rule, is articulated in Treas. Reg. Section 1.701-2 paragraphs (a) through (d). It provides a framework within which to determine whether a transaction violates the intent of subchapter K, and identifies the remedial steps that the Service may take to correct perceived transgressions. The second, which we refer to as the "abuse of entity" rule is embodied in paragraphs (e) and (f) of Treas. Reg. Section 1.701-2. This rule addresses situations in which a partnership is utilized, in lieu of an alternative business entity (e.g., a corporation), for a purported abusive purpose. When properly invoked, the Commissioner has the authority to treat the partnership as an aggregate of its partners to "carry out the purpose of any provision of the Internal Revenue Code or the regulations promulgated thereunder."[115]

a. **Intent of Subchapter K Rule**

The partnership anti-abuse abuse regulations purport to grant the Commissioner authority to recast partnership transactions to achieve tax results that are consistent with the intent of subchapter K. The anti-abuse rule applies only if (1) the taxpayer has a principal purpose to achieve substantial federal tax reduction, and (2) that tax reduction is inconsistent with the intent of subchapter K.[116] The regulations identify three requirements for demonstrating compliance with the "intent" of subchapter K:[117]

- The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose.

- The form of each partnership transaction must be respected under substance over form principles.

- The tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect

[115] Treas. Reg. Section 1.701-2(e).
[116] Treas. Reg. Section 1.701-2.
[117] Treas. Reg. Section 1.701-2(a).

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the partners' economic agreement and clearly reflect the partner's income. Clear reflection of income is not required in instances where the inaccurate reflection of income is clearly contemplated by the particular Code or regulation provision being applied.

The preamble to the final regulations explains that the first two "intent" requirements are intended as restatements of existing judicial doctrines.[118] As such, these requirements should be considered satisfied where it is determined that the judicial authorities regarding "business purpose" and "substance over form" are satisfied. As subsequently discussed in the Application of the Business Purpose/Economic Substance/Substance over Form Doctrines section of our opinion, we believe it is more likely than not that these judicial authorities are satisfied. Thus, consistent with these findings, we believe it is more likely than not that the first two "intent" requirements are satisfied.

To demonstrate compliance with the third "intent of subchapter K" requirement, a taxpayer must show that the tax consequences under subchapter K to each partner of partnership operations and of transactions involving a partner and the partnership accurately reflect the partners' economic arrangement and clearly reflect the partner's income. Clear reflection of income is not required, however, where the inaccurate reflection of income is clearly contemplated by the particular Code or regulation section being applied. The regulations set forth factors and examples that provide some limited guidance with respect to this requirement.

b. The Seven Factors

In an instance that a partnership is formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes to achieve tax results that are consistent with the intent of subchapter K. Whether a partnership is used in a manner inconsistent with the intent of subchapter K is determined based upon all the facts and circumstances. The seven factors set forth below may be indicative, but do not necessarily establish, that the partnership is used in such a manner. These factors are illustrative only, and, therefore, may not be the only factors taken into account in making the determination under Treas.

[118] T.D. 8588, 1995-7 I.R.B. 5, 8; *See also* Federal Taxation of Partnerships and Partners, (McKee, Nelson, and Whitmire), Chapter 1.05[2][a].

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Reg. Section 1.701-2. Moreover, the weight given to any factor depends on all the facts and circumstances. The absence or presence of any factor described does not create a presumption that a partnership was (or was not) used in such a manner. Relevant factors include:[119]

- The present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly;

- The present value of the partners' aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction. For example, this analysis may indicate that it was contemplated that a partner who was necessary to achieve the intended tax results and whose interest in the partnership was liquidated or disposed of (in whole or in part) would be a partner only temporarily to provide the claimed tax benefits to the remaining partners;

- One or more partners who are necessary to achieve the claimed tax results have a nominal interest in the partnership, are substantially protected from any risk of loss from the partnership's activities (through distribution preferences, indemnity or loss guaranty agreements, or other arrangements), or have little or no participation in the profits from the partnership's activities other than a preferred return that is in the nature of a payment for the use of capital;

- Substantially all of the partners (measured by number or interests in the partnership) are related (directly or indirectly) to one another;

- Partnership items are allocated in compliance with the literal language of Treas. Reg. Sections 1.704-1 and 1.704-2 but with results that are inconsistent with the purpose of Code Section 704(b) and those regulations. In this regard, particular scrutiny is paid to partnerships in which income or gain is specially allocated to one or more partners that may be legally or effectively exempt from federal taxation (for example, a foreign person, an exempt organization, an insolvent taxpayer, or a taxpayer with unused federal tax attributes such as net operating losses, capital losses, or foreign tax credits);

[119] Treas. Reg. Section 1.701-2(c), subparagraphs (1) through (7).

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- The benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained (directly or indirectly) by the contributing partner (or a related party); or

- The benefits and burdens of ownership of partnership property are in substantial part shifted (directly or indirectly) to the distributee partner before or after the property is actually distributed to the distributee partner (or a related party).

c. Examples

1) Example 10

In Example 10[120] of the regulations, A, B, and C are partners in a partnership, PRS, which has for several years been engaged in substantial bona fide business activities. For valid business reasons, the partners agree that A's interest in PRS, which has a value and basis of $100x, will be liquidated with a non-depreciable asset and related equipment with two years of cost recovery remaining. Under Code Sections 732(b) and (c), A's $100x basis in A's partnership interest will be allocated between the non-depreciable asset and the equipment received in the liquidating distribution in proportion to PRS's bases in those assets. These rules result in a federal tax advantage to A, with no offsetting detriment to B or C. In selecting the assets to be distributed to A, the partnership had a principal purpose to take advantage of the fact that A's basis in the assets will be determined by reference to A's basis in A's partnership interest, thus, in effect, shifting a portion of A's basis from the nondepreciable asset to the equipment, which in turn would allow A to recover that portion of its basis more rapidly.

The example sets forth the law as follows: subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. The decision to organize and conduct business through PRS is consistent with this intent. In addition, the first two "intent of subchapter K" requirements are satisfied. The validity of the tax treatment of this transaction is, therefore, dependent upon whether the transaction satisfies (or is treated as satisfying) the proper reflection of income standard. Subchapter K is generally intended to produce tax consequences that achieve proper reflection of income. However, the third "intent" rule provides that if the application of a provision of subchapter K produces tax results

[120] Treas. Reg. Section 1.701-2(d) Example 10.

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that do not properly reflect income, but the application of that provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision (and the transaction satisfies the first two "intent" requirements), then the application of that provision to the transaction will be treated as satisfying the proper reflection of income standard.

Applying the law to the facts, Example 10 concludes that the transaction is treated as satisfying the proper reflection of income standard included in the third "intent" requirement. A's basis in the assets distributed to it was determined under Code Sections 732(b) and (c). The transaction does not properly reflect A's income due to the basis distortions caused by the distribution and the shifting of basis from a non-depreciable to a depreciable asset. However, the basis rules of Code Section 732, which in some situations can produce tax results that are inconsistent with the proper reflection of income standard, are intended to provide simplifying administrative rules for bona fide partnerships that are engaged in transactions with a substantial business purpose. Taking into account all the facts and circumstances of the transaction, the application of the basis rules under Code Section 732 to the distribution from PRS to A, and the ultimate tax consequences of the application of that provision to subchapter K, are clearly contemplated.

2) Example 11

In Example 11, PRS has for several years been engaged in the development and management of commercial real estate projects. X, an unrelated party, desires to acquire undeveloped land owned by PRS. X expects to hold the land indefinitely after its acquisition. Pursuant to a plan, a principal purpose for which is to permit X to acquire and hold the land but nevertheless to recover for tax purposes a substantial portion of the purchase price for the land, X contributes $100x to PRS for an interest therein. Subsequently, PRS distributes to X, in liquidation of its interest in PRS, the land and another asset. The second asset is an insignificant part of the economic transaction but is important to achieve the desired tax results. Under Code Sections 732(b) and (c), X's basis in its partnership interest is allocated between the assets distributed in proportion to their bases to PRS. Thereafter, X plans to sell the second asset for its value so that X will, in effect, recover a substantial portion of the purchase price of the land almost immediately. In selecting the assets to be distributed to X, the partners had a principal purpose to take advantage of the fact that X's basis in the assets is determined under Code Sections 732(b) and (c). Thus, in effect, a portion of X's basis economically

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allocable to the land that X intends to retain shifts to an inconsequential asset that X intends to dispose of quickly. This shift provides a federal tax advantage to X with no offsetting detriment to any of PRS's other partners.

Although Code Section 732 recognizes that basis distortions can occur in certain situations, the provision is intended only to provide ancillary, simplifying tax results for bona fide partnership transactions that are engaged in for substantial business purposes. Code Section 732 is not intended to serve as the basis for plans or arrangements in which inconsequential or immaterial assets are included in the distribution with a principal purpose of obtaining substantially favorable tax results by virtue of the statute's simplifying rules. The transaction does not properly reflect X's income due to the basis distortions caused by the distribution that result in shifting a significant portion of X's basis to this inconsequential asset. Moreover, the proper reflection of income standard is not treated as satisfied, because, taking into account all the facts and circumstances the application of Code Section 732 to this arrangement, and the ultimate tax consequences that would result, were not clearly contemplated by that provision of subchapter K. In addition, by using a partnership, the partners' aggregate federal tax liability would be substantially less than had they owned the partnership's assets directly. Based upon these facts, Example 11 concludes that PRS has been formed and availed of in a manner that is inconsistent with the intent of subchapter K.

d. The Investor and the third "intent" requirement

In the case of the Investor who makes a contribution to Partnership, the factors and examples provide insight as to whether the transactions engaged in by the Investor and Partnership satisfy (or are treated as satisfying) the proper reflection of income standard embodied in the third "intent of subchapter K" requirement. Subchapter K is intended to permit Investor and other taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. Organizing and conducting business through Partnership is consistent with this intent. Subchapter K is generally intended to produce tax consequences that achieve proper reflection of income. However, this "intent" requirement recognizes that the application of certain provisions of subchapter K may not produce tax results that properly reflect income. In such cases, the application of such a provision of subchapter K to the transaction is treated as satisfying the proper reflection of income standard if the application of that provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.

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Investor's basis in its interest in Partnership is increased for the cash contributed and decreased by liabilities that are no longer allocated to Investor. As described above, Investor's basis in Partnership is not decreased by the amount of the bond premium obligation because such obligation is not treated as a "liability" for purposes of Code Section 752. As a result of this treatment of the bond premium obligation, the transaction may not properly reflect Investor's income as the basis in Investor's Partnership interest shifts (pursuant to Code Section 732) to the assets distributed to Investor when its interest in Partnership is liquidated. However, these rules (Code Sections 752 and 732) are intended (notwithstanding the potential that tax results inconsistent with the proper reflection of income standard may occur) to provide simplified administrative rules for bona fide partnerships that are engaged in transactions with a substantial business purpose. In particular, the Code Section 752 regulations do not account for the effect of the time value of money (except in limited circumstances that are not applicable here) to simplify the application of those rules to partnership transactions.

The instant case is readily distinguishable from Example 11. In Example 11, the plan or arrangement to reduce X's federal tax liability was structured so that X could obtain the tax results with minimal economic risk (i.e., X's participation in the partnership is terminated subsequent to its contribution to the partnership "at a time when the value of the partnership's assets have not materially changed"). Investor, however, is not afforded such protections. Investor's interest in Partnership is liquidated only after being exposed to the risks associated with the Investment Fund. While Investor could exit the Investment Fund after certain intervals of time and request to be redeemed from Partnership, Investor's economic return from Partnership is dependent upon the Partnership's performance while Investor is a member. In addition, Investor is not compelled as a legal or practical matter to exercise its rights to exit the Investment Fund.[121]

Based on the foregoing, we believe it is more likely than not that Investor's investment in the Investment Fund through Partnership will not be recast pursuant to the "intent of subchapter K" rule.

[121] *See* Treas. Reg. Section 1.701-2(d), Example 4 (which concludes that a transaction that includes an option to exit a partnership does not violate the partnership anti-abuse provisions).

e. **Abuse of Entity Rule**

Under the abuse of entity rule,[122] the Service is allowed to treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Code or the regulations promulgated thereunder.[123] This rule will not apply in situations where a provision in the Code or the regulations prescribes entity treatment for a partnership (either in whole or in part) and that treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.[124] The abuse of entity rule is separate and distinct from the intent of subchapter K rule. In other words, the Service may invoke the abuse of entity rule to ignore the subject partnership, and analyze the tax effects of a transaction as if they were engaged in directly by the partners of the partnership.

The Service illustrates the abuse of entity rule by way of three examples. The first two examples identify situations where the interposition of a partnership is intended to avoid application of unfavorable provisions applicable to corporations. Example 1 involves a transaction that tries to avoid limitations imposed by Code Section 163(e)(5). Example 2 involves a transaction attempting to avoid the application of Code Section 1059. Both of these Code sections specifically authorize regulatory authority to prevent taxpayers from using partnerships to avoid application of these sections. The Service will utilize its ability to invoke the abuse of entity rule in these types of situations.

Example 3 describes the use of a domestic partnership by a domestic U.S. corporation to improve that corporation's ability to utilize its share of foreign tax credits in respect of foreign country taxes expected to be incurred by a foreign corporation wholly-owned by the partnership. In this case, the Service observes that Code Sections 957(c) and 7701(a)(30) together require that the partnership be treated as an entity with respect to the issue of defining a U.S. shareholder and, thus, determining controlled foreign corporation ("CFC") status. The example also asserts that the use of the domestic partnership to qualify the foreign corporation as a CFC, and, thus, for the favorable foreign tax credit look-through rules of Code Section 904(d)(3), was clearly contemplated by Congress. Accordingly, the example concludes that the Service in this instance would be prevented from recasting the partnership as an aggregate of its

[122] *See* Treas. Reg. Sections 1.701-2(e) and (f).
[123] Treas. Reg. Section 1.701-2(e)(1).
[124] Treas. Reg. Sections 1.701-2(e)(2)(i) and (ii).

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partners by operation of Treas. Reg. Section 1.701-2(e).[125]

In contrast to the "intent of subchapter K" rule, the Service can invoke the abuse of entity rule of Treas. Reg. Section 1.701-2(e) to carry out the "purpose of any provision of the Internal Revenue Code or the regulations promulgated thereunder." Moreover, the Service claims the power under this rule to treat a partnership as an aggregate of its partners regardless of whether the partnership is imbued with economic substance. Accordingly, the Service could potentially invoke this rule if it determined that the tax consequences of the transaction involving Investor and Partnership were, in the Service's view, in conflict with the "purpose of any provision" of the Code or regulations.

The only constraint to which the Service's general capacity to invoke the abuse of entity rule is Treas. Reg. Section 1.701-2(e)(2). Under this section, the treatment of a partnership as an entity for purposes of applying a particular provision of the Code is respected if (i) the provision prescribes the treatment of a partnership as an entity, in whole or in part, and (ii) that treatment, and the ultimate tax results (which flow from that treatment), are clearly contemplated by that provision.[126]

The meaning of the phrase "prescribed entity treatment" is illustrated in Treas. Reg. Section 1.701-2(f), Example 3. This example asserts that Code Sections 957(c) and 7701(a)(30), when taken together, require that a partnership be treated as an entity for purposes of determining who is a U.S. shareholder in a foreign corporation and, thus, determining controlled foreign corporation (CFC) status. Code Section 7701(a)(30) states that the definition of the term "U.S. Person" includes a domestic partnership. Code Section 957(c) provides that, for purposes of Subpart F (and the CFC rules), the term "U.S. Person" has the meaning assigned to it by Code Section 7701(a)(30). Accordingly, for purposes of the CFC rules, a domestic U.S. partnership which holds stock in a CFC is treated as a U.S. shareholder. Evidently, the Service believes that entity treatment is "prescribed" in such a case because the partnership's entity-level stock ownership is respected (not disaggregated and attributed to its partners) for purposes of determining the level of U.S. shareholder stock ownership in a foreign corporation.

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[125] Treas. Reg. Section 1.701-2(f), Example 3.
[126] Treas. Reg. Sections 1.701-2(e)(2)(i) and (ii).

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The tax benefits associated with Investor's investment in Partnership are not derived by avoiding or enhancing results achieved under a Code section outside of subchapter K. Rather, it is subchapter K itself, in particular Code Sections 752 and 732, which drives the tax results for Investor. Both Code Sections 752 and 732 treat a partnership as an entity as opposed to an aggregate of its partners. Such treatment of a partnership as an entity is clearly contemplated by Code Sections 752 and 732. In these circumstances, we believe it is more likely than not that Partnership will not, for purposes of determining the federal tax treatment of Investor's investment in the Investment Fund through Partnership, be recast as an aggregate of its partners pursuant to the "abuse of entity" rule.

3. Application of the Business Purpose/Economic Substance/Substance over Form Doctrines

In order for losses arising from investments in financial instruments to be deductible, the transaction or series of transactions that gave rise to such losses must have economic substance, a business purpose, and a form that reflects their substance. A series of transactions will not be respected unless the transactions have economic substance separate and distinct from the economic benefit achieved solely by tax reduction.

a. Judicial Development of the Business Purpose/Economic Substance/Substance over Form Doctrines

The seminal case dealing with the necessity of having economic substance and a business purpose to effectuate a substantive tax transaction is Gregory v. Helvering,[127] decided in 1935. In Gregory, the taxpayer attempted to use the Code's reorganization provisions to convert a taxable dividend of corporate property into a capital gain transaction involving that same property. The taxpayer in Gregory owned 100% of a corporation that owned operating assets as well as passive, appreciated marketable securities. The taxpayer wanted to extract the securities from the corporation and sell them, but wanted to avoid dividend treatment. To accomplish this result, the taxpayer formed a new corporation ("Newco") and had the corporation holding the securities transfer the securities to Newco in exchange for Newco stock. The Newco stock was then distributed to taxpayer who immediately thereafter liquidated Newco. The taxpayer

[127] 293 U.S. 465 (1935).

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then sold the marketable securities and reported a capital gain. The series of transactions were undertaken over a six-day period.

Gregory is typically described as a business purpose case. It is also a substance over form case and is indicative of how the doctrines interrelate. The Supreme Court began its analysis of the transaction by stating that "if a reorganization in reality was effected...the ulterior [i.e., tax avoidance] purpose ...will be disregarded. The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted...But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended."[128]

The above observation by the Court acknowledges that a taxpayer may use the form of a transaction to minimize taxes, but there must be an underlying business purpose. Specifically, the Court noted that:

> ...when subdivision (B) speaks of a transfer of assets by one corporation to another, it means a transfer made 'in pursuance of a plan of reorganization' of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose – a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner.[129]

Accordingly, even if a taxpayer purports to reorganize a business and executes the transaction in a form which fits within the Code's definition of a tax-free transaction, the courts will look beyond the form to determine whether the purported business reorganization, in substance, occurred. In addition, a taxpayer must have a business purpose to support a transaction that is structured to reduce taxes.

[128] Gregory, 293 U.S. at 468.
[129] Gregory, 293 U.S. at 469.

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In 1960, the Supreme Court, citing Gregory, held that, just as there was never a business reorganization in Gregory, there was never a business loan in Knetsch v. United States.[130] The Court noted that it was "patent that there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction."[131] The taxpayer in Knetsch purchased 10, 30-year deferred annuity savings bonds, financed by a down payment and funds borrowed from the issuer against their cash surrender value. The basis for the Court's conclusion that the transaction was a sham was that the taxpayer was paying interest to the issuer of the bonds at the rate of 3.5 percent on its loan to him, while the investment was growing in value by only 2.5 percent. The net annual cash loss of 1 percent was incurred only to achieve a tax deduction for the interest paid.

Whereas Gregory and Knetsch involved relatively transparent tax avoidance schemes, the subsequently decided sale-leaseback cases involved more sophisticated transactions which combined differing levels of tax avoidance and non-tax motives. The seminal case in the sale-lease back area is the Supreme Court's decision in Frank Lyon Co. v. United States.[132] In the 1978 decision, the Supreme Court held that where there is a genuine multiple-party transaction with economic substance, which is compelled or encouraged by business or regulatory realities, is imbued with tax independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.

In 1990, the Court of Appeals for the Second Circuit construed the Supreme Court's opinion in Frank Lyon Co. to affect the form versus substance issue as follows:

> While we exalt substance over form, we do not ignore the form. The touchstone in determining whether the form of an agreement should govern is the opinion of the Supreme Court in Frank Lyon, which held that agreements which were intended to have economic substance, as opposed to mere tax avoidance, should be given effect for tax purposes...That opinion set forth several factors...The first factor inquires whether there is a legitimate non-tax business reason for the form; in other words, were the parties motivated at least in part by reasons unrelated to taxes?... The second...factor requires that the agreement have non-tax "economic

[130] 364 U.S. 361 (1960).
[131] Knetsch, 364 U.S. at 361.
[132] 435 U.S. 561 (1978).

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substance."...We have construed that factor to require a "change in the economic interests of the relevant parties."...[133]

b. Application of the Step-Transaction Doctrine

The judicially created doctrine of substance over form is sometimes referred to as the step-transaction doctrine. In general, the step-transaction doctrine has been used by the courts to determine whether the substance of a series of transactions undertaken by a taxpayer should prevail over the form of the transactions as constructed by the taxpayer. Application of the step-transaction doctrine by the courts can be described as amorphous. One of the more insightful observations that has been made in applying the doctrine was by Judge Easterbrook in Sears Roebuck & Co. v. Commissioner:[134] "substance prevails over empty forms." As articulated by the Tax Court, the step-transaction doctrine "treats a series of formally separate 'steps' as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result."[135]

In cases where the courts have found that the taxpayer has entered into a series of transactions that are in substance a single or indivisible transaction, they have applied the step-transaction doctrine to disregard the intermediary steps and give credence only to the end result.[136] The courts have traditionally applied three basic formulations of the doctrine. These are the "binding commitment," the "mutual interdependence," and the "end result" tests.[137]

The "binding commitment" test. The "binding commitment" test is the narrowest and most formalistic of the three formulations of the step-transaction doctrine. This

[133] Newman v. Commissioner, 902 F.2d 159, 163 (2d Cir. 1990). In Newman, the court vacated and remanded the decision of the Tax Court and concluded that an individual taxpayer was not precluded by former Code Section 46(e)(3) from claiming the investment tax credit on equipment that was subject to an operating agreement. The court held that the operating agreement between an employer and an independent trucking contractor was a valid contract and not a lease.

[134] 972 F.2d 858, 862 (7th Cir. 1992).

[135] Esmark, Inc. v. Commissioner, 90 T.C. 171, 195 (1988), *aff'd without published opinion*, 886 F.2d 1318 (7th Cir. 1989).

[136] *See e.g.*, Cal-Maine Foods, Inc. v. Commissioner, 93 T.C. 181, 198 (1989).

[137] McDonald's Restaurants of Illinois, Inc. v. Commissioner, 688 F.2d 520, 524-525 (7th Cir. 1982); Cal-Maine Foods, Inc. v. Commissioner, 93 T.C. 181, 198-199 (1989); and Penrod v. Commissioner, 88 T.C. 1415, 1429 (1987).

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approach integrates a series of transactions only if there is a binding legal commitment to undertake each of the steps.[138] The "binding commitment" test is primarily directed at transactions where the transactions under consideration span several tax years and at the time the first transaction is undertaken, there is a binding commitment to undertake the subsequent transactions.[139]

The "end result" test. In contrast to the "binding commitment" test, which looks to formal commitment as evidence of taxpayer intent, the "end result" test integrates a series of steps into a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be undertaken for the purpose of reaching an ultimate result.[140] The broadest in scope of the three approaches, the "end result test" focuses upon the subjective intent of the parties involved and whether, as revealed by the substance of the transaction, the ultimate result was intended from the outset.[141] Where such intent has been present, courts have been disposed to combine purportedly separate steps and bind taxpayers to the tax consequences of an integrated transaction. However, the courts have generally been reluctant to recharacterize a transaction by inventing steps not actually taken by the taxpayer under scrutiny.[142]

The "mutual interdependence" test. The "mutual interdependence" test requires the integration of a series of transactions only if each transaction is so interdependent on the others that the legal relationships created by each step is fruitless without the completion of the series.[143] This approach focuses not upon ultimate results but rather on the relationship between steps.[144] Its application is appropriate in instances where it is "unlikely that any one step would have been undertaken except in contemplation of the other integrating acts...."[145] For example, where the taking of one purportedly separate step in a transaction has been contingent on completion of another, courts have been

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138 Commissioner v. Gordon, 391 U.S. 83, 96 (1968).
139 Commissioner v. Gordon, 391 U.S. 83, 96; Redding v. Commissioner, 630 F.2d 1169, 1175 (7th Cir. 1980), *cert. denied* 450 U.S. 913 (1981), *rev'g* 71 T.C. 597 (1979); and King Enterprises, Inc. v. U.S., 418 F.2d 511, 518 (Ct. Cl. 1969).
140 King Enterprises, Inc. v. U.S., 418 F.2d 511, 516 (Ct. Cl. 1969).
141 King Enterprises, Inc. v. U.S. 418 F.2d 511, 518 (Ct. Cl. 1969).
142 Esmark, Inc. v. Commissioner, 90 T.C. 171, 196 (1988).
143 American Bantam Car Company v. Commissioner, 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950). *See also* Redding v. Commissioner, 630 F.2d. 1169, 1177; Dyess v. Commissioner, 65 T.C.M. (CCH) 2717 (1993), *aff'd*, 25 F.3d 1119 (5th Cir. 1994).
144 McDonald's Restaurants of Illinois, Inc. v. Commissioner, 688 F.2d 520, 524.
145 Kuper v. Commissioner, 533 F.2d 152, 156 (5th Cir. 1976).

unwilling to accord the steps independent significance and have integrated them into a single transaction for tax purposes.[146]

When such interlocking legal relationships are absent, however, courts have been reluctant to integrate multi-step transactions under the "mutual interdependence" approach. In Redding v. Commissioner,[147] for example, the taxpayer had received a distribution of transferable stock warrants from a corporation in which the taxpayer held common stock. The warrants entitled the taxpayer to purchase, for additional consideration, stock in the corporation's wholly-owned subsidiary. The taxpayer exercised all the warrants issued to him and purchased stock in the subsidiary. The Tax Court, in applying the step-transaction doctrine, concluded that the warrant distribution and acquisition of subsidiary stock ought to be treated as a single transaction involving the distribution of the subsidiary's stock to the taxpayer. Having also concluded that the other necessary requirements of Code Section 355 had been met, the Tax Court held that the overall transaction qualified as a Code Section 355 spin-off and should, therefore, be tax-free to the taxpayer.[148] On appeal by the Service, however, the Seventh Circuit, in reversing the Tax Court, refused to construe the warrant distribution and subsequent stock purchase as a single transaction under the "mutual interdependence" test.[149]

When the step-transaction doctrine is employed to eliminate transitory steps, it overlaps and becomes indistinguishable from the business purpose doctrine (under which the unnecessary step is disregarded because it is lacking in business purpose) and the substance over form doctrine (nullifying the unnecessary step as a formality that merely

[146] Associated Wholesale Grocers, Inc. v. U.S., 927 F.2d 1517 (10th Cir. 1991).
[147] 630 F.2d 1169, 1175 (7th Cir. 1980), *cert. denied* 450 U.S. 913 (1981), *rev'g* 71 T.C. 597 (1979).
[148] Redding, 71 T.C. at 597.
[149] Redding, 630 F.2d at 1178. The judgment was based on the fact that none of the shareholders of the corporation (including the taxpayer) were under any obligation to exercise the warrants distributed to them. In addition, the warrants were transferable to non-shareholders, and the underwriters involved had agreed to purchase (at a price somewhat reduced from the actual exercise price of the warrants themselves) any stock of the subsidiary not acquired by exercise of the warrants. Therefore, as the appeals courts pointed out, "the money would have come in and the stock gone out with or without the exercise of the warrants." Redding, 630 F.2d at 1177. Noting that the primary objective of the warrant distribution was the raising of new capital, the court also decided that it had economic significance independent of any individual shareholder's decision to exercise and to actually acquire the subsidiary's stock. Hence, the necessary level of interdependence between the two steps was lacking, and the court found little evidence that the corporation had acted in concert with its shareholders to achieve the joint objective of a tax-free spin off of the subsidiary. Redding, 630 F.2d at 1178.

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obscures the substance of the transaction). In Tandy Corp. v. Commissioner,[150] the Tax Court stated:

> When a taxpayer adheres strictly to the requirements of a statute intended to confer tax benefits, whether or not steps in an integrated transaction, when the result of the steps is what is intended by the parties and fits within the particular statute, and when each of the several steps and the timing thereof has economic substance and is motivated by valid business purposes, the steps shall be given effect according to their respective terms.[151]

The Tax Court's logic in Tandy Corp. is consistent with the Service's position in Revenue Ruling 79-250.[152] In this ruling the Service stated that formally separate transactions will be respected and that the step-transaction doctrine will not apply if each transaction demonstrates independent economic significance, is not subject to attack as a sham, and is undertaken for valid business purposes and not for mere tax avoidance.

In the instant case, the following separate transactions were undertaken:

- Investor entered into the $33,300,000 loan with a third party bank.
- Investor contributed $54,700,000 in cash to Partnership in a Code Section 721 transaction.
- Partnership undertook substantive investment activities.
- Investor opted to withdraw from the Investment Fund and his partnership interest was redeemed by Partnership.
- Investor's sole member sold a portion of the assets received as liquidating distributions.

We believe that it is more likely than not that each of the above steps will be respected and the step-transaction doctrine will not apply because:

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[150] 92 T.C. 1165 (1989).
[151] Tandy Corp., 92 T.C. at 1173.
[152] 1979-2 C.B. 156.

- Investor is the true borrower and Investor entered into the loan for a valid business purpose (i.e., by leveraging its capital contribution to Partnership outside Partnership, Investor was able to guarantee a minimum initial amount of financial leverage).

- The transactions entered into by Investor, as a member in Partnership, had inherent economic risks where there was the potential for gain or loss and Investor has represented that it had a reasonable expectation of making a pre-tax profit.

- Investor, the Managing Member, the Class B Member and Deutsche Bank AG have represented that they each acted independently and at arm's length with respect to the transactions described herein.

- There was no legally binding agreement, written or otherwise, that compelled Investor to complete the transactions in the way described herein.

- There were no written agency agreements consummated with respect to the transactions undertaken pursuant to the Investment Fund and none of the parties involved held itself out to a third party as an agent of any of the others with respect to these transactions.

c. Application of the Business Purpose/Economic Substance Doctrines

In Revenue Ruling 99-14,[153] the Service set forth its views on how the economic substance and business purpose doctrines applied within the context of "lease-in, lease-out" ("LILO") deals. In the analysis of its position that the transaction did not produce the sought after tax result of deductible lease and interest payments, the Service discussed its view of the relevant authorities. The underlying economics of the transactions described in the revenue ruling are significantly different from those of the instant case;[154] however, a number of the cases cited in the ruling have potential applicability to the instant case.

[153] 1999-13 IRB 3.

[154] In a typical LILO transaction, there is minimal, if any, inherent economic risk incurred as a result of the circular flow of cash payments. Most leveraged leases are structured based upon the guidelines contained in Revenue Procedure 75-21, 1975-1 C.B. 715, which has only a nominal profit requirement.

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In the ruling, the Service concluded that the LILO transaction lacked the potential for significant economic consequences other than the creation of tax benefits based upon the following observations:

- During the primary term of the sublease,[155] the taxpayer's obligations to provide property were completely offset by its right to use property;
- The taxpayer's obligations to make debt service payments on the loans were completely offset by the taxpayer's right to receive rent on the sublease; and
- The taxpayer's economic exposure to the headlease residual was rendered insignificant by an option structure and the pledge of the securities that defeased the other party's option payment.

The Service concluded that the "only real economic consequence" of the LILO transaction during the 20-year primary term of the sublease was the taxpayer's pre-tax return. The Service then concluded that the pre-tax return was too insignificant, when compared to the taxpayer's after-tax yield, to support a finding that the transaction had significant economic consequences other than the creation of tax benefits.[156]

The Service initially cited Frank Lyon Co., supra, in the ruling. The Service stated that in assessing the economic substance of a transaction, a key factor is whether the transaction has any practical economic effect other than the creation of tax losses. The Service further observed that courts have refused to recognize the tax consequences of a transaction that does not appreciably affect the taxpayer's beneficial interest except to reduce tax and that the presence of an insignificant pre-tax profit is not enough to provide a transaction with sufficient economic substance to be respected for tax purposes. Knetsch, supra, ACM Partnership v. Commissioner[157] and Sheldon v. Commissioner[158] were cited in support of its observations.

[155] In a LILO transaction, property is leased to the taxpayer under a "headlease" and the taxpayer immediately leases the property back under a "sublease."
[156] Revenue Ruling 99-14 is effectively a restatement of the Service's position on how to interpret the "for profit" standard as articulated in Notice 98-5, 1998-3 IRB 49. In the notice, the Service takes the position that a taxpayer is not entitled to foreign tax credits from an arrangement where "the reasonably expected economic profit is insubstantial compared to the value of the foreign tax credits expected to be obtained as a result of the arrangement."
[157] ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998).
[158] Sheldon v. Commissioner, 94 T.C. 738, (1990).

The Service noted that in determining whether a transaction has sufficient economic substance to be respected for tax purposes, courts have recognized that offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of the transaction. For example, in Knetsch, the taxpayer purchased an annuity bond using nonrecourse financing. However, the taxpayer repeatedly borrowed against increases in the cash value of the bond. Thus, the bond and the taxpayer's borrowings constituted offsetting obligations. As a result, the taxpayer could never derive any significant benefit from the bond. The Supreme Court found the transaction to be a sham, as it produced no significant economic effect and had been structured only to provide the taxpayer with interest deductions.

In Sheldon, the Tax Court denied the taxpayer the purported tax benefits of a series of Treasury bill sale-repurchase ("repo") transactions because they lacked economic substance. In the transactions, the taxpayer bought Treasury bills that matured shortly after the end of the tax year and funded the purchase by borrowing against the Treasury bills through simultaneously entering into a series of repo transactions.[159] The taxpayer accrued the majority of its interest deduction on the borrowings in the first year while deferring the inclusion of its economically offsetting interest income from the Treasury bills until the second year. In ten out of the eleven repo transactions in question, the repos each bore an interest rate higher than the yield of the corresponding Treasury bill. The court concluded that "the situation in form and substance is no different from that in Goldstein."[160] The Tax Court in a nine to seven decision denied the taxpayer the tax benefit of the transactions because the real economic impact of the transactions was "infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions."[161]

The Sheldon majority focused on the year-end timing of the transactions, their non-existent or negligible profit potential, and the use of repos to maturity to conclude that,

[159] The taxpayer in Sheldon purchased Treasury bills and, in order to finance the purchase, simultaneously entered into a series of repo transactions (in which it sold the T-bills back to the dealers from which it had purchased them and agreed to repurchase the T-bills in the future for the same price plus interest).
[160] Goldstein v Commissioner, 364 F.2d 734 (2nd Cir. 1966), is subsequently discussed.
[161] Sheldon, 94 T.C. at 769. In total, the transactions produced $18,381 of net gain on an investment of $1 million. The point of controversy in Sheldon was the court's observation that the non-tax business purpose should be weighted against the tax purpose. The court noted the profits generated were nominal and insignificant when considered in comparison with the claimed deductions. Although the cases discussed above uniformly support the notion that a taxpayer must have some business purpose, none of the cases attempt to quantify the amount of business purpose necessary for a taxpayer to prevail.

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like the transactions at issue in Goldstein, the repo transactions had no tax independent purpose:

> We recognize that taxpayers may structure their transactions so as to obtain the maximum benefit legally obtainable. . . Here, however, the sole objective was to obtain the interest deduction. This is abundantly evidenced by the use of repos to market with locked-in losses in the transactions with no potential for any profit. In instances where intermediate repos could have or did generate some gain from the carry, these amounts were nominal, either fixed or short-term and stable and, in any event, merely reduced fixed losses by relatively insignificant amounts.[162]

The dissenting judges believed that the majority misapplied Goldstein and, in fact, created a new and inappropriate standard for testing interest deductions. In the dissent's view, the proper Goldstein test for determining whether interest is deductible is whether the underlying transaction has a tax-independent purpose. Accordingly, the majority erred in introducing a profit objective standard and concluding that the de minimis profit potential deprived taxpayers of interest deductions. The dissent in Sheldon was willing to recognize the applicability of Goldstein to trades that ended in repos to maturity that effectively locked in losses and negated profitability. However, the dissenting judges were unwilling to condemn the trades in aggregate because, in the dissent's view, the taxpayer was, at times, exposed to the risk of profit and loss.

Again focusing on a transaction that did not appreciably affect the taxpayer's beneficial interest, the Service observed that in ACM Partnership, supra, the taxpayer entered into a near- simultaneous purchase and sale of debt instruments. Taken together, the purchase and sale "had only nominal, incidental effects on [the taxpayer's] net economic position."[163] The court held that transactions that do not "appreciably" affect a taxpayer's beneficial interest, except to reduce tax, are devoid of substance and are not respected for tax purposes.[164]

In Revenue Ruling 99-14, the Service's analysis did not cite the case that many view, including the Tax Court in ACM Partnership, as the cornerstone "for-profit" standard

[162] Sheldon, 44 T.C. at 767.
[163] ACM Partnership, 157 F.3d at 250
[164] ACM Partnership, 157 F.3d at 248

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case, Goldstein v. Commissioner. Goldstein involved a taxpayer's attempt to use a "T-bill roll" to shelter her Irish Sweepstakes winnings. The plan called for Mrs. Goldstein to borrow a total of $945,000 from two banks with interest at approximately 4% and to invest in Treasury Bills yielding 1.5%. Mrs. Goldstein prepaid the interest on her loans in the first year. This prepayment, which she deducted as interest, sheltered much of the Sweepstakes winnings. Eventually, the T-bills were sold at a loss on Mrs. Goldstein's behalf and her notes were canceled. The Tax Court disallowed the deductions holding that the transactions were not real and held out no prospect for economic benefit other than tax losses. Citing Knetsch, the Tax Court, noted specifically that "if saving 1958 income taxes was the *only significant benefit* to be derived ... then the Knetsch and Bridges cases require that the deductions for so-called prepaid interest must be denied."[165]

To determine whether any "significant benefit" did accrue to the taxpayer, the Tax Court analyzed the underlying economics of the investment and concluded that:

> ...to have realized anything substantial beyond recovering her said outlay, the Treasury notes would have had to be sold considerably in excess of par, notwithstanding that they bore interest of only 1.5%, and were to mature at par only a short time later ... [Thus, the taxpayer] could not reasonably have had any purpose or intention through the foregoing transactions to appreciably affect her beneficial interest except to reduce her taxes.[166]

On appeal, the Second Circuit disagreed with the Tax Court in holding that the loans were shams. In this regard, the court noted that the Goldsteins had entered into the transactions with independent financial institutions, that the loans remained outstanding for six months rather than just a few days and that the notes were with recourse. The Second Circuit affirmed the Tax Court, nevertheless, because it found that the Goldsteins had entered into the loan transaction for the sole purpose of securing a large interest deduction. The court noted that "the interest deduction should be permitted whenever it can be said that taxpayer's desire to secure an interest deduction is *only one of mixed motives* that prompts the taxpayer to borrow funds .... there must be *some*

[165] Goldstein, 44 T.C. at 299.
[166] Goldstein, 44 T.C. at 300.

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substance to the loan arrangement beyond the taxpayer's desire to obtain tax benefits [emphasis supplied]."[167]

Several recent court cases have also addressed the economic substance and business purpose doctrine. Three of such cases have addressed a Merrill Lynch investment program involving the purchase and resale of certain notes, which, pursuant to a literal application of the contingent installment sale rules, generated tax losses. First, in ACM Partnership, supra, a divided Third Circuit partly affirmed the Tax Court in holding that the economic substance doctrine precluded a partnership's deduction of losses attributable to such investment program; however, the Third Circuit reversed the Tax Court and allowed deductions for "actual economic losses" associated with the program.

ACM Partnership has certain parallels, and significant distinctions, to the instant case. The facts of the case were as follows. In 1988, Colgate incurred a large capital gain on the sale of one of its subsidiaries. Colgate used the proceeds of the subsidiary sale to retire short-term debt and also issued newly established long-term debt in connection with a newly established ESOP. As a result of the debt issuance, Colgate believed that it had a disproportionately large level of long-term debt. Colgate concluded that by acquiring its own debt through a partnership, rather than by simply refinancing it directly, it could pick the most advantageous market timing to actually refinance the debt. In 1989, Merrill Lynch devised a contingent installment note sale transaction structured through a partnership that would generate tax losses to offset the gain generated on the subsidiary sale.[168]

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[167] Goldstein, 364 F.2d at 740.

[168] Consistent with its plan to manage its long-term debt position and to shelter the subsidiary capital gain, in October of 1989, affiliates of ABN Bank ("ABN"), Colgate and Merrill formed ACM Partnership. The ABN, Colgate and Merrill affiliates contributed \$169.3 million, \$35 million and \$600,000 to the partnership and received partnership interests of approximately 82.63%, 17.07% and .29%, respectively. Initially, the partnership placed its \$205 million into a bank account earning interest at 8.75%.

On November 3, 1989, the partnership purchased \$205 million of floating rate notes from Citicorp that had a yield of 8.78%. Three weeks later, in order to generate the cash needed to finance the purchase of Colgate long-term debt held by third parties, the partnership sold \$175 million of the Citicorp notes in a taxable installment sale transaction to the Bank of Tokyo and Banque Francaise du Commerce Exterieur. In the sale, the partnership received \$140 million in cash and LIBOR-based installment notes with a present value of \$35 million. Colgate argued that the interest rate sensitivity of the notes allowed the partnership to hedge the interest rate exposure that it had as a holder of the Colgate debt.

Colgate took the position that by operation of the installment sale Regulations, the partnership could only use \$29 million of its total \$175 million basis in the Citicorp notes to offset the \$140 million in cash proceeds. As a result, the partnership recognized \$111 million of taxable income in its first year. The

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The Tax Court was asked to decide three issues: (1) whether the transaction should be disregarded because it lacked economic substance; (2) whether one of ACM's partners, the ABN affiliate, was actually a lender rather than partner; and (3) whether certain partnership allocations lacked substantial economic effect under Code Section 704(b). Because the court found for the Service on the first issue, it did not address the other two issues. In reaching its conclusion, the court discussed a number of major business purpose cases including, among others, Gregory, supra; Knetsch, supra; Frank Lyon, supra; and Goldstein, supra. The court focused particular attention on Goldstein and a major part of the court's ultimate conclusion is based upon the Goldstein analysis.

The Tax Court in ACM Partnership provided the following test for making its economic substance determination:

> ...the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry.[169]

The court then provided guidance concerning when a transaction is "rationally related" to the taxpayer's situation. According to ACM Partnership, a rational relationship will ordinarily not be found unless the taxpayer had a reasonable expectation that the nontax benefits of the transaction would at least equal the transaction costs. This conclusion effectively follows Goldstein, where the court held that it does not make economic sense to pay 4% for a chance to earn 1.5%.

Based upon a detailed analysis, the Tax Court concluded that the relevant portions of the ACM transactions were economic shams which were devoid of any non-tax business purpose and which did not have a rational nexus to Colgate's stated purpose of liability management. In reaching this conclusion, the court effectively bifurcated the ACM

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income was allocated to the partners in accordance with their partnership percentages so that more than 80% was allocated to the ABN affiliate, which was not subject to U.S. tax and which paid no tax in its country of incorporation. Under the Code Section 453 basis rules, the nearly $146 million in basis that was not available to offset the gain on the sale was reallocated to the LIBOR notes. The LIBOR notes, thus, became built-in loss assets with a value of $35 million and a basis of $146 million.

[169] ACM Partnership, 73 T.C.M. (CCH) 2189.

transaction into those components that provided the claimed tax benefit and all other components of the transaction. Although the court found that Colgate had made an overall pre-tax profit on its ACM investment, even after taking into account transaction costs, the court also found that the pre-tax profit of the tax benefit components did not exceed their transaction costs.[170]

In its analysis of the economic substance doctrine, the Third Circuit started its economic substance/business purpose discussion from the same basic starting point as the Tax Court, Gregory, supra. In Gregory, the Supreme Court held that the form of a transaction must be looked through in order to determine its substance. In this regard, the transaction must be viewed as a whole, and each step is relevant. Whether the taxpayer's transactions had sufficient economic substance to be respected turns on both the "objective economic substance of the transactions" and the "subjective business motivation" behind them. These are not, the Third Circuit pointed out in ACM Partnership, "discrete prongs of a "rigid two-step analysis" but rather are related factors in the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected."[171]

The Third Circuit subsequently refined the Tax Court's economic substance analysis by clarifying that the objective economic consequence test is first applied and then the subjective business motivation is examined, should a taxpayer not satisfy the objective test. The court stated that the inquiry into whether the taxpayer's transactions had sufficient economic substance to be respected for tax purposes turns on both the "objective economic substance of the transactions" and the "subjective business motivation" behind them.

The court's position in ACM Partnership is an affirmation of the Fourth Circuit's two-pronged subjective and objective tests contained in the Rice's Toyota World v. Commissioner.[172] Rice's Toyota World effectively provides that a transaction is not a

[170] The Tax Court found that at the time it entered into the partnership, Colgate's only real opportunity to earn a profit was through an increase in the credit quality of the issuers of the notes, or a 400-500 basis point increase in three-month LIBOR interest rates. The Tax Court found no impact on credit quality was possible as the lenders were already highly rated at the time of the transaction. Moreover, the Tax Court did a six year review of three-month LIBOR rates and did not find an increase of even 300 basis points in the necessary time frame. Since the analysis of the historical data showed no reasonable basis for expecting a profit, the Tax Court ruled against ACM.
[171] ACM Partnership, 157 F.3d at 247.
[172] 752 F.2d 89 (4th Cir. 1985).

sham if it has either "business purpose" (subjective) or "economic reality" (objective). Assuming a transaction has either (or both) of the prongs, it should not be viewed as a sham. The court in ACM Partnership reaffirmed that "business purpose" and "economic reality" (or economic substance) do not constitute discrete prongs of a "rigid two-step analysis," but rather represent related factors, both of which inform the analysis of whether the transaction had sufficient substance to be respected for tax purposes.

To better understand the Third Circuit's position in ACM Partnership, it should be contrasted with the Second Circuit's decision in Goldstein, supra, where the court focused on the primacy of actual economic returns in assessing business purpose. The Second Circuit did not attempt to engage in any subjective/objective dichotomy in determining business purpose, but undertook a relatively sophisticated economic analysis to determine whether there was a reasonable expectation of non-tax economic profit. The Third Circuit incorporates the Goldstein logic in its "subjective business motivation" analysis, which looks to intended business purpose and anticipated profitability.

In its appeal, ACM contended that because its transactions on their face satisfied each requirement of the contingent installment sale provisions, it properly deducted the losses arising from its "straightforward application" of these provisions which required it to recover only one-sixth of the basis in the Citicorp notes during the first of the six years over which it was to receive payments.[173] Thus, ACM contended it properly subtracted the remaining basis in the LIBOR notes which included the remaining five-sixths of the basis in the Citicorp notes used to acquire them. Consequently, ACM argued it properly subtracted the approximately $96 million remaining unrecovered basis in the LIBOR notes from the approximately $11 million consideration it received upon disposition of those notes and correctly recognized and reported the gains and losses arising from its sale or exchange of property in accordance with Code Section 1001. In his dissent, Circuit Judge McKee agreed.

The Third Circuit's reasoning in coming to its decision first looked to the objective aspects of the economic substance analysis and then to the subjective aspects. With respect to the objective analysis, ACM asserted that the Tax Court was bound to respect the tax consequences of ACM's exchange of Citicorp notes for LIBOR notes because,

[173] Temp. Treas. Reg. Section 15a.453-1(c).

under Cottage Savings Association v. Commissioner,[174] an exchange of property for "materially different" assets is a substantive disposition whose tax effects must be recognized. The majority found Cottage Savings inapposite, reasoning that the mortgages relinquished by the savings and loan association afforded it "legally distinct entitlements" from the ones it received.

The court observed that the distinctions between the exchange at issue in this case and the exchange before the Court in Cottage Savings predominate over any superficial similarities between the two transactions. The court noted that the taxpayer in Cottage Savings had an economically substantive investment in assets which it had acquired a number of years earlier in the ordinary course of its business operations. The investment had declined in actual economic value by over $2 million from approximately $6.9 million to approximately $4.5 million from the time of acquisition to the time of disposition.[175]

Based upon Cottage Savings, the Third Circuit majority in ACM Partnership effectively expanded upon the terminology used by the Tax Court by introducing the concept of a "bona fide" loss.[176] The court noted that the Supreme Court emphasized in Cottage

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[174] 499 U.S. 554 (1991). In Cottage Savings, the taxpayer, a savings and loan association, owned fixed rate mortgages whose value had declined as interest rates had risen during the preceding decade. The taxpayer simultaneously sold those mortgages and purchased other mortgages which were approximately equal in fair market value, but far lower in face value than the mortgages which the taxpayer relinquished. The Court found that the exchange for different mortgages of equivalent value afforded the taxpayer "legally distinct entitlements," and thus was a substantive disposition which entitled the taxpayer to deduct its losses resulting from the decline in value of the mortgages during the time that the taxpayer held them.

[175] In Cottage Savings, the taxpayer's relinquishment of assets (so altered in actual economic value over the course of a long- term investment) stood in "stark contrast" to ACM's relinquishment of assets that it had acquired 24 days earlier *under circumstances which assured that their principal value would remain constant and that their interest payments would not vary materially from those generated by ACM's cash deposits*. The court further distinguished the two transactions by making the following observation:

...while the dispositions in Cottage Savings and in this case appear similar in that the taxpayer exchanged the assets for other assets with the same net present value, beneath this similarity lies the more fundamental distinction that the disposition in Cottage Savings precipitated the realization of *actual economic losses* arising from a long-term, economically significant investment, while the disposition in this case was without economic effect as *it merely terminated a fleeting and economically inconsequential investment, effectively returning ACM to the same economic position it had occupied before the notes' acquisition 24 days earlier*. (Emphasis added). ACM Partnership, 157 F.3d at 251.

[176] Treas. Reg. Section 1.165-1(b) also requires that a loss be "bona fide," and that substance shall govern over form in determining the deductibility of a loss. The conclusion that Investor's loss is "bona fide" under ACM should be equally applicable under Treas. Reg. Section 1.165-1(b).

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Savings that deductions are allowable only where the taxpayer has sustained a "bona fide" loss as determined by its "[s]ubstance and not mere form."[177] According to ACM's own synopsis of the transactions, the contingent installment exchange would not generate actual economic losses. Rather, ACM would sell the Citicorp notes for the same price at which they were acquired, generating only tax losses which offset precisely the tax gains reported earlier in the transaction with no net loss or gain from the disposition.

In order to understand the court's use of the "bona fide" loss logic and determine the applicability of the resulting dicta in other contexts, one must carefully read footnote 31. In this footnote the court differentiates a "bona fide" loss from the ACM loss:

> While it is clear that a transaction such as ACM's that has neither objective non-tax economic effects nor subjective non-tax purposes constitutes an economic sham whose tax consequences must be disregarded, and equally clear that a transaction that has both objective non-tax economic significance and subjective non-tax purposes constitutes an economically substantive transaction whose tax consequences must be respected, it is also well established that where a transaction objectively affects the taxpayer's net economic position, legal relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations. See, e.g., Gregory, 293 U.S. at 468-69, 55 S.Ct. at 267 ("if a reorganization in reality was effected . . . the ulterior purpose will be disregarded"), Northern Indiana Pub. Serv. Co., 115 F.3d at 512 (emphasizing that Gregory and its progeny "do not allow the Commissioner to disregard economic transactions . . . which result in actual, non-tax-related changes in economic position" regardless of "tax-avoidance motive" and refusing to disregard role of taxpayer's foreign subsidiary which performed a "recognizable business activity" of securing loans and processing payments for parent in foreign markets in exchange for legitimate profit); Kraft Foods Co. v. Commissioner, 232 F.2d 118, 127-28 & n.19 (2d Cir. 1956) (refusing to disregard tax effects of debenture issue which "affected . . . legal relations" between taxpayer and its corporate parent by financing subsidiary's acquisition of venture used to further its non-tax business interests). In analyzing both the objective and subjective aspects of ACM's transaction in this case where the objective attributes of an

[177] Cottage Savings, 499 U.S. at 567-68 (quoting Treas. Reg. Section 1.165-1(b)).

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> economically substantive transaction were lacking, we do not intend to suggest that a transaction which has actual, objective effects on a taxpayer's non-tax affairs must be disregarded merely because it was motivated by tax considerations. [178]

After concluding that the taxpayer did not satisfy its objective economic consequence portion of the economic substance analysis, the Third Circuit then looked to the subjective aspects of the economic substance analysis. In its subjective purpose inquiries, the court determined that the transactions were not intended to serve ACM's professed non-tax purposes and were not reasonably expected to generate a pre-tax profit (a Goldstein-type of analysis). The court stated in footnote 44 that "where such objective economic effects are lacking, scrutiny of the subjective intent behind the transactions becomes an important means of determining whether the transactions constitute a scheme with 'no purpose other than tax avoidance' that may not give rise to deductible losses even where the statute contains no express requirement that the transaction serve a non-tax business purpose."[179]

The Third Circuit observed that ACM's stated business purpose for engaging in the transactions, to provide an interim investment until ACM needed its cash to acquire Colgate debt and as a hedge against interest rate risk, did not comport with economic reality or with what actually transpired. In addition, the court agreed with the Tax Court's conclusion that there was no pre-tax profit potential using the Tax Court's bifurcation approach to analyze profitability. Accordingly, the Third Circuit concluded that ACM did not satisfy the subjective business motivation test.

ACM Partnership is an endorsement of the principles previously set forth in cases such as Goldstein, supra, Sheldon, supra, and Wexler, supra. Beyond the base logic of these cases, it is our view that ACM Partnership stands for the simple proposition that a transaction with no reasonable potential for pre-tax profit cannot be salvaged because the taxpayer also has unrelated profit-generating activity.

Since the Third Circuit's decision in ACM Partnership, the Tax Court has denied losses claimed by investors in two other cases involving the Merrill Lynch investment program, ASA Investerings Partnership v. Commissioner[180] and Saba Partnership v.

[178] ACM Partnership, 157 F.3d at 248.
[179] ACM Partnership, 157 F.3d at 254.
[180] 76 T.C.M. (CCH) 325.

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Commissioner.[181] In ASA, the Tax Court ruled that the arrangement between the taxpayer and the accommodating Dutch bank was formed for the purpose of generating tax losses and was not a valid partnership. Like the ACM Partnership transaction, the plan involved a partnership with a foreign partner. The partnership invested in high-grade, floating rate private placement notes, and sold the notes for cash and LIBOR-indexed installment notes. Also, like the ACM Partnership transaction, the ASA transaction entailed interest rate swaps that virtually eliminated the risks to the accommodating parties involved in the transaction. As in ACM Partnership, the Service argued that the Dutch bank was not a partner, but a lender, since the Dutch bank had no entrepreneurial risk in the partnership.

The Tax Court agreed stating that no business purpose existed for the partnership. This conclusion was supported by the existence of hedges and side agreements entered into for the purpose of ensuring the Dutch bank received its required return at little risk. Although partnership formalities were observed and the Dutch bank was not promised a guaranteed return, the bank was receiving a lender's return under the guise of partnership profits. Because partnership profits were insufficient, the parties had to enter into arrangements outside the partnership agreement.

Similarly, in Saba, the Tax Court held that a partnership could not deduct losses from transactions almost identical to the investment program involved in ACM Partnership. The Tax Court applied the economic substance doctrine as set forth in ACM Partnership. It conducted both a subjective inquiry as to whether the investment program was carried out for a valid business purpose other than to obtain tax benefits, and an objective inquiry as to whether the investment program had practical economic effects other than the creation of tax benefits.

The Tax Court first rejected the business purposes offered by the taxpayer for its involvement in the investment program, holding that the record contained overwhelming evidence that the partnerships in the investment program were formed solely to generate tax benefits. The Tax Court then noted that even absent a business purpose, a transaction will be respected if it has economic substance. However, given the substantial costs associated with the investment program in Saba, the Tax Court held that the investment program could not generate a profit over the short period in which it was intended to

[181] 78 T.C.M. (CCH) 684.

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remain open. Thus, the investment program lacked business purpose, lacked economic substance, and accordingly, was held to be an economic sham.

While the Tax Court in Saba concluded that no profit could have been generated over the period of the taxpayer's investment, it also noted that "relatively modest profits are insufficient, *standing alone*, to clothe the disputed CINS transactions with economic substance."[182] The Tax Court then cited the Seventh Circuit in Yosha v. Commissioner[183] in noting that a transaction has economic substance when it is such that people enter into without tax motives. The Tax Court noted that the taxpayer incurred significant costs to convert cash into illiquid investments, and then back into 80% cash and 20% LIBOR notes, when the taxpayer could have simply used 20% of the cash to purchase LIBOR notes. Because no reasonable business person would have entered into such a transaction absent tax motives, the transaction lacked economic substance.

Thus, like the Tax Court in Sheldon, the Tax Court in Saba warned that modest profit potential may not be sufficient to give a transaction economic substance. However, the Tax Court did not hold that economic substance requires that a transaction generate profit in excess of the tax benefits, nor did it attempt to define any sort of objective standard for determining whether a profit potential is sufficient. It merely held that, where the transaction at issue is one in which no person would enter into without the tax benefits, a small profit potential will not imbue a transaction with economic substance.

The facts in the instant case can be distinguished from ASA and Saba in that a profit motive existed for Investor and Presidio in entering into Partnership, and a valid partnership was formed. The pooling of the partners' assets to manage a substantial amount of property is a valid reason to use a partnership, and need not be conducted through a corporation.[184] The investment vehicle chosen by Presidio was a limited liability company treated as a partnership for U.S. income tax purposes. Both Presidio and Investor contributed funds to Partnership pursuant to the Limited Liability Company Agreement. All investments, disbursements, and ongoing activities, including maintenance of capital accounts, are required under the LLC Agreement to be accounted for under generally accepted accounting principles. Unlike the lender relationship described in ASA, Presidio will share in partnership profits during the term of the

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[182] *Id.* (emphasis added).
[183] 861 F.2d 494, 499 (7th Cir. 1988).
[184] *See* Chisholm v. Commissioner, 79 F.2d 14 (2nd Cir.), *cert. denied*, 296 U.S. 641 (1935).

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partnership, will receive the amount of its capital account upon liquidation of the partnership, and will be fully subject to the risks of Partnership investments.

Furthermore, unlike the transactions in Saba, the debt undertaken by Investor and the investments by the Partnership in foreign currency are transactions that are entered into by people without a tax motive. Thus, the Tax Court's admonition in Saba that a modest profit potential in a transaction is insufficient, where no person would enter into the transaction absent the tax consequences, is inapplicable in the instant situation. Therefore, the economic substance doctrine as formulated by ACM Partnership, supra, in which the Third Circuit merely determined whether the transaction at issue objectively affected the taxpayer's net economic position, legal relations, or non-tax business interests, and did not make an inquiry as to the degree of economic profit potential that is required, should be applied. Since Investor had a reasonable opportunity to earn a reasonable pre-tax profit from the transactions, we believe it is more likely than not that the economic substance prong is satisfied by Investor.

Finally, the Tax Court has recently addressed the business purpose and economic substance doctrine in three different cases. In Winn-Dixie Stores v. Commissioner,[185] the Tax Court applied the ACM Partnership analysis and held that interest expense incurred by Winn-Dixie on a corporate-owned life insurance (COLI) program was not deductible because the program lacked both economic substance and a business purpose.

Winn-Dixie used a "zero-cash" strategy to purchase life insurance on all of its employees with borrowed funds. The insurance carrier charged a high rate of interest, but credited Winn-Dixie with a high rate of return, with a 40 basis point spread (in favor of the insurance carrier). The pre-tax cost of the COLI program -- calculated by subtracting the annual premium, loan interest and administration fees from the cash surrender value plus the death benefits -- ranged from approximately \$4.6 million in the first year of the program to over \$18 million in later years of the program. The projected pre-tax loss for the life of the COLI program was slightly more than \$750 million. The projected tax benefit of the program, on the other hand, achieved by deducting the interest as interest expense, was more than \$3 billion. Thus, the COLI program only made economic sense when the tax savings were considered. As a result, the Tax Court held that the COLI program lacked economic substance.

[185] 113 T.C. No. 21 (10/19/99).

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Additionally, the Tax Court held that the COLI program lacked a business purpose. The taxpayer claimed that "savings" from the COLI program allowed it to fund its other benefits obligations. However, since the "savings" from the COLI program were solely tax savings, the Tax Court held that the COLI program's sole purpose was to generate tax deductions. The Tax Court also rejected the other claimed business purposes of the COLI program, noting that the taxpayer terminated the COLI program after a tax law change that prohibited the deduction of policy loan interest under the program, thereby calling into question the taxpayer's purported business purposes. Thus, the Tax Court declared the COLI program a sham, and held that Winn Dixie was not entitled to deduct its interest expense.

Similarly, the Tax Court applied the economic substance and business purpose doctrine in Compaq v. Commissioner[186] to disallow a foreign tax credit claimed by Compaq. In Compaq, the taxpayer designed and prearranged a transaction whereby it purchased, and immediately resold, American Depository Receipts (ADRs) of a foreign corporation on the floor of the NYSE. As a result of the transaction, the taxpayer was the shareholder of record of 10 million ADRs on the dividend record date. The taxpayer received a dividend of $22,545,800, less withheld foreign taxes of $3,381,870. As a result of the dividend, the ADRs decreased in value, so on the resale of the ADRs, the taxpayer recognized a $20,652,816 capital loss, which was offset against previously realized capital gains. The net cash flow from the transaction, without regard to tax consequences, was a $1,486,755 loss.

The Tax Court found that this transaction was predetermined and designed by the taxpayer to yield a specific result and eliminate all market risks. The Tax Court noted that the taxpayer virtually eliminated the risk of price fluctuation through use of predetermined purchase and resale prices, and through the execution of almost simultaneous purchase and resale cross-trades. The taxpayer also used special next-day settlement terms and large blocks of ADRs to eliminate the risk of third parties breaking up the trades. Furthermore, the Tax Court held that the taxpayer had no reasonable possibility of a profit from the ADR transaction without its anticipated federal income tax consequences. The transaction thus operated as "an integrated package, designed to produce an economic gain when—and only when –the foreign tax credit was claimed."[187] Accordingly, the Tax Court found that the transaction lacked economic substance and operated as a mere tax artifice.

[186] 113 T.C No. 17 (9/21/99).
[187] 113 T.C. No. 17, 19.

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The Tax Court also held that the taxpayer had no business purpose for the purchase and sale of ADRs apart from obtaining a federal income tax benefit. The Tax Court noted that the ADR transaction was marketed to the taxpayer for the purpose of partially shielding a previously realized capital gain, and that the taxpayer committed itself to a questionable multi-million dollar transaction without thoroughly considering and analyzing its economic ramifications. Thus, the taxpayer failed both the economic substance and business purpose inquiries, and the foreign tax credit it claimed was disallowed.

Finally, the Tax Court applied the economic substance and business purpose doctrine in United Parcel Service of America v. Commissioner[188] to find the taxpayer liable for taxes on income that it attempted to divert to another entity. UPS charged shippers 25 cents for parcels with a declared value of over $100 as an "excess value charge" (EVC). These payments were used to offset its risks associated with liability for its shipping losses. In 1983, UPS restructured its EVC activity, and created OPL, an overseas insurance subsidiary. UPS continued performing the same EVC services and activities after the restructuring, but began transferring excess value revenues to OPL, and did not report these revenues as income for federal income tax purposes.

The Tax Court held that the EVC restructuring was driven by expected tax benefits for the UPS and OPL common shareholders, and that no other business purpose existed. The restructuring was not, as UPS alleged, motivated by a good faith concern that UPS was violating state or federal insurance laws by collecting excess value revenues. Nor did UPS shift excess value revenues to OPL to justify raising its shipping rates. Furthermore, the EVC restructuring did not transfer or reduce UPS's liability to shippers in any meaningful sense.

The Tax Court further held that UPS's arrangement with OPL lacked economic substance. The restructuring did not significantly reduce UPS's financial exposure, so as to provide a nontax benefit to UPS. The Tax Court also asserted that the absence of arm's length price negotiations between UPS and OPL, as well as the relationship between price coverage and fair market value, suggest that the arrangement was a sham. Finally, contemporaneous documentation established that UPS seriously considered, and was motivated by, the reduction of federal income tax that would occur after the restructuring. In contrast, no such documentation, such as corporate minutes, substantiated UPS's nontax business reasons for the restructuring.

[188] 77 T.C.M. (CCH) 2030 (1999).

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In summary, the case law applying the business purpose/economic substance doctrine consistently require that the following factors be satisfied:

- Either the transactions entered into by an investor must have inherent economic risks where there is the potential for gain or loss and the investor must be able to demonstrate a reasonable potential for making a pre-tax profit, or the transactions must have some subjective non-tax business purpose; and

- In determining whether there is a potential profit, unrelated transactions should not be taken into account.

Based upon Investor's representation that Investor independently reviewed the economics underlying the Investment Fund before entering into the program and believed there was a reasonable opportunity to earn a reasonable pre-tax profit from the transactions undertaken, the first requisite is satisfied. Based upon Presidio's description of the Investment Fund, the profit from the Investment Fund arises from an integrated investment strategy. Accordingly, there are no unrelated transactions providing incremental profit potential.

In addition to the requisite profit motive for entering into the investment strategy, the Service could challenge Investor's business purpose for the structuring of its financing to participate in the Investment Fund. As discussed, the Tax Court in ACM Partnership stated that "the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry."[189] The court observed that a rational relationship will ordinarily not be found unless the taxpayer had a reasonable expectation that the nontax benefits of the transaction would at least equal the transaction costs.

As noted, to participate in the Investment Fund, Investor was required to commit a sufficient level of funding to the program so as to afford the Managing Member with the capital to act upon extraordinary market opportunities. The $33,300,000 loan was integral to Investor's financing structure in that the use of the premium loan arrangement resulted in an integrated investment strategy whereby there was complementary levels of investment risks and financing risks at all times during the term of the Investment Fund.

[189] ACM Partnership, 73 T.C.M. (CCH) 2189 at p.118.

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By having the loan premium, it was possible to match the investment risks with the financing risks. Investor entered into the $33,300,000 loan in its individual capacity and then contributed the loan proceeds and additional cash to Partnership. By leveraging its capital contribution to Partnership outside Partnership, Investor was able to guarantee a minimum initial amount of financial leverage. This leveraging effect is especially important during the first two stages of the Investment Fund where investment returns are premised upon investments in low and moderate risks positions. In essence, Investor has an inherently high profit potential on its investment capital even though the investment strategy is relatively conservative in the first two stages.

Whereas the above sets forth the commercial rationale for Investor's choice of financing structure, in assessing economic substance and business purpose, of most importance relative to existing case law is that Investor had the expectation of a pre-tax profit from participating in the Investment Fund that exceeded its financing costs. We believe that it is more likely than not that Investor will satisfy the requisite economic substance/business purpose doctrine with respect to participation in the Investment Fund and as to the financing arrangement utilizing the loan premium structure. Although not consistent with the other cases, Sheldon, supra, provides that there must be not only a reasonable chance of making a pre-tax profit, but the reasonably expected pre-tax profit must be greater than de minimis. In the instant transaction, the expectation was that this standard would also be met.

A potentially more difficult issue would arise if the motive to make a pre-tax profit must be greater than the tax benefit sought. Several courts have indicated that they would consider whether the profit motive was greater than the tax motive.[190] However, requiring that the profit motive be primary would be inconsistent with other areas of the tax law that have adopted a more generalized business purpose requirement either judicially (such as in reorganizations) or statutorily (such as Code Section 269).

Notwithstanding that the transactions in the instant case have the requisite economic substance, Code Sections 165(c) and 183, where applicable, impose additional limitations on the ability of individuals to claim deductions for losses. Code Section 165 applies to loss deductions, and Code Section 183 applies to all deductions. If an individual incurs a loss from the disposition of assets in the individual's trade or

[190] *See, e.g.,* Fox v. Commissioner, 82 T.C. 1001 (1984) and Estate of Baron v. Commissioner, 83 T.C. 542 (1984), *aff'd*, 798 F.2d 65 (2d Cir. 1986).

business or in a transaction entered into for profit, Code Sections 165(c) and 183 generally permit the allowance of such loss.

The regulations under Code Section 165 do not define the meaning of "for profit," whereas the regulations under Code Section 183 do define the phrase. The determination of whether a transaction has been undertaken for profit for purposes of Code Section 183 is based on all the facts and circumstances. Treas. Reg. Section 1.183-2(b) lists nine specific factors that are to be taken into account in making this determination. This regulation also provides that "[a]lthough a reasonable expectation of profit is not required, the facts and circumstances must indicate that the taxpayer entered into the activity... with the objective of making a profit."

Code Section 183(a), Treas. Reg. Section 1.183-1, Code Section 165(c)(2) and Treas. Reg. Section 1.165-1(e) all require that individuals incurring a loss from a transaction not involving a trade or business have a profit motive. Thus, these two statutes and regulatory provisions parallel each other. Notwithstanding the literal language of Code Sections 165(c)(2) and 183, some courts have imposed a judicial gloss on Code Section 165(c)(2), and to some extent on Code Section 183(a), by ruling that the taxpayer's *primary* motive must be to generate pre-tax profits from the activity.[191]

In Fox v. Commissioner,[192] the Tax Court based its expansion of the language of the statute on dictum found in Helvering v. National Grocery Co.,[193] an accumulated earnings case. The Tax Court's reasoning in Fox seems questionable as there is little in the National Grocery decision to support the Tax Court's contention that the Supreme Court intended to change the meaning of Code Section 165(c)(2) in this way. The Court in Fox also based its decision on an earlier Code Section 165(c)(2) case, Smith v. Commissioner.[194] In Smith, however, the Tax Court did not impose the "primary" test articulated in Fox, but rather stated:

> The mere fact that petitioners may have had a strong tax avoidance motive in entering into their commodity tax straddles does not in itself result in a disallowance of petitioner's losses under Code Section 165(c)(2), provided petitioners also had a non-tax profit motive for their

[191] *See, e.g.*, Fox v. Commissioner, 82 T.C. 1001 (1984).
[192] 82 T.C. 1001 (1984).
[193] 304 U.S. 282, 289 n.5 (1938).
[194] 78 T.C. 350 (1982), *aff'd*, 820 F.2d 1220 (4th Cir. 1987).

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> investments at the time. Knetsch v. United States, 348 F.2d 932 (Ct. Cl. 1965). Such hope of deriving an economic profit aside from the tax benefits need not be reasonable so long as it is bona fide. Bessenyey v. Commissioner, 45 T.C. 261 (1965), *aff'd,* 1379 F.2d 252 (2d. Cir. 1967).[195]

Much of the confusion that arises in this area results from misreadings of dicta and former courts' findings. Originally, the term "primarily" was a notion developed to determine how a mixed personal-profit transaction was to be characterized and not how a commercial transaction was to be treated.[196] As illustrated by the multitude of decided cases, no single, uniform standard exists for applying the primary profit motive test. This lack of uniformity can be attributed in part to the varying language and standards used by the courts to identify and apply the primary test. Additionally, the courts' failure to explicitly indicate the method used to compare a taxpayer's various objectives exacerbates the confusion surrounding the application of the primary test.

Judge Swift of the U.S. Tax Court discussed the proposition that the primary profit motive test has not been developed uniformly by the courts in his concurring opinion in Peat Oil & Gas Assocs. v. Commissioner.[197] In this case, Judge Swift noted:

> The courts have not been consistent in the language used to describe the quantity or level of profit objective that must be established. .... The inconsistent profit-objective language that has been used has included, among other language, the following: "Basic," "dominant," "primary," "predominant," "substantial," "reasonable," "bona fide," and "actual and honest." As one court commented, we have been glutted with tests. Many such tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify.[198]

[195] Smith, 78 T.C. at 391.
[196] *See* Austin v. Commissioner, 298 F.2d 583 (2d Cir. 1962).
[197] 100 T.C. 271 (1993).
[198] Peat Oil, 100 T.C. at 280. For a further discussion of the lack of uniform language used by courts to describe the primary test, see Rose v. Commissioner, 88 T.C. 411-14 (1987), discussing different words used to describe the profit objective test; and Johnson v. United States, 11 Cl. Ct. 17 (1986), discussing various profit objective tests applied by the Tax Court.

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Both the Fox and Smith cases, as well as the bulk of subsequent cases involving the "primary" profit motive standard under Code Section 165(c)(2), arose in connection with commodities straddle transactions in which, looking at the transactions as a whole, the taxpayer had little or no opportunity to earn any meaningful profit. On the other hand, we are not aware of any cases applying the "primary" profit motive standard under Code Section 165(c)(2) involving taxpayers who had some meaningful profit motive or potential. Accordingly, the Code Section 165(c)(2) cases go into little detail in analyzing the degree of profit motive required where both a profit motive and non-profit motives exist. Such cases merely reiterate the primary profit motive standard, and hold that since only non-profit, tax motives exist, the profit motive requirement of Code Section 165(c)(2) is not met. Some cases under Code Section 183, on the other hand, do engage in an analysis of weighing profit motives against non-profit motives. Since Code Section 183 contains nearly identical language as Code Section 165(c)(2), the case law decided under Code Section 183 is instructive in interpreting Code Section 165(c)(2).

One such case under Code Section 183 is Estate of Baron v. Commissioner.[199] In Baron, the Tax Court rejected the primary profit motive test and used an "intermediate" test in which it balanced profit against tax benefits. This test required a weighing "in the context of all the factors involved in determining the existence of the requisite profit objective, rather than applying a 'primary or dominant' test for nontax factors ... or a sole objective test for the tax benefits."[200] In Baron, the Tax Court looked at the taxpayer's profit potential under the more optimistic profit projections given the taxpayer at the time of the transaction, and determined that such profit potential was insignificant when compared to the tax savings and the taxpayer's overall lack of interest in the transaction. Accordingly, the Tax Court held that the taxpayer did not have an adequate profit motive under Code Section 183.

The Court of Claims subsequently offered yet another view of the profit motive test in Johnson v. United States.[201] Johnson involved a wrap lease of computer equipment, in which the taxpayer had both tax and profit motives for entering into the lease. It rejected the primary profit motive test, stating that such test only applies in the hobby-loss area, and not to business losses. The court held that a taxpayer satisfies the profit motive requirement if, at the time of the transaction, the taxpayer had a reasonable expectation of making a reasonable pre-tax profit. Applying this test, the Court of Claims held that

[199] 83 T.C. 542 (1984), *aff'd*, 798 F.2d 65 (2d Cir. 1986).
[200] Baron, 83 T.C. at 558.
[201] Johnson v. United States, 11 Cl. Ct. 17 (1986).

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the taxpayer therein had such a reasonable expectation, rejecting the Service's argument that the profit expectation of 6 percent was too low. The Court explicitly stated that tax motives were irrelevant – the sole question was whether the taxpayer, in fact, had a profit motive.

As discussed above, Investor had a reasonable expectation of a reasonable pre-tax profit from its investments. Since Investor had a profit motive and a reasonable expectation of profit, the analysis of the Tax Court in Baron and the Court of Claims in Johnson is more on point to the instant situation than Fox and its progeny, which involved straddle cases in which the potential for economic profit was minimal or non-existent. Thus, we believe the better argument is that the "primarily for profit" test articulated in Fox will not apply where the taxpayer is motivated at least in part by profit potential, and that a test similar to that applied by the Tax Court in Smith (bona fide hope of deriving an economic profit), the Tax Court in Baron (a weighing of all factors, including tax motivations), and the Court of Claims in Johnson (reasonable expectation of a reasonable profit, with tax motivations disregarded) will instead by applied under both Code Sections 165(c)(2) and 183.

d. Notice 99-59

In Notice 99-59,[202] the Service announced that tax losses generated by a specific investment strategy were not allowable for federal income tax purposes. The arrangement targeted by the IRS typically involves taxpayers who, acting through a partnership, contribute cash to a foreign corporation in exchange for common stock. Another party contributes additional capital to the corporation in exchange for preferred stock. The foreign corporation then borrows additional capital from a bank and gives the bank a security interest in securities that equals the value of the loan. The foreign corporation then distributes the encumbered securities to the partnership. As a result of that distribution and other fees and transaction costs, the remaining value of the common stock is reduced to zero or a minimal amount.

Sometime later, the foreign corporation, as agreed by the parties, repays the bank debt with other corporate assets. Although the parties previously treated the debt as reducing the amount of the earlier distribution, according to the notice, promoters of this strategy

[202] 1999-52 I.R.B. 761

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advised investors to take the position that the foreign corporation's repayment of the debt is not a distribution of its common stock.

The Service contends in Notice 99-59 that the losses generated by this arrangement (or any similar arrangement) lack economic substance under ACM Partnership, *supra*. According to the Service, through a series of contrived steps, taxpayers claim tax losses for capital outlays that they have in fact recovered. Also according to the Service, such artificial allowances are not allowable for federal income tax purposes. Also, in the view of the Service, the purported benefits from the transactions "may also be subject to challenge under the provisions of the Code and regulations, including, but not limited to sections 269, 301, 331, 446, 475, 482, 752, and 1001 of the Code."

The Service also cites Sculley v. United States, 840 F.2d 478, 486 (7th Cir. 1987) (to be deductible, a loss must be a "genuine economic loss"), and Shoenberg v. Commissioner, 77 F.2d 446, 448 (8th Cir. 1935) (to be deductible, a loss must be "actual and real"). In Scully, the Seventh Circuit held that there was no deductible loss involving the sale of real estate by trustees of the family trust to other family trusts with the same fiduciaries, beneficiaries and remaindermen. The disposition merely resulted in a reshuffling of assets which resulted in no "genuine economic loss" because the taxpayer retained control over the property – i.e., the sale was effectively a circular transaction with no economic substance. Citing from 7 J. Mertens, Law of Federal Income Taxation § 28.26 (1980), the Court relied upon the following principle for its conclusion that the loss incurred on the sale of the real estate was not deductible:

> Losses will not be allowed which are claimed in connection with transactions which do not vary control or change the flow of economic benefits. . .
>
> . . . .
>
> [A taxpayer] will not be permitted to transfer assets from one pocket to another and take a loss thereby where he remains at the conclusion of the transfer the real owner of the property, either because of retention of title, command over the property, either directly or through the person who appears as the nominal vendee or transferee.

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In the instant situation, Investor did not continue to own, beneficially or otherwise, the asset the disposition of which generated a loss. Thus, the above stated principle and, therefore, the reasoning set forth in Sculley for denying a loss deduction, are not applicable to the subject transaction.

In Shoenberg, the Eighth Circuit held that there was no deductible loss where an investor sold stock at a loss and on the same day bought the same number of identical shares though his investment company. A little more than thirty days later, the investor purchased the shares from his investment company at a lower price than that for which he had originally sold them. The Eighth Circuit denied the investor's loss deduction, stating that "where such sale is made as part of a plan whereby substantially identical property is to be reacquired and that plan is carried out, the realization of loss is not genuine and substantial; it is not real." Economically, the transaction was again a circular transaction with no economic substance. Shoenberg, like Sculley, is a case in which the court held that a loss was not realized by the taxpayer because the taxpayer held the same beneficial interest in the purportedly sold assets both before and after the sales. As previously stated, in the instant situation, Investor did not continue to own, beneficially or otherwise, the asset the disposition of which resulted in a loss. Accordingly, the reasoning set forth in Shoenberg for denying a loss deduction also is not applicable to the subject transaction.

Furthermore, we have concluded above that the transactions entered into by Investor do not lack economic substance under ACM. Finally, the Code sections cited in Notice 99-59 are specific to the investment strategy described therein.[203] Accordingly, Notice 99-59 does not change our opinion that it is more likely than not that Investor's participation in the Investment Fund satisfies the economic substance doctrine and the requirements for deducting a loss under Code Section 165(c)(2).

IV. Conclusion

Based on and subject to the facts, documentation and representations described and our discussion, and our analysis of the relevant statutory provisions and judicial doctrines, we believe that, under current U.S. income tax law, there is a greater than 50 percent

[203] In any event, the applicability of the relevant Code sections to Investor's participation in the Investment Fund is considered throughout this opinion letter.

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likelihood (i.e., it is "more likely than not") that the following positions will be upheld if challenged by the Internal Revenue Service:

- The $20,000,000 loan premium will not constitute a liability of Investor or Partnership for purposes of Code Section 752, but represents an addition to the $33,300,000 loan to be amortized under Treas. Reg. Section 1.163-13 against the issuer's interest expense over the life of the loan;

- Investor will recognize no gain or loss upon receipt of the loan proceeds of $33,300,000, including the loan premium of $20,000,000;

- Investor will be recognized as the true borrower of the loan for U.S. federal income tax purposes;

- Investor will recognize no gain or loss with respect to its capital contribution of $54,700,000 to Partnership subject to the $33,300,000 loan;

- The fixed rate debt instrument and interest rate swap will not be integrated under Treas. Reg. Section 1.1275-6(c)(2);

- Upon liquidation of Investor's Partnership interest, Investor's adjusted basis of $21,400,000,[204] plus or minus its allocable share of Partnership income or loss in its Partnership interest is first reduced by actual cash received of $348,733 and the residual amount is allocated to the financial instruments distributed;

- The difference between the basis allocated to the financial instruments received in a liquidating distribution and the proceeds received upon disposition of such financial instruments will be deductible by Investor's sole member as an capital loss under Code Section 165(a) subject to Code Section 165(f) which provides that losses from sales or exchanges of capital assets are allowed only to the extent allowed in Code Sections 1211 and 1212;

- Investor's sole member's Code Section 465 "at risk" amount for its taxable year ending on December 31, 1999, includes the cash and the adjusted basis of the assets distributed to Investor as liquidating distributions by Partnership;

[204] See Footnote 13.

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- Partnership income (or loss) and the loss upon disposition of the assets received by Investor upon liquidation of its interest in Partnership will not be subject to limitation under the Code Section 469 passive activity loss rules;

- Investor's issuance of the debt instrument will not have a substantial effect on the issuer's U.S. income tax liability that could be construed as unreasonable in light of the purposes of Code Sections 163(e), 1271 through 1275, or 701-777.

Our conclusions are based on the completeness and accuracy of the above-stated facts, representations and assumptions. If any of the foregoing is not entirely complete or accurate, it is imperative that we be informed immediately, as the inaccuracy or incompleteness could have a material effect on our conclusions. We are relying upon the relevant provisions of the Internal Revenue Code of 1986 as amended, the regulations thereunder, and the judicial and administrative interpretations thereof, all as in effect as of the date of this letter. These authorities are subject to change or modification by subsequent legislative, regulatory, administrative, or judicial decisions. Any such changes also could have an effect on the validity of our conclusions. Unless separately engaged to do so in writing, we will not update our advice for subsequent changes or modifications to the law and regulations or to the judicial and administrative interpretations thereof.

Very truly yours,

KPMG LLP

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December 31, 1999

Permanent Subcommittee on Investigations
Markings on Exhibits 90a and 90b were made by the Permanent Subcommittee on Investigations to draw attention to virtually identical language in the two purportedly independent tax opinions.

You have requested our opinion regarding the U.S. federal income tax consequences of certain investment transactions that have been concluded by
("Investor"), a Delaware single-member limited liability company. As more fully described below, Investor participated in a series of transactions involving investments in foreign currency-based securities and derivative contracts through an investment fund. The investment transactions were structured through an investment program (the "Investment Fund") designed by Presidio Growth LLC ("Presidio"). Presidio is an independent investment advisor registered under the Investment Advisers Act of 1940 that specializes in structured financial products and the execution of associated investment and derivative-based trading strategies.

Presidio acted as investment advisor and managing member (the "Managing Member") with respect to Investor's participation in the Investment Fund. Prior to its entry into the Investment Fund, Presidio provided to Investor the attached Strategic Investment Fund Confidential Memorandum that sets forth the potential financial returns and risks from participation in the investment program. Based upon Investor's independent assessment of the Strategic Investment Fund Confidential Memorandum, Investor has represented that Investor believed that there was a reasonable expectation of earning a reasonable pre-tax profit from the investment transactions described that would be in excess of all associated fees and costs, without regard to any tax benefits that might occur.

Permanent Subcommittee on Investigations
EXHIBIT #90b

XX-001857

I. **Description of Investment Transactions**

A: **Overview of Investment Program**

The following describes the investment program entered into by Investor and the investment structure utilized based upon information provided to us by Presidio. A more detailed explanation of the underlying investment strategy devised by Presidio is contained in the attached Strategic Investment Fund Confidential Memorandum.

Presidio has represented the following relative to the investment program entered into by Investor:

> Since inception of floating exchange rates in 1973, all currencies have been subject to wide swings in value. The general consensus by the international financial community is that exchange rate volatility is undesirable because of the adverse impact these swings have on international capital flows. Consequently, many governments influence the level of their currency by intervening in foreign exchange markets. Emerging market governments are typically more active participants in their respective currency markets because emerging market currency levels are more easily controlled and the benefits to the emerging market nations are more significant. By controlling the level of their currency, emerging market nations encouraged capital inflows by mitigating the risk of currency devaluation. In addition, by entering into a managed currency regime, the emerging market nation can curb hyperinflation, a problem faced by many emerging market nations due to a combination of rapid growth and imprudent fiscal management common to many of these countries.
>
> The Investment Fund entered into by Investor was established by Presidio as an investment that sought to provide investors with a high total return. To obtain this objective, the Investment Fund invested in U.S. dollar and foreign currency denominated debt securities of corporate and governmental issuers and entered into forward foreign currency contracts, options on currencies and securities and other investments selected by Presidio, as Managing Member of the Investment Fund.[1]

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[1] An investment in the Investment Fund increased or declined in value as a result of changes in the value of the securities in which the Investment Fund invested and the currencies and securities underlying the forward foreign currency contracts and options.

It was Presidio's belief that successful implementation of its investment strategy could best be achieved through a relatively long-term investment horizon. Accordingly, the Investment Fund was structured as a three stage, seven year investment program. The core investment strategy underlying all three stages was to maintain long or short positions in debt securities and currency exchange contracts. Through such investments, the Investment Fund sought to profit from changes that Presidio anticipated would occur in the value of the currencies in which such securities were denominated or quoted or to which the forward currency exchange contracts related.[2]

The three investment stages were differentiated by the degree of risk assumed by the Investment Fund. In each successive stage, Presidio was to allocate a greater percentage of the Investment Fund's assets to securities and currency positions that allowed a greater opportunity for profit but also correspondingly greater risk. Reflecting the greater degree of risk, Presidio could require investors to make additional capital contributions. However, the aggregate contributions of an investor could not exceed the amount to which such investor agreed at the time of subscription to the Investment Fund. The obligation to make additional capital contributions terminated if the investor notified Presidio of its election to withdraw its entire capital account balance from the Investment Fund.

The anticipated time horizons and associated investment strategies for the three stages at the time Investor entered into the Investment Fund were as follows:

- *__Stage I:__* The first stage was expected to last 60 days, during which time the Investment Fund would engage in strategies that the Managing Member believed entailed relatively low levels of risk compared to later investment stages. An example of a strategy that could be used during this stage was for the Investment Fund to sell short currencies under managed currency regimes ("pegged currencies") that the Managing Member believed were likely to depreciate in the short term.

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2 These profit opportunities were primarily based upon selectively selling ("shorting") overvalued emerging market currencies and selectively buying ("going long") undervalued emerging market currencies. The investment strategy effectively sought to obtain high risk-adjusted returns for its investors by exploiting opportunities to short currencies under unsustainable managed currency regimes and going long currencies previously subject to managed currency regimes that were considered fundamentally undervalued by Presidio due to political or economic upheaval. By monitoring the economic conditions in emerging market countries and the direction of the currency markets, Presidio sought to identify, and profit from, those currency devaluations which were most likely to occur over the life of the Investment Fund.

- ***Stage II:*** The second stage of the investment strategy was expected to last approximately 120 days. During stage two, the Investment Fund would pursue similar investment strategies as during stage one. However, the degree of risk taken by the Investment Fund would increase. More of the Investment Fund's capital was to be allocated to riskier positions, resulting in higher potential profit but also higher potential losses and volatility. Due to the increase in risk during investment stage two, the members could be required to increase their capital contributions to the Investment Fund.

- ***Stage III:*** The third stage of the investment strategy was expected to last approximately 6.5 years. During the third investment stage, the Investment Fund would pursue investment strategies that had the potential for greater rewards but also would entail substantially greater risk. For example, in addition to maintaining short positions in pegged currencies which the Managing Member believed to be overvalued, the Investment Fund could establish long positions in emerging market currencies that have recently been devalued. By buying debt securities denominated in recently devalued currencies or entering into forward currency exchange contracts after a devaluation, the risk profile of the Investment Fund would be higher than during the first two stages; however, the potential returns were expected to be commensurately higher.[3]

The minimum investment for an investor in the Investment Fund was $10 million in return for a Class A interest. Contributions to the Investment Fund had to be in cash. At the discretion of Presidio, as the Managing Member, the Investment Fund allowed a Class A Member to contribute cash subject to indebtedness at the time of subscription. If an investor funded its investment capital through a loan, the Managing Member required investors to arrange at least seven-year financing in order to cover the expected term of the program.[4] In addition to one or more Class A Members and the Managing Member, the Investment Fund allowed for one or more holders of Class B interests. The Class B Member(s) were affiliates of the Managing Member.

Class A Members had the right to withdraw all (but not part) of their capital account balances upon written request to the Managing Member beginning on the

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[3] Presidio believed that currencies which had recently been devalued typically were undervalued due to economic upheaval and abnormally high interest rates. The value of these currencies may, however, be particularly volatile.

[4] Presidio effectively allowed an investor a choice of funding its participation in the Investment Fund on either a non-leveraged basis or a leveraged basis by contributing cash subject to an outstanding loan to the Investment Fund.

60th day following the Class A Member's initial investment and each 60 day anniversary thereafter provided that the Managing Member received the written request at least 10 business days prior to such date. Unless the Managing Member otherwise agreed, Class B Members could only withdraw their capital account balances following the withdrawal by all of the Class A Members. In lieu of accepting a Class A Member's withdrawal request, the Managing Member could have elected either to liquidate the Investment Fund or to arrange for the purchase of the Class A Member's interest at a price equal to the withdrawal proceeds that the Class A Member would otherwise have received.

B. The Investment Structure

On September 30, 1999 Investor obtained a $33,300,000 fixed rate nonrecourse loan ("Loan")[5] from Deutsche Bank AG ("Bank"). Under the terms of the credit agreement (the "Credit Agreement")[6] between Bank and Investor, the $33,300,000 principal amount of the Loan was payable on the seventh anniversary of the borrowing date.[7] Interest on the Loan was payable quarterly at a rate of 17.557 percent per annum. The Loan proceeds were initially transferred to Investor's personal bank account at Bank and then immediately transferred to Investor's trading account at Bank.

Presidio has represented to us that Investor opted to repay the Loan at a 17.557 percent interest rate in return for a premium payment of $20,000,000 ("Premium") in order to lessen the financial risks associated with participation in the Investment Fund. As discussed, the Investment Fund uses a three stage approach with increasing levels of investment risk in each subsequent stage. Presidio further represented to us that Investor entered into a financing arrangement whereby higher levels of financing risks were incurred early in the program, with such risks declining as the Loan premium amount was amortized over the term of the Loan. According to Presidio, the structure of Investor's Loan results in an integrated investment

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5 Section 9.14 of the Credit Agreement states that Bank agrees and acknowledges that neither it (nor any of its affiliates) shall have any recourse against the Investor or any of its assets or property other than the pledged collateral.

6 Any future references to the Credit Agreement incorporating terms defined within the Credit Agreement will use the convention of capitalizing such terms.

7 Under the terms of the Credit Agreement (Section 3.01), Investor had the ability to prepay the loan subject to any applicable prepayment penalties and breakage fees. Pursuant to Section 3.02 of the Credit Agreement, the amount of any prepayment penalty is a function of interest rates at the time of prepayment.

strategy whereby there are complementary levels of investment risks and financing risks at all times during the term of the Investment Fund. By having the loan premium structure, it is the view of Presidio that it is possible to match investment risks with financing risks.[8]

The investment program entered into by Investor was structured through Longs Strategic Investment Fund, LLC, a Delaware limited liability company ("Partnership") that was treated as a partnership for U.S. federal income tax purposes.[9] Presidio, through two limited liability companies, contributed $155,554 to Partnership for a 1% interest as Managing Member and a 9% Class B interest.[10] Investor contributed $54,700,000[11] subject to the $33,300,000 nonrecourse Loan to Partnership for a 90 percent Class A interest on October 12, 1999.[12] The assumption of the Loan by Partnership was approved by Bank pursuant to the Assignment and Assumption Agreement dated October 12, 1999. To mitigate its risk position with respect to interest rate changes during the term of the Loan, Partnership entered into a fixed-for-floating rate interest rate swap with Bank for a term of approximately seven years.[13]

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8 Presidio has represented to us that over the seven-year term of the loan, an investor would be exposed to several types of financial risks resulting from potential changes in interest rates. Of particular concern to an investor is residual interest rate risk (the "convexity" effect). According to Presidio, Investor has managed residual interest rate risk through the structuring of a financing package with a loan premium as its integral economic component. See the attached discussion of the underlying financial theory in the "Analysis of Financing Alternatives" prepared by Presidio. In the analysis, Presidio recommends the use of the loan premium structure to mitigate residual interest rate risk.

9 A limited liability company with multiple members can elect to be classified as a partnership or as an association taxable as a corporation. Absent an election, a domestic multi-member limited liability company will automatically be classified as a partnership pursuant to Treas. Reg. Sec. 301.7701-3(b)(1)(i).

10 Presidio Growth LLC was the Managing Member with a 1% interest in Partnership and Presidio Resources LLC had the 9% interest.

11 The capital contribution stated in this opinion letter does not reflect a de minimis amount of accrued interest earned by Investor during the period between the time of entering into the loan and the contribution of the proceeds to Partnership. Accordingly, future references in this Opinion to the capital contribution by Investor and Investor's adjusted basis in Partnership or any distributed asset do not reflect such accrued interest. Such references are merely made to illustrate the operation of applicable tax laws to Investor's transactions, and do not imply that we are opining on the precise amount of Investor's capital contribution or adjusted basis.

12 Bank represented that there was no plan or intention to require Investor to convey the loan proceeds or assign the loan obligation to Partnership.

13 Partnership entered into the fixed-to-floating rate swap to hedge interest duration risk. Duration

The Limited Liability Company Agreement of the Partnership required that capital accounts be maintained pursuant to Code Section 704(b) and the Regulations promulgated thereunder. In general, Partnership net profits and losses were allocated among the Members as follows: 90% to the Class A Members, 9% to the Class B Members and 1% to the Managing Member except for a management fee, which was allocated to the Class A and Class B Members on the basis of their capital account balances. The Class B Members were entitled to a preferred return equal to 12% per year (or any portion thereof) of their capital account balances before any allocation of profit was made to the Class A Members or the Managing Member.

C. **Subsequent Events and Investment Results**

On December 13, 1999, upon completion of Stage I of the Investment Fund, Investor opted to terminate its participation in the Investment Fund. As a result of Investor not opting to participate in Stage II of the Investment Fund, Investor elected to have its Partnership interest redeemed. On December 13, 1999, Investor's Partnership interest was liquidated. Investor's liquidating distribution consisted of the following Partnership assets:

• Cash	$348,733
• 425 shares of Microsoft Corp.	$39,897

Subsequent to Investor's withdrawal from Partnership, Partnership continued making investments with the remaining partnership assets utilizing the $33,300,000 Loan for financing. The covenants contained in the Credit Agreement allowed Bank to call the $33,300,000 Loan if the Investor ceased to own directly or indirectly at least a majority of the outstanding membership units in Partnership (an "Event of Default") upon giving written notice to Partnership.

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risk (or more precisely "modified" duration) is a measure of the price sensitivity of a bond to interest rate movements. It is used to measure the sensitivity of a bond's price (i.e., the present value of its cash flows) to interest rate movements. A swap from fixed-to-floating can be used to hedge interest rate duration risk. See attached discussion of the underlying financial theory in the "Analysis of Financing Alternatives" prepared by Presidio.

II. Representations

A. Representations Made by Investor

In connection with the transactions described above, Investor has represented the following:

1. Investor's single member invests directly in marketable securities and other financial instruments on Investor's own account.

2. Investor acted independently of, and at arm's length from, the Managing Member, the Class B Member and Bank with respect to the transactions described herein.

3. There was no legally binding agreement, written or otherwise, that compelled Investor to complete the transactions in the way described herein. The duration of Investor's participation in the Investment Fund was dependent upon the performance of the program relative to alternative investments.

4. There were no written agency agreements or arrangements (apart from Presidio's role as Managing Member of Partnership) consummated with respect to the transactions undertaken pursuant to the Investment Fund and neither Investor, nor to the best of Investor's knowledge, any parties involved held themselves out to a third party as agents of any of the others with respect to these transactions.

5. Investor independently reviewed the economics underlying the Investment Fund before entering into the program and believed there was a reasonable opportunity to earn a reasonable pre-tax profit from the transactions described herein (not including any tax benefits that may occur), in excess of all associated fees and costs.

6. Investor's sole member[14] sold a portion of the financial instruments received as the Partnership liquidating distributions.

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[14] As a single member limited liability company for which no check-the-box election was made, Investor is disregarded as an entity separate from its owner. Accordingly, for tax purposes, any transactions entered into by Investor are treated as entered into directly by Investor's sole member. For stylistic purposes, references may be made in this opinion to transactions entered into by (or to the tax consequences of such transactions) "Investor's sole member." Such references to "Investor's sole member" are made to indicate that the resulting tax consequences are borne by Investor's sole member, whereas the actual transaction at issue may have been entered into by Investor.

7. Investor has provided all facts and circumstances that Investor knows, or has reason to know, are pertinent to this opinion letter and believes that all its representations on which this opinion relies are reasonable.

8. Investor and Investor's sole member each use the U.S. dollar as its functional currency.

9. The capital contribution, made by Investor's sole member, was made from Investor's sole member's separate property.

B. <u>Representations Made by Presidio</u>

In connection with the transactions described above, Presidio has represented the following:

1. Presidio believed there was a reasonable opportunity for Investor to earn a reasonable pre-tax profit, in excess of all associated fees and costs, and without regard to any tax benefits that may occur, by participating in the Investment Fund. Presidio communicated this belief to Investor.

2. Presidio acted independently of, and at arm's length from, Investor and Bank with respect to the transactions described herein.

3. Bank did not, directly or indirectly, control or participate in the management or operations of Partnership.

4. Bank did not, directly or indirectly, control or direct the investments of Partnership apart from its rights under a Pledge and Security Agreement, Credit Agreement, and Account Control Agreement.

5. All of Partnership's foreign currency transactions were conducted over the counter. Therefore, Partnership did not undertake transactions on a national securities exchange registered with the Securities and Exchange Commission. Furthermore, Partnership did not undertake transactions on a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission.

6. There did not exist at the time Investor or any assignee entered into trading strategies, within the range of Permitted Investments, an Event of Default under the terms of the Credit Agreement.

7. Neither the Investor nor any assignee entered into trading strategies, within the range of Permitted Investments, in a manner that results in or causes an Event of Default under the terms of the Credit Agreement.

8. The Loan collateral and covenants were not altered or amended upon assumption of the Loan by Partnership.

9. The descriptions of the Investment Fund and the economics of the financing arrangement used by Investor, as set forth in the Overview of Investment Program and The Investment Structure sections of this opinion letter, and in the attachments hereto, are accurate.

10. Any amount due under the Note, other than the aggregate outstanding principal amount, any accrued but unpaid interest, and the unamortized premium is expected to be incidental (i.e., under all reasonably expected market conditions on the date of issuance of the Note, the potential amount of any such payment would be insignificant relative to the total expected amount of the remaining payments on the Note).

C. Representations Made by Bank

In connection with the transactions described above, Bank has made the following representations:

1. The Loan made pursuant to the Credit Agreement was approved by the competent authorities within Bank as consistent, in the light of all the circumstances such authorities consider relevant, with Bank credit and documentation standards.

2. Bank acted independently of, and at arm's length from, Investor and the other participants in the Investment Program.

3. Bank recorded for U.S. GAAP accounting purposes and U.S. regulatory purposes the Stated Principal Amount and the Initial Unamortized Premium Amount of the Loan made pursuant to the Credit Agreement as follows: a $33,300,000, seven-year loan and a $20,000,000 unamortized premium amount, respectively.

4. The Credit Agreement provides that the Maturity Date of the Loan made thereunder is the seventh anniversary of the applicable Borrowing Date. Furthermore, Section 8 of the Credit Agreement sets forth the conditions upon which the principal of and any accrued interest in respect of the applicable Note, the applicable Prepayment Amount, if any, the applicable Breakage Fee, if any, and all other obligations owing under such Credit Agreement and the applicable

Note may be declared to be, or become, due and payable prior to the applicable Maturity Date. Except as provided in such Credit Agreement, Bank would not accelerate any stated principal or interest payment due under the Credit Agreement.

5. While as part of the negotiation of the form of the Credit Agreement a form of Assignment and Assumption Agreement was negotiated and it was the expectation of Bank that the Bank (as defined in the Credit Agreement) would be requested to give its consent to an assignment of the applicable Borrower's rights and obligations under the Credit Agreement pursuant thereto to the Presidio limited liability company used to effectuate the Investment Program, the Credit Agreement would not require the Borrower to assign the Loan made thereunder to any Person and Bank had no plan or intention to require such assignment.

III. Summary of Opinions

In rendering our opinions, we have reviewed representations and advice, including financial information, from various parties to the transactions described herein and made certain assumptions, which representations, advice and assumptions are referred to below. In rendering our opinions, we have also examined such agreements, certificates, instruments, and documents, and we have made such other inquires of officers, owners and representatives of the entities involved in the transactions described herein as we have considered necessary to render the opinions set forth herein. We have made no independent verification of such representations, advice, assumptions, records, agreements, certificates, instruments, documents, and responses to such inquiries. If any such representations, advice, assumptions, records, agreements, certificates, instruments, documents, or responses is inaccurate in any material respect, or any such agreements, certificates, instruments, and documents prove not to be authentic the opinions contained herein may not be relied upon. In rendering our opinion, we have reviewed the applicable provisions of the Code and of the final, temporary, and proposed Treasury Regulations ("Treas. Reg." or "Treasury Regulations") promulgated thereunder; relevant decisions of the U.S. Federal courts; published Revenue Rulings ("Rev. Rul.") and Revenue Procedures ("Rev. Proc.") of the Internal Revenue Service ("IRS"); and such other materials as we have considered relevant. In certain instances we have determined that there is no authority directly on point, and in such instances we have reached our opinion reasoning from such other authority as we believe to be relevant to the issues addressed.

Although we are not representing Presidio in connection with the transactions described herein, in the past we have represented Presidio and persons affiliated with Presidio with respect to certain matters and may continue to do so in the future. By accepting this opinion, you have agreed to waive any legal conflict that may arise from such past or future representation.

Based on and subject to the summary set out at I above, the representations set out at II above and the analysis of the pertinent statutory provisions at Sections IV. A-F below, as affected by the analysis of the statutory provisions and legal doctrines at IV. G below, all as of the date hereof, we are of the opinion that for U.S. federal income tax purposes it is more likely than not[15] that:

1. Investor will recognize no gain or loss upon receipt of the Loan proceeds of, including the Premium, which represents an amount to be amortized under Treas. Reg. §1.163-13 against the issuer's interest expense over the life of the Loan;

2. The Commissioner of Internal Revenue will have no authority under Treas. Reg. §1.1275-6(c)(2) to integrate the fixed rate debt instrument and interest rate swap;

3. Investor will recognize no gain or loss with respect to its capital contribution of the Loan proceeds, including the premium, and other property to Partnership subject to the Loan; and the amount of the liability to be taken into account under Code Section 752 with respect to the Loan is the principal amount of the Loan;

4. Investor's basis in its interest in the Partnership will be equal to Investor's basis in the contributed property, reduced by the principal amount of the Loan to which the contributed property was subject, and increased by Investor's share thereof;

5. Upon redemption of Investor's interest in the Fund, Investor's adjusted basis in its Fund interest immediately before such distribution, reduced by the amount of any money distributed to Investor in the redemption, will be allocated to the financial instruments distributed to Investor in the redemption; and

6. Any loss recognized by Investor upon the disposition of financial instruments distributed to Investor in the redemption will be characterized as a capital loss.

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15 Under a "more likely than not" standard, we are of the opinion that under current U.S. federal income tax law there is a greater than 50 percent likelihood (i.e., it is "more likely than not") that the positions taken will be upheld if challenged by the Internal Revenue Service.

IV. Analysis

A. Receipt of Loan Proceeds

Bond issuance premium[16] is the excess of a debt instrument's issue price over its stated redemption price at maturity ("SRPM"). Under Code Sections 1273(b)(1) - (5) and 1274, the issue price of a debt instrument depends on the circumstances surrounding its issuance. For other debt instruments not issued for property[17], including a bank's lending transactions, the issue price under Code Section 1273(b)(2) is the amount paid by the first purchaser. Treas. Reg. §1.1273-2(a)(1) reiterates this rule and further provides:

> [I]f the issue consists of a single debt instrument that is issued for money, the issue price of the debt instrument is the amount paid for the instrument.

Consequently, in the instant case, the issue price of the Loan under Code Section 1273(b)(2) is the sum of the principal amount of the Loan and the amount of the Premium.

Code Section 1273(a)(2) defines SRPM to include all amounts payable under the debt instrument (other than interest based on a fixed rate or an objective interest index, and payable unconditionally at fixed intervals of one year or less during the entire term of the debt instrument.) In the instant case, the Loan's SRPM is its principal amount. Thus, the bond issuance premium is the excess of the obligation's issue price under Code Section 1273(b)(2), described above, over the SRPM, i.e. the Premium.

Under Treas. Reg. §1.61-12(c), prior to amendment by the final regulations, the issuer of a premium debt instrument took the premium into account as a separate item of income over the

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16 The Code and Regulations refer to all forms of indebtedness as "debt instruments." The term "bond" has the same meaning as the term "debt instrument" in Treas. Reg. §1.1275-1(d)[16]. Thus, the terms are used interchangeably for purposes of this opinion.

17 For purposes of applying the above rules, the term "property" includes services and the right to use property, but does not include money. In transactions to which Code Section 1273(b)(2) applies, a payment from the borrower to the lender (other than a payment for property or for services provided by the lender such as commitment fees or loan processing costs) reduces the issue price of the debt instrument evidencing the loan. Solely for purposes of determining the tax consequences to the borrower, the issue price is not reduced if the payment is deductible under Code Section 461(g)(2). Treas. Reg. §1.1273-2(g)(2). Therefore, any payment of points to obtain the loan will reduce the obligation's issue price.

life of the debt instrument and interest payable was also a separate deductible item. However, under amended Treas. Reg. §1.61-12(c)(1), an issuer does not recognize gain or loss upon the issuance of a debt instrument. Accordingly, we are of the opinion that it is more likely than not that Investor will recognize no gain or loss upon receipt of the total Loan proceeds, including the bond premium.

Under Treas. Reg. §1.163-13, a borrower/issuer amortizes the bond issuance premium by offsetting the qualified stated interest[18] allocable to an accrual period[19] with the bond issuance premium. Thus, rather than bond premium creating an item of income over the term of the bond as under Prop. Treas. Reg. §1.61-12(c), the interest deduction otherwise allowable under Code Section 163 is reduced by the amount of bond issuance premium allocable to the period. The interest deduction amount and amortization of bond issuance premium are determined on a constant yield method and accrue ratably within an accrual period. The amount of bond issuance premium allocable to an accrual period is the product of the debt instrument's adjusted issue price[20] at the beginning of each period and its yield to maturity[21] as adjusted to reflect the length of the period. In the instant case, the Premium will be amortized ratably as an offset to Investor's interest expense deductions for each accrual period.[22]

It is possible that the IRS might contend that the Loan was made directly by Bank to Partnership, rather than to Investor, who then contributed the Loan proceeds to the Partnership

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18 As defined in Treas. Reg. §1.1273-1(c).

19 Treas. Reg. §1.446-2(b) determines the accrual period to which qualified stated interest is allocable and the qualified stated interest allocable to an accrual period.

20 Determined under Treas. Reg. §1.1275-1(b).

21 Determined under Treas. Reg. §1.1272-1(b)(1)(i).

22 We have been advised by KPMG Peat Marwick that for financial accounting purposes a loan discount or premium is not an asset or liability separate from the note giving rise to it, but is reported as a direct deduction from, or addition to, the face amount of the loan. Conceptually, a premium on debt payable is a liability valuation account that has no existence apart from the related debt. For financial accounting purposes, based upon U.S. generally accepted accounting principles, the premium account is referred to as an adjunct account. Similarly, Treas. Reg. §1.163-13 clarifies that the issuer determines its interest deduction by offsetting the interest allocable to an accrual period with the bond issuance premium allocable to that period. This change effectively makes the tax accounting rules consistent with the financial accounting rules by recognizing that premium and discounts are merely valuation accounts, not discrete liabilities or assets.

subject to the Loan. Were the IRS successful in so contending, the Investor would not be treated as receiving the Premium and contributing it to the Partnership, with the result that the Investor's tax basis in the Partnership would not be increased by the amount of the contributed Premium, as discussed below.

The issue of who is the borrower in comparable situations has been raised by the IRS in the context of whether a loan was made to an S corporation or its shareholder. The most recent decision to address this is Bolding v. Comm'r, 117 F.3d 270 (5th Cir. 1997), rev'g T.C. Memo. 1995-326. In Bolding, the shareholder of an S corporation established a $250,000 line of credit with the bank in the shareholder's own name. The party on the line of credit was the shareholder and not the S corporation. The Bank's records appeared to have shown the shareholder rather than the corporation as the approved borrower, and the shareholder signed the loan agreement in his own name. The bank took and perfected a security interest in corporate assets, but the shareholder was the sole signatory to the UCC 1 filed by the bank. The bank disbursed the loan proceeds directly to the corporation's bank account, and interest and principal payments were made to the bank on checks drawn by the corporation. When a default subsequently occurred, the bank sued the shareholder. The Court of Appeals recognized that the form of the transaction was a loan to the shareholder and not to the corporation and refused to accept the IRS argument that the substance of the transaction was a loan directly to the corporation on the grounds that the parties clearly intended the loan to be to the shareholder, as evidenced by the parties' records and financial statements and further evidence that upon default the bank pursued it remedies against the shareholder.

Similarly, in Selfe v. U.S., 778 F2d 769 (11th Cir. 1985), the of Appeals remanded the case to the U.S. District Court for a determination of whether a loan to an S corporation that was guaranteed by its shareholder was in was in substance a loan to the guarantor, based on Plantation Patterns v. Comm'r, 462 F.2d 712 (5th Cir. 1972).[23] In Plantation Patterns, the court determined that a solvent shareholder of a thinly capitalized corporation was the true borrower, where the bank made the loan in form to the corporation, but the evidence before the court made clear that the bank was looking to the guarantor for repayment. In this regard Bolding and

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[23] Est. of Leavitt v. Comm'r, 90 T.C. 206 (1988), aff'd , 875 F.2d420 (4th Cir. 1989), cert. denied, 493 U.S. 958 (1989), the Tax Court over a strong dissent, stated that it would not the reasoning of Selfe, to apply the Plantation Patterns rationale to cases involving S corporations.

Plantation Patterns are consistent in looking to who the parties intended to be the borrower and to repay the loan in determining who should be treated as the borrower for U.S. federal income tax purposes. See also, Goodstein v. Comm'r, 267 F.2d 127 (1st Cir. 1959), affg 30 T.C. 1178 (1958).

An additional line of relevant cases deal with loans by one party to an intermediary party who re-lends to another party (a so-called back-to-back loan). The principal case is Northern Indiana Public Service Co. v. Comm'r, 115 F.3d 506 (7th Cir. 1997), where the court held that a finance subsidiary engaged in a back-to-back loan arrangement was not treated as a conduit merely because it was thinly capitalized. Most importantly, the court focused on the fact that the finance subsidiary earned a positive spread on its lending activity. The court also emphasized that the intermediary was not merely transitory and that the intermediary exercised dominion and control over interest proceeds. By contrast, in Aiken Industries, Inc. v. Comm'r, 56 TC 925 (1971), the intermediary was a mere conduit because it earned no profit (and, thus, was not respected as the borrower).

The facts in the instant case support the treatment of Investor as the true borrower due to the existence of a business purpose for Investor entering into the loan and the bona fide nature of the debt. Investor was able to effectively guarantee a minimum initial amount of financial leverage by borrowing prior to the contribution to Partnership. In addition, we believe that the bona fide nature of the debt as evidenced by the underlying Credit Agreement and the existence of economic risk and reward with respect to holding the Loan proceeds during the period between the time of entering into the loan and the contribution of the proceeds to Partnership is a key determinant with respect to Investor being recognized as the true borrower.

The underlying loan documentation clearly establishes that Investor was the true borrower:

- The loan was entered into by Investor in its individual capacity, not as a representative (or member) of Partnership.
- Investor signed the Credit Agreement in its individual capacity.
- The cash proceeds were initially transferred to Investor's personal bank account and then immediately transferred to its securities trading account, not the account of Partnership.

Upon assumption of the Loan by Partnership, the Assignment and Assumption Agreement provided that the Loan was originally entered into by Investor and assumed by Partnership. The assumption of the Loan had to be approved by Bank and was subject to a significant number of condition precedents. Bank has represented that there was no plan or intention to require Investor to convey the Loan proceeds or assign the Loan obligation to Partnership.

With respect to economic risk and reward, during the period before the Loan proceeds were contributed to Partnership, Investor had "dominion and control" of the Loan proceeds in that Investor could decide how to invest the cash, subject to the Loan covenants. In addition, Investor had the economic "benefits and burdens" associated with tax ownership of such proceeds. The income derived from investing the proceeds was income to Investor and the interest associated with carrying the loan was an expense to Investor.

Accordingly, based upon the foregoing and upon the description of the transactions contained in I, above, and the representations contained in II, it is more likely than not that Investor will be recognized as the true borrower of the loan, and, consequently, it is more likely than not that the IRS would not be successful were it to contend that the Loan was made directly by Bank to Partnership, rather than to Investor.

B. **No Integration of Debt and Swap**

Investor obtained the Loan from Bank to partially fund its participation in the Partnership. As discussed, the Loan is a fixed rate debt instrument with a 7 year term and interest payable quarterly at a fixed rate. As also discussed following Partnership's assumption of the Loan, Partnership entered into a fixed-for-floating rate interest swap for a 7 year term to reduce its risks related to a change in interest rates. Were the Loan and the swap to be integrated, the Loan would be treated as a floating loan rather than a fixed rate loan. In that event, under the rules of Treas. Reg. §1.1275-5 it might be possible for the Loan to be characterized as having an SRPM in excess of its stated principal amount, with the result that the amount of the premium would be reduced.

Prior to the release of Treas. Reg. §1.1275-6, the integration of a debt instrument and a hedge was permitted only in limited situations[24] and generally was considered to be a favorable result by taxpayers and commentators. On June 14, 1996, the IRS released final Regulations concerning debt instruments with original issue discount, contingent payment debt instruments, and the anti-abuse rule for OID.[25] The purpose of the Regulations under Treas. Reg. §1.1275-6 was to extend the integration treatment to financial instruments that perfectly hedge a qualifying debt instrument into a synthetic fixed or floating rate obligation. It was thought that the simplified tax treatment of the resulting synthetic debt instrument would enable a nonfinancial institution issuer to reduce its diligence required to evaluate a financing package and to reduce its costs of financing.

The integration rules generally were intended to reduce taxpayer complexities associated with matching tax results with the corresponding cash flows of a transaction. Although the integration rules are taxpayer elective, an anti-abuse rule allows the IRS relatively broad powers to force integration. As discussed below, the IRS cannot force integration, however, when a taxpayer simply swaps from a traditional fixed rate obligation to a floating rate debt, or vice versa.

1. <u>Treas. Reg. §1.1275-6</u>

Treas. Reg. §1.1275-6(a) applies to either issuers or holders of qualifying debt instruments. This Regulation provides for the integration of a qualifying debt instrument and "Section 1.1275-6 hedges" if certain requirements are met and if the combined cash flows of the components are substantially equivalent to those of a fixed or variable rate debt instrument. The purpose of the Regulations is to "permit a more appropriate determination of the character and timing of income, deductions, gains or losses than would be permitted by separate treatment of the components."

Treas. Reg. §1.1275-6(b)(4) provides that if its provisions apply to a qualifying debt instrument and hedge, the integrated transaction is deemed to create a synthetic debt instrument with the same cash flows as the combined cash flows of the qualifying debt instrument and

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24 Examples include integration under Treas. Reg. §1.988-5, 1.446-4, and 1.1221-2.

25 T.D. 8674, 61 Fed. Reg. 30133 (June 14, 1996).

hedge. This integrated instrument generally is subject to the Treas. Reg. §1.1275-6 Regulations, rather than the rules to which each component of the transaction would be subject on a separate basis.

Under Treas. Reg. §1.1275-6(b) a qualifying debt instrument is any debt instrument other than:

1. A tax-exempt obligation as defined in Code Section 1275(a)(3);
2. A debt instrument to which Code Section 1272(a)(2)(6) applies (certain interests in or mortgages held by a REMIC, and certain other debt instruments with payments subject to acceleration); or
3. A debt instrument that is subject to Treas. Reg. Sections 1.483-4 or 1.1275-4(c) (certain contingent payment debt instruments issued for non-publicly traded property).

A Section 1.1275-6 hedge is any financial instrument if the combined cash flows of the financial instrument and the qualifying debt instrument permit the calculation of a yield to maturity under the principles of Code Section 1272, or the right to the combined cash flows would qualify under Treas. Reg. §1.1275-5 as a variable rate debt instrument that pays interest at a floating rate or rates (except for the requirement that the interest payments be stated as interest). A financial instrument can be a Section 1.1275-6 hedge only if it is issued substantially contemporaneously with, and has the same maturity as, the qualifying debt instrument. In addition, a financial instrument that hedges currency risk is not a Section 1.1275-6 hedge.

For purposes of determining what constitutes a Section 1.1275-6 hedge, Treas. Reg. §1.1275-6(b)(3) defines a financial instrument as a spot, forward, or futures contract; an option; a notional principal contract; a debt instrument, or a similar instrument, or a combination or series of financial instruments. Stock is not a financial instrument for purposes of this Regulation. Under this definition, the Swap would be a financial instrument.

2. <u>Requirements for Integration by Taxpayer</u>

A taxpayer may integrate a qualifying debt instrument and a Treas. Reg. §1.1275-6 hedge if the taxpayer meets all of the following requirements provided for in Treas. Reg. Sections 1.1275-6(c)(1)(i) through (vii):

(i) The taxpayer must adequately satisfy the identification requirements of Treas. Reg. §1.1275-6(e) by entering and retaining as part of its books and records information related to issuance and acquisition of the qualifying debt instrument and the Section 1.1275-6 hedge;

(ii) None of the parties to the hedge may be related unless the related party uses a mark-to-market tax accounting method;

(iii) Both the qualifying debt instrument and the Section 1.1275-6 hedge are entered into by the same individual, partnership, trust, estate, or corporation;

(iv) If the taxpayer is a foreign person engaged in a U.S. trade or business, all items of income and expense associated with the integrated transaction (other than interest expense subject to Treas. Reg. §1.882-5) would, in the absence of the integration rules, be effectively connected income during the synthetic debt instrument's term;

(v) Within 30 days immediately preceding the issue date of the synthetic debt instrument, the taxpayer did not terminate, or leg out[26] of, an integrated transaction containing the qualifying debt instrument, any other debt instrument that is part of the same issue, or the Section 1.1275-6 hedge;

(vi) The qualifying debt instrument must be issued on or before, or substantially contemporaneously with, the date of first payment on the Section 1.1275-6 hedge, regardless of whether the payment is made or received by the taxpayer; and

(vii) The taxpayer cannot have entered into a straddle[27] prior to the issue date of the synthetic debt instrument containing the Section 1.1275-6 hedge or the qualifying debt instrument.

As stated in representation 3 above, Trust has represented that it has not and will not elect to integrate the Loan and the Swap under Treas. Reg. §1.1275-6.

3. <u>Integration by Commissioner</u>

Notwithstanding integration by the taxpayer, under a general anti-abuse provision, the Commissioner may treat a qualifying debt instrument and a financial instrument (whether entered into by the taxpayer or by a related party) as an integrated transaction if the combined

26 "Legging" into and out of integrated transactions is described in Treas. Reg. Sections 1.1275-6(d).

27 "Straddle" as defined under Code Section 1092(c).

cash flows on the qualifying debt instrument and financial instrument are substantially the same as the combined cash flows required for the financial instrument to be a Section 1.1275-6 hedge.

Treas. Reg. §1.1275-6(c)(2) provides that the Commissioner may not integrate a transaction unless the qualifying debt instrument is subject to Treas. Reg. §1.1275-4 (related to "contingent payment debt instruments"[28]) or Section 1.1275-5 (related to "variable rate debt instruments") and pays interest at an objective rate. Under Treas. Reg. §1.1275-5, a "variable rate debt instrument" is a debt instrument that meets all of the following conditions:

(a) The issue price of the debt instrument must not exceed the total noncontingent principal payments by more than an amount equal to the lesser of:

 (i) .015 multiplied by the product of the total noncontingent principal payments and the number of complete years to maturity from the issue date, or

 (ii) 15 percent of the total noncontingent principal payments.

(b) The debt instrument must only provide for stated interest (compounded or paid at least annually), at:

 (i) one or more qualified floating rates,

 (ii) a single fixed rate and one or more qualified floating rates,

 (iii) a single objective rate, or

 (iv) a single fixed rate and a single objective rate that is a qualified inverse floating rate.

(c) The debt instrument must provide that a qualified floating rate or objective rate in effect at any time during the term of the instrument is set at a current value of that rate.

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28 A "contingent payment debt instrument" is defined under Treas. Reg. §1.1275-4 as any debt instrument that provides for one or more contingent payments, unless such payments are "incidental" within the meaning of Treas. Reg. §1.1275-2(h). Based upon the advice of Investment Advisor, it is more likely than not that any contingent payments under the Loan would be treated as incidental for purposes of Treas. Reg. §1.1275-4, with the result that it is more likely than not that the Loan would not be treated as a contingent payment debt instrument for purposes of that provision.

(d) The debt instrument must not provide for any contingent principal payments.

Because, under the facts in the instant case, the Loan is a fixed rate debt instrument, Treas. Reg. §1.1275-6(c)(2) does not provide the Commissioner with authority to integrate the loan and interest rate swap. Furthermore, the inability of the Commissioner to integrate a hedge with a fixed rate debt instrument was specifically addressed in the preamble to the Final Regulations[29] concerning the anti-abuse rule for original issue discount, as follows:

> Section 1.1275-6 INTEGRATION RULES:
>
> Commentators generally approved of the integration rules in the proposed Regulations, and those rules are adopted with only two significant changes. First, the final Regulations allow (but do not require) the integration of a hedge with a fixed rate debt instrument. For example, a taxpayer may integrate a fixed rate debt instrument and a swap into a VRDI. Although the hedging transaction Regulations (Section 1.446-4) cover many of these transactions, the integration rules provide more certain treatment. The final Regulations, however, do not allow the Commissioner to integrate a hedge with either a fixed rate debt instrument or a VRDI that provides for interest at a qualified floating rate. In these cases, treating the hedge and the debt instrument separately is a longstanding rule that generally clearly reflects income.

Based upon the foregoing, we are of the opinion that it is more likely than not that the Commissioner will have no authority under Treas. Reg. §1.1275-6(c)(2) to integrate the fixed rate debt instrument and interest rate swap.

C. <u>No Gain Recognition on Investor's Capital Contribution to Partnership</u>

1. <u>The Partnership as a Partnership</u>

Treas. Reg. §301.7701-2(b)(1)-(8) describes certain entities that are classified as corporations for U.S. federal income tax purposes. Treas. Reg. §301.7701-3 provides that an entity not described in Teas. Reg. §301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) is considered to

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[29] T.D. 8674, 61 Fed. Reg. 30133 (June 14, 1996).

be an "eligible entity", which may elect to be classified as a corporation or, if it has 2 or more owners, a partnership. Treas. Reg. §301.7701-(3)(b)(1) provides that a domestic eligible entity that has two or more members and does not elect to be classified as a corporation will be classified as a partnership for U.S. federal income tax purposes.

Based on the facts set forth above, it is more likely than not that Partnership will constitute a domestic eligible entity. Consequently, if Partnership does not elect to be classified as a corporation, it is more likely than not that Partnership will be treated as a partnership for U.S. federal income tax purposes.

2. <u>Investor's Capital Contribution</u>

a. <u>Code Section 721 Generally</u>

Code Section 721 (a) and Treas. Reg. §1.721-1 generally provide that no gain or loss is recognized by either the partnership or any partner in the case of a contribution of property to the partnership in exchange for a partnership interest. . Money constitutes "property" for purposes of Code Section 721(a). Treas. Reg. §1.721-1(b)(1). Consequently, it is more likely than not that Investor's contribution of the proceeds of the Loan, including the portion of the proceeds attributable to the Premium, will qualify as transfer of property for purposes of Code Section 721 and, therefor, it is more likely than not that Code Section 721 will generally apply to such contribution. Notwithstanding the general application of Code Section 721 to the transfer by Investor to the Partnership, as discussed below, there are certain circumstances where the Code Section 721(a) nonrecognition rule would not apply.

b. <u>Investment Partnership Rules</u>

Notwithstanding that Code Section 721(a) generally provides for nonrecognition of gain or loss upon the contribution of property to a partnership. Code Section 721(b) provides that the general nonrecognition rule of Code Section 721(a) does not apply to gain realized on a transfer of property to a partnership that would be treated as an investment company within the meaning of Code Section 351. Thus, gain, but not loss, will be recognized with respect to the transferred assets were the Partnership an investment company within the meaning of Code Section 351 were it incorporated. Because Investor contributed money to the Partnership, the transferred property was not appreciated. Consequently, it is more likely than not that Code

Section 721(b) would not require the Investor to recognize gain upon the contribution of the Loan proceeds, including the premium, to the Partnership.

c. Code Section 707

Under Code Section 707(a)(2)(B), a contribution of property by a partner to a partnership may be characterized as a sale if the partnership distributes to the contributing partner cash or other property that is consideration for the contribution. However, Treas. Reg. §1.707-3(b)(1) specifically excludes money or the obligation to contribute money from the definition of what constitutes "property transferred by a partner" for purposes of Code Section 707(a)(2)(B). In the instant case, Investor is contributing cash. Consequently, it is more likely than not that Code Section 707(a)(2)(B) would not apply to the contribution of the Loan proceeds, including the premium to the Partnership.

d. Code Section 752

If property transferred to a partnership subject to an obligation that is a liability for purposes of Code Section 752, the amount of such liability reduces the contributing partner's tax basis in his or her partnership interest (determined as discussed below) or, if the amount of such liability exceeds the basis of the contributed property, may cause the contributing partner to recognize gain on the contribution.

(i) Liabilities under General Income Tax Principles

With respect to the definition of a "liability" under general income tax principles, the issue often arises regarding the amount to be included in the tax basis of a purchaser who either assumes a liability or acquires an asset subject to a liability. In analyzing these authorities, the question first arises in the case of borrowed money whether the principal amount of a loan is the starting point or whether present value concepts must be taken into account.

The general rule appears to be that in the absence of specific statutory authority to the contrary, the amount of a liability is its stated principal amount, regardless of the interest rate. In PLR 8747004 (8/11/87), a Technical Advice Memorandum, the agent, among other things, requested advice that that the amount of insurance reserves which were otherwise treated as debt should be valued using present value concepts, rather than at face for purposes of determining the buyer's tax basis under Code Section 334(b)(2). In Section II.B. of the TAM the IRS National Office stated:

> This office has been unable to find any authority supporting this argument. In, fact the authorities this office has found indicate that a liability should be included in basis at face value if it is fixed and determinable at the date of purchase. [Citations omitted]

In Follender v. Comm'r, 89 T.C. 943 (1987), the Tax Court held that the absence of explicit statutory authority, present value concepts cannot be used for purposes determining the amount of a liability under Code Section 465. See, also, Pritchett v. Comm'r, T.C. Memo. 1989-21, aff'd without published opinion, 944 F.2d 909 (9th Cir. 1991); and Henkind v. Comm'r, T.C. Memo 1992-555. City of N.Y. v. Comm'r, 70 F.3rd 142 (D.C. Cir. 1995), aff'g 103 T.C. 481 (1994), citing Follender for the proposition that absent explicit statutory authority, held that time value of money concepts cannot be used for determining the amount borrowed under Code Section 141(c). Based on the foregoing is more likely than not that the face amount of the Loan is the appropriate amount to treated as a liability under general these general federal income tax principles.[30]

There is no authority that specifically addresses whether the amount of a liability in the context of an above-market interest rate loan, such as the Loan, includes either the above market element of such interest or a potentially significant prepayment premium. The authorities discussed below, however, lead to the conclusion that it is more likely than not that such interest is not treated as a liability prior to the time that it is taken into account under the taxpayer's.

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30 Under Code Section 752, time-value-of money concepts are applied in two defined situations. Treas. Reg. §1.752-2(e) treats a nonrecourse obligation as a recourse obligation if a partner guarantees a substantial portion of the interest that will accrue under the obligation. If such rule applies, the partner that has guaranteed the payment of interest is treated as bearing the economic risk of loss for the partnership liability to the extent of the present value of the guaranteed future interest payments. Treas. Reg. §1.752-2(g) provides that if a partner's obligation to make a payment or contribution is unreasonably delayed, the obligation is adjusted to reflect the time value of money of the deferral. The result of failing to satisfy an obligation on a "timely" basis is to effectively cause the obligation to be valued at less than its "face" amount. If an obligation does not bear interest at a rate at least equal to the applicable federal rate at the time of valuation, the value of the obligation is the discounted present value of all payments due from the partner. Neither fact pattern applies to the instant case.

method of accounting and that such premium is not treated as a liability until the obligation to pay such premium is triggered upon the prepayment of the loan.

As a general rule, interest economically accrues as a liability over the term of a loan and is not taken into account as a deduction by the taxpayer until it is paid or accrued under the taxpayer's method of accounting. Treas. Reg. §1.461-1(4)(e).This view was taken by the IRS in Revenue Ruling 83-84, 1983-1 CB 97, dealing with the continuing viability of the "Rule of 78's" method. In the ruling, the IRS stated that "no deduction will be allowed to the extent that the debtor's liability or payment is for interest that does not economically accrue in the current year." See also, Sandor v. Comm'r, 62 T.C. 469 (1974), which provide that the rules regarding interest are subject to the general tax accounting rules of Code Section 461 and Treas. Reg. §1.461-1(a)(2).[31] See also, Treas. Reg. §1.461-1(4)(e).[32]

With respect to a prepayment premium, the rule appears to be that it is disregarded as an obligation or liability of the borrower until it is triggered upon the borrower's election to prepay. In Rev. Rul. 86-42, 1986-1 CB 82, the IRS ruled that a prepayment penalty is an additional charge for the use of the lender's funds and is not taken into account by a cash basis payor until the penalty is actually paid. The Ruling relies on Gen. Amer. Life Ins. Co. v. Comm'r, 25 T.C. 1265 (1956), acq. 1956-2 CB 5; Rev. Rul. 57-198, 1957-1 CB 94; and Rev. Rul. 73-137, 1973-1 CB 68, all of which reached the same conclusion. Although not capable of being relied upon, 1993 FSA LEXIS 195, reaches the same conclusion with respect to issue 7, i.e. that a prepayment penalty is treated in the same way as interest.

Although Prudential Ins. Co. of Amer. V. Comm'r, 882 F. 2d 832 (3rd Cir. 1989), rev'g 90 T.C. 6 (1989), disputes the view that a prepayment penalty is interest in the context of

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31 Under the Regulation, the all events test traditionally permitted the accrual of an expense when "all events have occurred which determine the fact of the liability, and the amount of such liability can be determined with reasonable accuracy." See Code Section 461(h)(4) (restating traditional test). Since 1984, however, Code Section 461(h) generally has required that the test not be treated as having been satisfied until the occurrence of economic performance, such as the provision of required goods or services. Pub. L. No. 98-369 section 91(a), 98th Cong., 2d Sess. (1984) (adumbrating "all events" test of Treas. Reg. §1.461-1(a)(2)).

32 In LaRue v. Comm'r, 90 T.C. 465 (1988), the Tax Court held that an obligation is not incurred and taken into account by an accrual basis taxpayer until the year in which all events have occurred to fix the amount of the obligation and economic performance has occurred with respect to the obligation.

the early redemption of a commercial mortgages, the decision is consistent with the above authorities in that it does not take the penalty into account until it is triggered. The Court in Prudential analogized the penalty to a call premium on a corporate bond, treating it as additional consideration received under Code Section 1232 on the retirement of the mortgages, rather than as interest.

There are a number of cases following either Gen. Amer. Life or Prudential, depending upon whether a corporate or non-corporate obligation was involved, but a close reading of each of them makes clear that the pertinent time for taking the prepayment penalty into account is when it is paid. A few of the cases, (see, for example, Phoenix Mutual Life Ins. Co. v. Comm'r, 96 T.C. 481 (1991)) in dicta discuss whether there was an intention to prepay the loan. However, no case specifically addresses that situation, and no case takes the position that the rule discussed above, i.e. the penalty is not taken into account until it is triggered, would not apply in that case.

Logically, these cases follow the general rule, discussed below, that a contingent obligation, whether interest or prepayment penalty, is not taken into account until the contingency is eliminated. Under general tax accounting rules a liability doesn't exist until it is an "existing, unconditional, and legally enforceable obligation for the payment of money." Kovtan v. Comm'r, 54 T.C. 331, 338 (1970), aff'd per curiam, 448 F.2d 1268 (9th Cir. 1971).[33] See, also, Rev. Rul. 77-266, 1977-2 CB 236 ("where there exists a contingency as to payment of an obligation, and such contingency relates to other than the ability of the obligor to pay, the obligation is not fixed...."), Rev. Rul. 72-34, 1972-1 CBV 132. In the instant case, no prepayment penalty is due/obligation arises unless and until the taxpayer elects to prepay the loan under the Loan Agreement. Consequently, it is more likely than not that the prepayment penalty does not constitute a liability under general income tax principles until such time.

Based on the foregoing, it is more likely than not that under general federal income tax principles, (i) the amount of the liability arising under the Loan will be its principal amount, (ii) the above-market rate aspect of the interest on the Loan will be ignored as a liability prior to the time that an interest deduction is taken into account under the Investor's method of

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33 In Kovtan v. Comm'r, 54 T.C. 331, 338 (1970), aff'd per curiam, 448 F.2d 1268 (9th Cir. 1971), no interest deduction was allowed to a partnership where a note was found to be unenforceable. This implies that the note was not an obligation of the partnership.

accounting, and (iii) the prepayment penalty associated with the above-market-rate Loan will not treated as a liability until the obligation to pay such an amount is triggered upon the Investor's election to prepay the Loan or the Bank requires prepayment.

(ii) Liabilities under Code Section 752

In 1988, the Treasury promulgated proposed and temporary regulations under Code Section 752.[34] In 1991, Treasury issued a new set of regulations under Code Section 752 in an attempt to simplify the rules. The current Regulations under Code Section 752 do not define the term "liability".[35] However, Treas. Reg. §1.752-1T(g) of the 1988 Regulations provided that an "obligation" was a "liability" only to the extent that incurring or holding the obligation gave rise to:

(1) The creation of, or increase in, the basis of any property owned by the obligor (including cash attributable to borrowings);

(2) A deduction that is taken into account in computing the taxable income of the obligor; or

(3) An expenditure that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital.

The IRS's Revenue Rulings defining the term "liability" in the context of Code Section 752 tend to be consistent with the definition in the 1988 Regulations, requiring both an obligation and the creation of either basis, a deduction, or an expenditure that is neither deductible or chargeable to capital. In neither case, does the IRS take the position that a liability arises prior to the time an obligation would be considered to a rise under the general federal income tax principles discussed above.

This is confirmed in Revenue Ruling 73-301, 1973-2 CB 215. In the Ruling, the IRS ruled that interim payments received by a partnership for services rendered in connection

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[34] T.D. 8327, 1989-1 CB 180.

[35] See Federal Taxation of Partnerships and Partners, McKee, Nelson, and Whitmire, Chapter 7. Code Section 752 and the Treasury Regulations thereunder do not define the term "liability." Although Temporary Regulations issued in 1988 provided a definition, the definition was deleted without specific comment in the Final Regulations as part of Treasury's efforts to simplify the Regulations.

with a long-term contract reported on the completed contract method do not constitute liabilities for purposes of Code Section 752. Instead, the ruling characterizes such payments as "unrealized receivables", the income from which increases the basis of partners' interest only when recognized by the partnership for tax purposes. The Ruling emphasizes that the partnership had fully earned the payments and was under no obligation to return them or perform additional services to retain them. Although the partnership received money, there was no attendant legally binding obligation to repay and, consequently, no liability. See also, Kovtan v. Comm'r, supra.

The IRS's position in Revenue Ruling 73-301 is consistent with the position of the Tax Court in Helmer v. Comm'r, T.C. Memo. 1975-160. In Helmer, a partnership wrote an option on property to a prospective buyer in exchange for consideration. The Tax court held that, even though the option resulted in the partnership receiving money (and increasing the basis of its property) without a correlative increase in the partner's bases, the option agreement did not create a liability because it created no obligation on the part of the partnership to repay the fund's paid or to perform any services in the future. Accordingly, the contingent obligation to deliver the property upon exercise of the option did not create a liability.

With respect to the creation of a deduction prong of the Temporary Regulations, in Revenue Ruling 88-77, 1988-2 CB 128, the IRS ruled that accrued, unpaid expenses and accounts payable of a cash method partnership are not partnership liabilities. The IRS's conclusion was based upon the view that although the payables and expenses created obligations, "liabilities" include only those obligations that either create basis (including cash from the borrowings) or give rise to an immediate deduction, which the payables and expenses did not do did not do.

The phrase "expenditure that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital" is not defined in the Temporary Regulations. However, a substantially similar phrase, "expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account", is found in Code Section 705(a)(2)(B), which requires the reduction of a partner's tax basis in his or her partnership interest if the partnership makes such an expenditure. Most recently that phrase was interrupted in two Revenue Rulings, Rev. Rul. 96-10, 1996-1 CB 138, and Rev. Rul. 96-11, 1996-1 CB 140. Each states:

> In determining whether a transaction results in...a noncapital expenditure within the meaning of §705(a)(2)(B), the proper inquiry is whether the transaction has a permanent effect on the partnership's basis in its assets, without a corresponding current or future effect on its taxable income.

As discussed above, under Treas. Reg. §1.163-13, a borrower/issuer amortizes the bond issuance premium by offsetting the qualified stated interest allocable to an accrual period with the bond issuance premium. Furthermore, under Treas. Reg. §1.61-12(c)(2)(ii) and (iii) any prepayment penalty upon repayment of a loan either reduces the amount of income or creates a deduction, depending on the extent to which payment of such penalty, together with the payment of the outstanding balance of the loan, is greater or less than the issue price of the loan. Therefor, the prepayment penalty is an expenditure that does have " a corresponding current or future effect on [the Partnership's] taxable income. Consequently, it is more likely than not that any prepayment penalty that might be made under the loan would not constitute an expenditure described in the 1988 Regulations.

Rev. Rul. 88-77 revoked Rev. Rul. 60-345, 1960-2 CB 211, in which the IRS had concluded that the term "liabilities" included the accounts payable and accrued expenses of a cash method partnership. Rev. Rul. 88-77 was issued, in part, in response to Congress' disagreement with the holding of Rev. Rul. 60-345. See, H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 856-857 (1984); Staff of the Joint Committee on Taxation, General Explanation of the Deficit Reduction Act of 1984, 98th Cong., 2d Sess., 215 (1984).

The courts have also held that contingent claims or obligations are not liabilities under Code Section 752. In Long v. Comm'r, 71 T.C. 1 (1978), aff'd and remanded, 660 F.2d 416 (10th Cir. 1981), the court considered whether contested liabilities were liabilities within the meaning of Code Section 752. The partnership in this case was in the construction business and was sued for defects in a building. The suits were pending when one of the partners died, raising the question of the partnership basis. The court rejected the argument that the contingent liabilities were liabilities for purposes of Code Section 752, stating:

> Although they may be considered "liabilities" in the generic sense of the term, contingent or contested liabilities such as the Kansas City Life-TWA and USF&G claims are not "liabilities" for partnership basis purposes at least until they have become fixed or liquidated. This Court has held on a number of occasions that

> contingent and indefinite liabilities assumed by the purchaser of an asset are not part of the cost basis of the asset. . . . We think that partnership liabilities should be treated in the same manner. . . . We see no logical reason for distinguishing the above cases solely because the asset involved is an interest in a partnership, and neither party suggests such a distinction. Those liabilities should be taken into account only when they are fixed or paid. . . .
>
> The Kansas City Life-TWA and USF&G claims were too contingent at the death of the decedent to be included in the estate's initial computation of its basis in the decedent's partnership interest. Liability for those claims had not been established and was in fact contested. Moreover, the amounts of damages sought were by no means definite or fixed.
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> 71 T.C. at 7-8 [Citations omitted].

The Tax Court again held contingent liabilities not to be liabilities within the meaning of Code Section 752 in La Rue v. Comm'r, 90 T.C. 465 (1988). The taxpayers in this case were general partners of Goodbody & Co., a stock brokerage firm. Because of its inability to keep up with the trading volume, Goodbody incurred large "back-office" liabilities due to the following types of transactions: (i) the failure to purchase securities at a stated price; (ii) the failure to sell securities at a stated price; (iii) differences between the securities actually held and the securities the partnership should have held; and (iv) the failure to receive dividends or interest on securities held for customers. Goodbody was fully liable for the losses represented by these errors. Another firm acquired the assets and assumed the liabilities of Goodbody for an amount equal to the difference between the fair market value of the assets and the liabilities. In an attempt to minimize their gain, the partners sought to increase their basis in Goodbody by including the reserves for the back office claims as partnership liabilities under Code Section 752. The court rejected this attempt, noting that the reserves were for potential liabilities, and that the amount of the liabilities was speculative and could not be determined with reasonable accuracy.

> Once the "back office" failures occurred, Goodbody incurred an obligation. The partnership was contractually obligated to its customers under the NYSE rules. Goodbody was under an obligation to replace any missing securities or money. Essentially, Goodbody's books were in error because of the back office problems, and the Haskins report reflected estimated liability

> figures. All of petitioners' witnesses testified that these were transactions for which the partnership was liable. There was, however, a contingency or speculative quality concerning the amount of Goodbody's liability. Until any missing securities were purchased or excess securities sold, at market price, there was no way of determining the amount of loss, or in some circumstances, gain.
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> Petitioners have not shown that these amounts were determinable with reasonable accuracy. As a result of the Haskins audit, Goodbody (and Merrill Lynch) knew which particular securities would have to be sold or purchased and how much money was missing from customer accounts. However, it was not certain upon which of these claims Goodbody would ultimately be liable, because the smaller the amount of the transaction the less likely the customer would be to claim it. In addition, the exact amount of loss or gain was not determinable until actual purchase or sale. Valuation of the claims may be a purely ministerial matter because of the ready market for securities, but is not readily determinable until purchase or sale occurs. The additional reserves reflected potential liabilities of the partnership, valued by reference to listed stock prices but before actual sale or purchase and, accordingly, represented estimates. Accrual accounting requires that the amount be determinable with "reasonable accuracy." A loss is not determinable until the securities are actually purchased or sold and the transaction closed. We accordingly hold that because the reserves were not a fixed obligation of the partnership sufficiently determinable in amount in 1970, they cannot be included in the partners' bases in that year.
>
> 90 T.C. at 479.

The court stated that the "all events" test of Code Section 461 (a), which is used to determine when an expense can be accrued for deduction purposes, should also be applied to determine when a liability is fixed or definite and thus includible in basis. In La Rue, the liabilities were not sufficiently fixed to be accrued as an expense, and therefore could not be included in basis. In the present situation, it is more likely than not that the future interest payments and the prepayment premium are similarly not sufficiently fixed to be considered a liability for purposes of Code Section 752.

In Revenue Ruling 95-26, 1995-1 CB 131, the IRS concluded that a partnership obligation to return securities sold short creates a partnership liability for purposes of Code Section 752. The Ruling addressed each prong of the obligation/deduction-basis-capital test. First, it maintained that a short sale created an obligation to return the securities borrowed to effect the sale. Second, the ruling maintains that the cash proceeds of the short sale create a partnership asset, thereby increasing basis and bringing the obligation within the definition of liability based upon the logic of Revenue Ruling 88-77.[36]

Rev. Rul. 95-26, supra, is distinguishable from the case of an above market interest or a contingent prepayment penalty, because a short sale creates a fixed legally enforceable obligation to deliver securities. The creation of such a fixed and enforceable obligation, coupled with the receipt of sale proceeds by the partnership, therefore allowed the IRS to bootstrap itself into the conclusion reached by the Ruling. See, also Rev. Rul. 88-77, 1988-2 CB 129, cited in the Ruling, that also involved fixed, legally enforceable obligations. As discussed above the obligation to pay interest arises over the term of the Loan and the prepayment penalty is not fixed or legally enforceable until the election to prepay is made.[37]

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[36] Revenue Ruling 95-45, 1995-1 CB 53 applies a similar analysis to characterize the short-sale obligation of a shareholder who contributes its interest in the sales proceeds, in conjunction with a Code Section 351 incorporation of a going business, as a liability for purposes of Code Section 357 (which treats liabilities transferred in incorporations as taxable "boot" to the extent in excess of the basis of the transferred property) and Code Section 358 (which treats transferred liabilities as money received in calculating the basis of the transferor's stock). Applying the same reasoning as in Revenue Ruling 95-26, Revenue Ruling 95-45 cites Deputy v. du Pont for the proposition that a short sale creates an obligation to return the borrowed securities. Because that obligation results in an increase in asset basis, the ruling concludes that the obligation constitutes a "liability," even though acknowledging that the sales proceeds are not currently taxable. In contrast, Revenue Ruling 95-8, although issued in conjunction with the other two rulings, holds that an exempt organization's income from a short sale does not result in unrelated business taxable income under Code Section 511 from "debt-financed property" under Code Sections 512(b)(4) and 514(a) and (b). Its rationale is that there is no "acquisition indebtedness" within section 514(c) because under Deputy v. du Pont, 308 U.S. 488 (1940) a short-sale obligation creates an "obligation" but not an "indebtedness."

[37] Rev. Rul. 95-74, 1995-2 CB 36, the IRS concluded that contingent environmental liabilities are not liabilities for purposes of Code Section 358/357(c), but, while admitting that the liabilities were not fixed or enforceable, the Ruling reached its conclusion by relying on Code Section 357(c)(3)(A), which excludes deductible liabilities from Code Section 357(c). This Ruling could be read as treating contingent liabilities as liabilities under Code Section 357(c) (and presumably the partnership analog of Code Section 752) unless they do not give rise to an asset, are deductible, or otherwise fit within an exception under Code Section 357(c)(3). However, t

Based on the foregoing, it appears that the authorities specifically addressing the amount of a liability for purposes of Code Section 752 do not create a different standard regarding the existence of an obligation than the authorities discussed in respect of general federal income tax principles.

(iii) Summation

In the instant case, Investor obtained the Loan from Bank that included a premium payment in addition to the principal amount. Investor contributed the Loan proceeds, including the Premium, and additional amounts in cash subject to the Loan to Partnership. Investor's basis in its interest in Partnership is a function of the amount of the cash contributed and the amount of the liability created by the Loan under Code Section 752. Based upon the foregoing analysis in Sections (i) and (ii) hereof, it is more likely than not that the amount of the liability to be taken into account under Code Section 752 with respect to the Loan is limited to its principal amount. Consequently, it is more likely than not that Investor will not recognize gain on the transfer under Code Section 752 and that Investor's tax basis in Investor's interest in Partnership will be reduced by the principal amount of the Loan to which the contributed property was subject and increased by Investor's share thereof.

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reading is belied by a recent FSA in which the Service issue of whether a contingent liability is the type of liability that is to be taken into account for purposes of I.R.C. sections 357 and 358. However, because of the specific language of I.R.C. sections 357(c)(3) and 358(d) (2), as interpreted by Rev. Rul. 95-74, 1995-2 C.B. 36, we do not believe that it is necessary to address this broader issue. That is, we will assume for purposes of the following discussion that such contingent liability is the type of liability to be taken into account currently under I.R.C. sections 357 and 358.[37]" The FSA then goes on to analyze the obligations under Code Section 357(c)(3). However, this reading is belied by a recent FSA in which the Service faced the issue of whether a contingent liability is the type of liability that is to be taken into account for purposes of I.R.C. sections 357 and 358. The FSA stated: "However, because of the specific language of I.R.C. sections 357(c)(3) and 358(d)(2), as interpreted by Rev. Rul. 95-74, 1995-2 C.B. 36, we do not believe that it is necessary to address this broader issue. That is, we will assume for purposes of the following discussion that such contingent liability is the type of liability to be taken into account currently under I.R.C. sections 357 and 358." The FSA goes on to analyze the obligations under Code Section 357(c)(3). See, 199905008 (10/29/98). Consequently, it appears that the Service has not reached the conclusion that contingencies themselves do not keep the obligation from being a "liability" for purposes of Code Sections 357/752.

a. Treas. Reg. §1.61-12(c)(2)

Treas. Reg. §1.61-12(c)(2) provides that an issuer generally does not realize gain or loss upon the repurchase of a debt instrument. The term "repurchase" includes the retirement of a debt instrument, the conversion of a debt instrument into stock of the issuer, and the exchange (including an exchange under Code Section 1001) of a newly issued debt instrument for an existing debt instrument. In the instant case:

The debt instrument has not been retired;

The debt instrument has not been converted into stock of the issuer; and

The debt instrument has not been exchanged for purposes of Code Section 1001 (see discussion below regarding whether the transfer subject to the debt constitutes a modification that is treated as an exchange.)

Consequently, it is more likely than not that Investor's contribution of cash subject to the Loan would not constitute a repurchase of a debt instrument under Treas. Reg. §1.61-12(c)(2).

b. Treas. Reg. §1.1001-3

A significant modification of a debt instrument will result in an exchange of the original debt instrument for a modified instrument. The deemed exchange will be a realization event under Treas. Reg. §1.1001-1(a) and could potentially give rise to gain or loss, to cancellation of indebtedness income for the issuer, and/or to a change in accounting for interest on the new instrument.[38]

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38 If an assumption of a debt instrument involves a modification that triggers an exchange under Code Section 1001, Treas. Reg. §1.1274-5(b)(1) provides that the modification is treated as a separate transaction taking place immediately before the sale or exchange. In such case, Treas. Reg. §1.163-7(c) provides that if a debt instrument is repurchased in a debt-for-debt exchange, the repurchase price is the issue price of the new debt instrument. In the instant case that would be $100 million. Under Treas. Reg. §1.61-12(c)(2)(ii), the difference between such amount and the adjusted issue price of the "old" instrument, which in the instant case is $150 million, is discharge of indebtedness income.

Treas. Reg. §1.1001-3 provides a two-tier test to determine whether there has been a deemed exchange of a debt instrument. Any alteration to the terms of a debt instrument must be tested to determine if a "modification" of the debt instrument has occurred. If so, the modification must then be tested to determine whether it is "significant".

Under Treas. Reg. §1.1001-3(c)(1)(i) a modification is broadly defined as any alteration, addition, or deletion of a legal right or obligation of the issuer or holder of a debt instrument whether evidenced by an amendment of the instrument, conduct of the parties, or otherwise.[39] Under Treas. Reg. §1.1001-3(c)(1)(ii), however, provides that an alteration of a legal right or obligation that arises by operation of the terms of the instrument is generally not a modification. Such an alteration may occur automatically under the terms of the instrument or may occur as the result of the exercise of an option provided to an issuer or a holder to change a term of an instrument.

Under Treas. Reg. §1.1001-3(c)(2) certain alterations are nevertheless modifications even though they occur by operation of the terms of the instrument. Among these is (i) an alteration that results in the substitution of a new obligor, the addition or deletion of a co-obligor, or a change in whole or in part in the recourse nature of the instrument, and (ii) an alteration that results from the exercise of an option provided to an issuer or holder to change a term of the instrument, unless the option is unilateral and, in the case of an option exercisable by the holder, the exercise does not result in a deferral of or a reduction in any payment of principal or interest. Under Treas. Reg. §1.1001-3(e)(4)(ii), the change of an obligor on a nonrecourse obligation is not a "significant" modification that would result in a deemed exchange under Treas. Reg. §1.1001-3.

The term "nonrecourse" is not defined in Treas. Reg. §1.1001-3. It is also not generally defined elsewhere in the Code or Treasury Regulations. However, in Raphan v. U.S., 759 F.2d 879 (Fed Cir. 1985), the Court distinguished between recourse indebtedness and nonrecourse indebtedness stating:

> Personal liability for a debt ("recourse indebtedness") means all of the debtor's assets may be reached by creditors if the debt is not paid. Personal liability is normally contrasted with limited liability

[39] Treas. Reg. §1.1001-3(c).

("nonrecourse indebtedness"), against which a creditor's remedies are limited to particular collateral for the debt.

See also, Dakotah Hills Offices Limited Partnership v. Comm'r, T.C. Memo 198-134, citing Raphan in footnote 5. A number of bankruptcy cases also adopt this definition. See, e.g., In re Buchferer, 216 B.R. 332 (E.D. N.Y. 1997); In re: Lindsey, Stephenson & Lindsey v. FDIC, 995 F.2d 626 (5th Cir. 1993). Consequently, it appears that the general definition of nonrecourse debt is debt pursuant to which the creditor's remedies are limited to certain assets of the borrower and the creditor does not have the right to go against all of the debtor's assets.

In the instant case, the Credit Agreement limit's the Bank's remedies to specified assets, i.e. the assets in the collateral account, both before and after the transfer by the Investor of assets to the Partnership subject to the Loan. In addition, under the Credit Agreement, assets in the collateral account in excess of those necessary to meet the loan-to-value ratio may be withdrawn from the collateral account and, consequently cannot be reached by the Bank. Consequently, it is more likely than not that the Loan would be treated as a nonrecourse loan, both before and after the transfer. As a result, it is more likely than not that there would not be a change in the recourse nature of the Loan so as to cause a modification treated as deemed exchange under Treas. Reg. §1.1001-3, and, although the change in obligor resulting from transfer would be a modification, it is more likely than not that such change would not be a "significant" modification treated as deemed exchange under Treas. Reg. §1.1001-3.

Under Treas. Reg. §1.1001-3(c)(3) an option is unilateral if under the terms of the instrument or applicable law (i) at the time, or as a result, of the exercise of the option the other party does not have the right to alter or terminate the instrument or put the instrument to the other party or a related party; (ii) the exercise of the option does not require the consent or the approval of the other party, a related person, or a court or arbitrator; and (iii) the exercise of the option does not require consideration (other than certain consideration that on the issuance of the instrument is de minimus or objectively determined).

The Loan may require increases in collateral to maintain the requisite loan-to-value ratio, permits substitutions of collateral so long as such substitutions or additions are of property within permitted classes of collateral described in the Loan, and permits withdrawal of amounts in excess of the amount of collateral necessary to maintain the loan into value ratio. This situation is similar Example 2 of Treas. Reg. §1.1001-3(d), which states:

> The original terms of the bond provides that the bond must be secured by a certain type of collateral having a specified value. The terms also require the issuer to substitute collateral if the original collateral decreases. Any substitution of collateral that is required to maintain the value of the collateral occurs by operation of the terms of the bond and is not an alteration described in paragraph (c)(2) of this paragraph. Thus, such a substitution of collateral is not a modification.

Based on the foregoing, it is more likely than not that increases in collateral to maintain the requisite loan-to-value ratio, substitutions of collateral, and withdrawals of collateral so long as such additions, substitutions, or withdrawals are permitted under the Loan, such additions, withdrawals, or substitutions will not be treated as a modification under Treas. Reg. §1.1001-3, because the consent of the Bank is not required to make such additions or substitutions.

D. <u>Investor's Tax Basis in Partnership Interest</u>

Code Section 722 provides, in general, that the basis of a partnership interest to the partner is equal to the amount of money plus the adjusted basis of the property contributed to the partnership, increased by the amount of gain, if any, recognized by the partner on the contribution. Consequently, the Investor's basis in the Partnership will be equal to the basis of the amount cash contributed, increased by the gain recognized, if any, on the contribution.

Code Section 752(a) provides that any increase in a partner's share of the partnership liabilities or any increase in a partner's individual liabilities by reason of an assumption of a partnership liability is treated as a contribution of money from the partner to the partnership.

Code Section 752(b) provides that any decrease in a partner's share of the partnership liabilities or the assumption by the partnership of a partner's individual liabilities is treated as a distribution of money from the partnership to the partner.

Code Section 752(c) provides that for purposes of Code Section 752, a liability to which property is subject is considered a liability of the owner of the property, to the extent of the fair market value of such property. Treas. Reg. §1.752-3 provides that a partner's share of nonrecourse liabilities equals the sum of: (1) the partner's share of the partnership's Code

Section 704(b) taxable gain; (2) the partner's Code Section 704(c) minimum gain; and (3) the partner's share of the partnership's excess nonrecourse liabilities.

Under Code Section 722, a partner's basis in the partnership interest is increased by the amount of money and the adjusted basis of property other than money contributed by a partner, increased by the amount of gain, if any recognized by the contributing partner upon the contribution. Under Code Section 733, a partner's basis in the partnership interest is decreased by the amount of money and the adjusted basis of property other than money distributed to a partner other than in liquidation of the partner's interest.

Because as discussed above, it is more likely than not that the Loan would be considered a liability in the amount of its principal amount for purposes of Code Section 752, with the result that it is more likely than not that Investor's basis in the Partnership would be reduced by such amount, but would be increased by Investor's share, as determined under Code Section 752, of the liabilities of the Partnership, including the principal amount of the Loan. Under Treas. Reg. §1.752-1(f) these amounts are netted in determining the effect to Investor.

E. Termination of Investor's Interest in Partnership: <u>Investor's Basis in Distributed Property</u>

1. <u>Treatment of Investor and Fund</u>

When Investor withdrew from Fund, Investor received a liquidating distribution of Partnership assets equal to the then value of Investor's Partnership interest. Code Section 731(a) provides that a partner does not recognize gain on the distribution of property from a partnership, except to the extent that the amount of money received exceeds the partner's adjusted basis for the partnership interest. Loss is recognized only if the property distributed consists solely of money, unrealized receivables and inventory. Code Section 731(b) provides that a partnership does not recognize gain or loss on the distribution to a partner of property, including money. However, in 1994, Congress amended Code Section 731 to provide that the term "money" would include "marketable securities," which would include the financial instruments. On Investor's withdrawal from the Fund, Investor received a distribution of cash and financial instruments.

However, Code Section 731 (c)(3) provides that this special definition will not apply if the Fund is an "investment partnership" and each partner is an "eligible partner." Code Section 731(c)(3)(C)(i) defines an "investment partnership" as any partnership that has never been engaged in a trade or business and substantially all of the assets of which consists of money, stock, notes, bonds, debentures, interest rate, currency or equity notional principal contracts, foreign currencies, and specified other marketable securities. An "eligible partner" is any partner who has not contributed to the partnership any property other than that described in Code Section 731(c)(3)(C)(i).

Because the Partnership is not engaged in any activity other than investing in the types of securities listed in Code Section 731 (c)(3)(C)(i), distributions to Investor of financial instruments should not be considered money for purposes of Code Section 731 (a). However, Code Section 752(b) provides that any decrease in a partner's individual liabilities by reason of assumption by the partnership of such liabilities shall be considered as a distribution of money to the partner by the partnership which, under Code Section 733, reduces the basis of the partner's partnership interest. See, Treas. Reg. §1.752-1(f). Under Code Section 752, the basis of Investor's partnership interest is effectively the amount of the money contributed to the partnership reduced by the net liability relief (the difference between Investor's Loan liability transferred to the partnership and Investor's share of the liability as a partner). Treas. Reg. §1.752-3 provides that a partner's share of nonrecourse liabilities equals the sum of: (1) the partner's share of the partnership's Code Section 704(b) taxable gain; (2) the partner's Code Section 704(c) minimum gain; and (3) the partner's share of the partnership's excess nonrecourse liabilities. Accordingly, Investor's basis from its cash contribution is reduced by the net amount of the Code Sections 752(a) and 752(b) adjustments.[40]

Consequently, because Investor's tax basis in its Partnership interest exceeded the amount of cash distributed or deemed distributed under Code Section 752, it is more likely than not that Investor would not recognize gain on the distribution in redemption of Investor's Partnership interest. Furthermore, under Code Section 731(b), the Fund should not recognize gain or loss on the distribution in redemption of Investor's Partnership interest.

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[40] The principal amount of the Loan assumed by Partnership less the share thereof allocated to Investor pursuant to Treas. Reg. §1.752-3.

Under Code Section 705(a)(2), a partner's basis is decreased (but not below zero) by the amount of cash distributed to him; the basis of any property distributed to him by the partnership; and his distributive share of partnership losses and nondeductible expenditures of the partnership not properly chargeable to capital account. Treas. Reg. §1.752-1(c) provides that any decrease in a partner's share of partnership liabilities is treated as a distribution of money by the partnership to that partner.

2. Basis in Distributed Property

Upon a complete liquidation of a partner's partnership interest, Code Section 732(b) provides that the basis of any distributed property is equal to the partner's basis in its partnership interest immediately prior to the distribution, reduced by any actual cash received. Under Code Section 732(c), if the basis of the distributee's partnership interest after reduction for any money received exceeds the partnership's basis in distributed unrealized receivables and inventory, each of these assets is allocated a basis equal to its basis to the partnership and the balance of the partner's basis in its partnership interest is allocated to other distributed assets as follows:

> First, each other distributed asset is provisionally assigned a basis equal to its pre-distribution partnership basis.
>
> If the provisional bases so assigned are less than the remaining basis to be allocated, the excess basis is allocated first to increase the bases of any appreciated assets so as to reduce all differences between values and bases proportionately, with any remaining excess basis allocated to all other distributed assets in proportion to their respective fair market values.

Based upon the forgoing, it is more likely than not that upon termination of Investor's interest in the Partnership Investor's adjusted basis in its Partnership interest, plus or minus its allocable share of Partnership income or loss, is reduced by the amount of cash received and deemed received under Code Section 752 and the residual amount is allocated to the financial instruments distributed under the methodology described above.

3. No Adjustment to Partnership Assets

The general rule is that a partnership does not adjust the basis of its remaining assets to reflect the distribution of property to a partner. Code Section 734(a). However, a special election is available under Code Section 754 that would allow such an adjustment. The Partnership has represented that it not made this election, and thus will not adjust the basis of its assets to reflect the distribution to Investor of the foreign currency.

In his budget proposal, the President has proposed to modify these rules by requiring a partnership to adjust the basis of its assets following the distribution of property to a partner. The proposal would require the partnership to increase the basis of its remaining property by the excess of (1) the amount of money and the basis the property distributed, over (2) the amount by which the distributee partner's share of the partnership's basis in its assets and money is reduced by the distribution. The partnership would reduce the basis of its property by the excess of the amount in (2) over the amount in (1).

Under the President's proposal, the adjustment to basis would be made to the basis of the partnership's nondepreciable capital assets held after the distribution. The description of the proposal specifically notes that "unrealized receivables" are included in the term nondepreciable capital asset. If the required positive basis adjustment cannot be made because the partnership does not own any nondepreciable capital assets, then the partnership will recognize a long-term capital loss. In the case of a required negative adjustment, the adjustment is first made to the basis of nondepreciable capital assets, and then to the basis of other assets. If the partnership cannot make the required adjustment because it has insufficient basis in its assets, the partnership would recognize a long-term capital gain.

Under the President's proposal, the proposed changes would be effective for distributions made after the date of enactment and, consequently, would have no effect on the transactions described herein.

F. Disposition of Financial Instruments

The financial instruments are capital assets in Investor's hands. Under Code Section 1001(a) a taxpayer recognizes gain or loss from the sale of an asset equal to the difference between the taxpayer's adjusted basis in such asset and the amount realized by the taxpayer from its sale or other disposition. Under Code Section 1222(1)-(4), gain or loss from the sale or exchange of a capital asset is a capital loss. Based on the forgoing, it is more likely than not that the amount of loss recognized by Investor on its disposition of the financial instruments would constitute a capital loss.

G. Other Tax Provisions and Judicial Doctrines

1. Applicability of the Code Section 465 "At Risk" Rules

Generally, the "at risk" provisions limit the ability of certain taxpayers to currently deduct the losses attributable to certain activities to the extent those losses exceed the taxpayer's "amount at risk" in the "activity". Code Section 465(a) provides that in the case of an individual engaged in an "activity" to which the section applies, any "loss from such activity" for the taxable year shall be allowed only to the extent of the aggregate amount with respect to which the taxpayer is "at risk for such activity" at the close of the taxable year.

The Code Section 465 "at risk" rules apply to individuals directly and to individuals in their capacity as partners in a partnership.[41] The "at risk limitation" of Code Section 465 does not apply to a partnership, it applies to the partners.[42] Consequently, the Code Section 465 "at risk" rules have potential applicability to Investor both with respect to Investor's direct investments and investments through Partnership.

The determination of the extent to which the taxpayer is "at risk" is made on the basis of the facts existing as of the close of the taxable year. Prop. Treas. Reg. §1.465-1(a). That Regulation provides that the amount of the loss is allowed as a deduction only to the extent that the taxpayer is "at risk" with respect to the activity at the close of the taxable year. The determination of the amount the taxpayer is "at risk" in cases where the activity is engaged in by an entity separate from the taxpayer is made as of the close of the taxable year of the entity unless otherwise stated.

Accordingly, the analysis with respect to activities undertaken by a partnership is based upon viewing the partnership as a separate entity and making the determination of the amount "at risk" at the partner level. Prop. Treas. Reg. §1.465-41 uses the following example of a calendar year individual taxpayer and a partnership with a taxable year ending on June 30 to demonstrate an application of this concept:

> Example (5). On July 1, 1976, C, along with many other persons, forms partnership W. C is a calendar year taxpayer and partnership W is on a taxable year ending June 30. On July 1, 1976, C contributes $3,000 to W. On August 1, 1976, W borrows a sum of money for which C's allocable share of personal liability is $7,500. On October 1, 1976, W borrows a sum of money under a nonrecourse financing arrangement with respect to which C's allocable share is $10,000. On March 1, 1977, W repays a portion of the loan for which C is personally liable, thereby reducing C's personal liability to $6,000. C's allocable

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41 The "at risk" rules apply to trusts and estates as well. See Code Section 542(a)(2) and S. Rep. No. 94-938, 94th Cong., 2d Sess. 48 (1976), 1976-3 C.B. at 86 (the "Senate Report"); see also Code Section 641(b) (the taxable income of an estate or trust is computed in the same manner as an individual).

42 HR Rep. No. 432, 98th Cong., 2d Sess. 1597 (1984).

share of W's losses for the taxable year ending June 30, 1977, is $13,000. On September 1, 1977, C contributes unencumbered personal assets with an adjusted basis of $6,000 to W. On November 1, 1977, W repays another portion of the loan for which C is personally liable, reducing C's personal liability to $5,000. On December 1, 1977, W repays part of the nonrecourse loan thereby reducing C's allocable portion of the amount outstanding to $8,000. The amount of loss deduction which C is allowed for 1977 is determined as follows:

Amount at risk in activity as of 7/1/76 (prior to contribution)	$0
Plus:	
Contribution -- 7/1/76	$ 3,000
Allocable share of loan	$ 7,500
	$10,500
Less:	
Allocable share of net reduction in personal liability	$1,500
Amount at risk in activity as of 6/30/77	$9,000

Although C's allocable share of W's losses for the taxable year ending June 30, 1977, is $13,000, C's allowable loss deduction is limited to the amount at risk as of the close of the partnership's taxable year. Thus, C's loss deduction for the taxable year ending December 31, 1977, is $9,000. The $4,000 not allowed as a loss deduction in 1977 will be treated as a deduction in 1978. The fact that prior to December 31, 1977, but after the close of W's taxable year on June 30, 1977, C made a contribution to W does not increase the amount of loss which C may deduct for 1977. That amount is limited to the amount C was at risk in the activity as of the close of W's taxable year.

Prop. Reg. §1.465-39(c) further provides that the amount a taxpayer is "at risk" in an activity "at the close of a taxable year of the taxpayer" is determined by:

> Increasing the amount "at risk" in the activity by all factors occurring during the taxable year which increase the amount at risk; and
>
> Decreasing the amount "at risk" in the activity by all factors occurring during the taxable year which decrease the amount "at risk".

In the above example, the "loss from the activity" was a loss generated by a partnership with a June 30 taxable year that overlapped the taxable year of the individual. In the instant case, Partnership redeemed Investor's Partnership interest during the taxable year of Investor.[43] Furthermore, Partnership generated a loss from its activity. As discussed below, Investor's Partnership interest is part of Investor's existing portfolio of investments, which should constitute an "activity" under Code Section 465(b)(1). Accordingly, the determination of whether there is a "loss from the activity" would be based upon the income or loss derived from Investor's investment portfolio during the taxable year, including Investor's loss on the redemption of its Partnership interest.[44] Furthermore, to the extent a loss was generated from the activity of the Partnership, the Partnership's activities will be treated as a separate activity for purposes of Code Section 465.

From a Code Section 465 perspective, the assets distributed to Investor[45] upon liquidation in a non-taxable transaction were withdrawn from the "old activity" being undertaken by Partnership and contributed to a separate existing "activity" being undertaken by Investor. Accordingly, the determination of the extent to which the taxpayer is "at risk" with respect to Investor's investment portfolio is made on the basis of the facts existing as of the close of the taxable year of Investor. Consequently, the activity undertaken through a separate entity, Partnership, during the taxable year is not impacted by the Code Section 465 "at risk" limitation rules, unless Partnership itself generated a loss on its investment activities.

a. <u>Activities Subject to the Code Section 465 Rules</u>

Code Section 465(c)(1) originally applied to four types of activities: holding, producing, or distributing motion picture films or video tapes; farming; leasing certain tangible personal property; or exploring for, or exploiting, oil and gas resources. Congress extended the application of the "at risk" rules in 1978 to exploring for, or exploiting, geothermal deposits and to each activity engaged in by the taxpayer in carrying on a trade or business or for the

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43 Since Investor is a disregarded entity for federal tax purposes, references to Investor shall include its single member for purposes of this section of the opinion.

44 The "activity" being undertaken by Investor through a separate legal entity (as the concept of separate legal entity is used in Prop. Reg. §1.465-1(a)) effectively terminated at the date of the redemption of its interest.

45 Since Investor is a disregarded entity for federal tax purposes, references to Investor shall include its single member for purposes of this section of the opinion.

production of income not described in Code Section 465(c)(1). See, Code Section 465(c)(1)(E); Code Section 465(c)(3). In 1986, the "at risk" rules were extended to cover real estate.

In applying the "at risk" rules, a two-step analysis is required. The scope of an activity must be first defined and then it must be determined whether separate activities should be aggregated or segregated for purposes of applying the "at risk" rules. The Code Section 465 Proposed Regulations provide only limited guidance regarding how to determine the scope of the activities in which a taxpayer is engaged. If two activities are interrelated, it is not clear whether there are two activities or only one.

Code Section 465(c)(3) applies to each activity engaged in by the taxpayer in carrying on a trade or business or for the production of income. Although a partnership itself is not subject to the "at risk" rules, the nature of any activity involving a partner is determined at the partnership level. Investor engages in its activity with respect to the investments made by Partnership for the production of income. Thus, the "at risk" activity of Investor includes its investments through Partnership. In addition, Investor invests directly in marketable securities and other financial instruments on its own account. Investor's direct investments in marketable securities and other financial instruments also constitute an "at risk" activity. Accordingly, Investor's investment portfolio consists of a combination of Investor's direct investments and investments through Partnership. By design, Investor's investment strategy necessitates an integration of risk positions with respect to the all investments composing the portfolio in order to optimize investment returns. Accordingly, in an economic sense Investor's investment activities are interdependent and integrated.

However, for purposes of Code Section 465 Investor's direct investments activity and its investment through Partnership would constitute two separate "at risk" activities. With respect to carrying on a trade or business under the Code Section 465(c)(3) rules, if a taxpayer actively participates in the management of such trade or business, then all activities comprising the trade or business are aggregated for purposes of the "at risk" rules. Code Section 465(c)(3)(B). No such rules are provided for the production of income. In addition, Code Section 465(c)(3)(C) provides that activities are aggregated or treated as separate activities as Treasury prescribes by Regulations. No such Regulations have been proposed or adopted since enactment of the provision in 1978.

Until such time that Regulations are released defining parameters for aggregation and segregation of activities relating to the production of income it is more likely than not that Investor would be permitted to combine all directly-held investment activities undertaken pursuant to an integrated investment portfolio strategy into one activity. Because Prop. Treas. Reg. §1.465-1(a) treats partnerships as a separate entity for purposes of applying the "at risk" rules, we believe that the intended treatment of activities undertaken by partnerships is to view such activities as separate from related activities undertaken directly by the individual partner. Accordingly, to the extent that Partnership incurred a loss in its investment activities, Investor's allocable share of such loss will be allowed to the extent of Investor's at-risk amount with respect to the Partnership. Furthermore, Investor's interest in Partnership was liquidated before the end of its taxable year. The assets withdrawn from that activity upon liquidation were contributed to the investment activity being undertaken by Investor on its own account. Accordingly, because Investor was then engaged in only one activity, investment activities on its own account, it is more likely than not that Investor's at-risk amount with respect to its directly held investments is determined by aggregating all of its directly held investment activities.

b. Amount "At Risk"

For purposes of Code Section 465, a taxpayer is considered "at risk" for an activity with respect to the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity and the amount borrowed for use in an activity to the extent that the taxpayer is personally liable for repayment of such amount or has pledged property, other than property used in the activity, as security for such borrowed amount (to the extent of the net fair market value of the taxpayer's interest in such property) . Code Sections 465(b)(1) and (2). A taxpayer is not considered "at risk", however, with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements. Code Section 465(b)(4).

An amount borrowed is not "at risk" with respect to an activity if the amount is borrowed from any person who has an interest in the activity (other than an interest as a creditor in the activity) or from a related person to a person (other than the taxpayer) having such an interest. Code Section 465(b)(3). This rule applies with respect to any activity engaged in by the taxpayer in carrying on a trade or business or for the production of income only to the extent provided in Treasury Regulations. Code Section 465(c)(3)(D); Alexander v. Comm'r, 95 T.C.

467, rev'g on motion for reconsideration, T.C. Memo 1990-141. No such Regulations have been proposed or issued.

A taxpayer's amount "at risk" in a partnership is increased by the amount of the partner's distributive share of taxable and tax-exempt income generated from the activity.[46] Code Section 465(b)(5) provides that if in any taxable year the taxpayer has a loss from an activity to which Code Section 465 applies, the amount with respect to which a taxpayer is considered to be "at risk" in subsequent taxable years with respect to that activity is reduced by that portion of the loss which is allowable as a deduction.

The legislative history underlying the enactment of Code Section 465 provides that the "at risk" amount for a partner is computed with reference to the basis of the partner's partnership interest.[47] The close and substantive linkage between Code Sections 752 and 465 is corroborated in PLR 9036013 (6/8/90) where the IRS stated that the economic risk of loss analysis of Code Section 752 applied to determine partner's "at risk" amounts.

In Follender v. Comm'r, supra, the Tax Court rejected the IRS's position that imposed present value concepts on the "at risk" rules under Code Section 465. Based upon the lack of support in the legislative history or the statutory language of Code Section 465, the Tax Court refused to find an "implied limitation of the borrowed amount to present value," observing that "Congress has been explicit in the areas it has chosen to require present value calculations." The court further stated that "the statute does not allow for present value calculation, expressly or implicitly." Accordingly, the amount of debt contributed to an activity is the "face" amount of the debt, the principal payable.[48]

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[46] Prop. Treas. Reg. Sections 1.465-22, 1.465-23, and 1.465-66. See also Lansburgh v. Comm'r, 92 T.C. 448 (1989), (taxpayer's "at risk" amount increased to extent the taxpayer recognizes income with respect to the activity) and Allen v. Comm'r, 55 T.C.M. (CCH) at 688 (1988), (gain recognized on the disposition of the activity or an interest in the activity increases the taxpayer's amount "at risk"). These adjustments reflect the fact that the "at risk" amount is determined in a manner consistent with the determination of the taxpayer's adjusted basis, except that certain nonrecourse debt amounts and amounts protected against loss are not included. See the Senate Report at 50.

[47] S. Rep. No. 938, 94th Cong., 2d Sess. 50 n.8 (1976)

[48] As previously discussed, the application of the time-value-of money concepts in the Code Section 465 context parallels the base Code Section 752 logic. In the Code Section 752 context, time-value-of money concepts are only applied in two defined situations: (1) a special rule for

There are two general areas of divergence in the application of the principles of the Code Section 465 at risk rules and the Code Section 704(d) partnership loss allowance rules. The first difference is that a partner can acquire basis through nonrecourse financing for Code Section 704(d) purposes; whereas, under Code Section 465(b)(4) nonrecourse financing is generally insufficient to create an amount at risk for Code Section 465 purposes. Second, in the event a partnership interest is sold and the selling partner has suspended, unallowed Code Section 704(d) losses, subsequent gain on the sale of the partnership interest can not be used to free-up the Code Section 704(d) loss carryover amount. The partnership's taxable year closes with respect to the selling partner under Code Section 706(c)(2)(A) and the basis for the partner's partnership interest at that date is zero.[49] This can be contrasted with the Code Section 465 rules which allow an offset of losses suspended under Code Section 465 against income from the sale of a partnership interest, as such income is treated as "income from the activity." Prop. Treas. Reg. §1.465-66(a). In effect, the Code Section 465 limitation applies at the partner level, while the Code Section 704(d) limitation isolates the disallowed loss at the partnership level.[50]

With respect to the instant case, the determination of the extent to which Investor is "at risk" is made on the basis of the facts existing as of the close of Investor's taxable year. At the close of Investor's taxable year, Investor had liquidated its interest in Partnership in a non-taxable transaction ~~and the investment assets~~ distributed to Investor were contributed to its existing activity consisting of directly-held investment assets. Accordingly, in determining the amount "at risk," the analysis should effectively track the assets distributed to Investor as liquidating distributions. Such assets were contributed to the investment activity being undertaken by Investor on its own account.

Based on the foregoing analysis, it is more likely than not that Investor's Code Section 465 "at risk" amount for its taxable year ending December 31, 1999, includes Investor's

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nonrecourse liabilities with interest guaranteed by a partner and (2) with respect to an unreasonable delay of a partner's obligation to make payments to the partnership.

49 In Sennett v. Comm'r, 80 T.C. 825, aff'd per curiam, 752 F2d 428 (9th Cir. 1985), the Tax Court concluded that a partner's suspended Code Section 704(d) deductions expire upon the sale of his partnership interest.

50 The underlying logic is that at the point that an investor terminates its entire interest in an investment, Code Section 465 should not preclude deduction of any suspended losses.

cash contribution to Partnership reduced by the amount of nonrecourse debt as described above, i.e. the Premium, plus or minus its allocable share of Partnership income or loss.

2. **Application of Code Section 469**

Conceptually similar to the application of the Code Section 465 "at risk" rules, the passive activity loss rules of Code Section 469 do not apply directly to partnerships or S corporations, but (as a result of the entity's flow-through nature) apply to the partners or shareholders. Prop. Treas. Reg. §1.465-66(a). Thus, Code Section 469 should apply to Investor.

The aggregate amount of deductions disallowed for the taxable year under Code Section 469 is generally equal to a net amount designated as the "passive activity loss." A taxpayer's passive activity loss for any taxable year is the excess of the taxpayer's passive activity deductions for the taxable year over the taxpayer's passive activity gross income for the taxable year. Treas. Reg. §1.469-2T(b)(1). Under the Regulations, in order to compute a taxpayer's passive activity gross income and passive activity deductions, the taxpayer must first determine the items of gross income "from a passive activity" and the items of deduction that "arise in connection with a passive activity."

Code Section 469(c) states that for purposes of this section the term "passive activity" means any activity which involves the conduct of any trade or business in which the taxpayer does not materially participate.[51] Code Section 469(c)(6) further provides that, to the extent provided in regulations, the term "trade or business" includes any activity in connection with a trade or business or any activity with respect to which expenses are allowable as a deduction under Code Section 212. Treas. Reg. §1.469-1(e)(2) and 1.469-4(b)(1)(i) provide that the term "trade or business activity" includes any activity that involves the conduct of a trade or business within the meaning of Code Section 162.

To date, no Regulations have been issued with respect to "any activity with respect to which expenses are allowable as a deduction under Code Section 212." However, Treas. Reg. §1.469-1T(e)(6) provides that the activity of trading personal property for the account of owners of interests in the activity is not a passive activity, regardless of whether the activity is a trade or

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[51] Under Code Section 469(h)(2), a limited partner is presumed not to materially participate in a limited partnership.

business and regardless of a partner's level of participation. Treas. Reg. §1.469-1T(e)(6) provides an example of "trading for the account of owners of interests in the activity." This example indicates that a partnership's trading activities consists of "trading for the account of its partners" where the capital employed by the partnership in the trading activity consists of amounts contributed by the partners in exchange for their partnership interests.

The term "personal property" is defined in the regulations to have the same meaning as under Code Section 1092(d), but without regard to Code Section 1092(d)(3) which generally excludes stock from the definition. Under Code Section 1092(d), personal property means any personal property of a type which is "actively traded." Treas. Reg. §1.1092(d)(1) further provides that actively traded personal property includes any personal property for which there is an established financial market. An established financial market includes an interdealer market. The regulations defines an interdealer market as being characterized by a system of general circulation that provides a reasonable basis for determining current fair market value (e.g., Reuters screen quotations of indicative terms). Presidio has represented that the contracts entered into by Partnership would be considered actively traded based upon the above definition of established financial market.

With respect to the instant case, Investor's participation in the Partnership will constitute an activity that is not a passive activity based upon the exception for the "activity of trading personal property for the account of owners of interests in the activity" described in Treas. Reg. §1.469-1T(e)(6). Accordingly, the income (or loss) generated by Partnership should not be subject to the limitations under Code Section 469. It is more likely than not that such conclusion should extend losses from the disposition of any property received upon liquidation of Investor's partnership interest since the assets were not used in a passive activity.

3. <u>Application of Anti-abuse Rule under Treas. Reg. §1.1275-2(g)</u>

The anti-abuse rule of Treas. Reg. §1.1275-2(g) provides that if a principal purpose in engaging in a transaction is to achieve a result that is unreasonable under Code Sections 163(e), 1271 through 1275, or any related Code Section, the Commissioner can apply or depart from the Regulations to achieve a reasonable result. Whether a result is considered unreasonable will depend upon the facts and circumstances surrounding the transaction. A significant fact in making this determination will be whether the treatment of a debt instrument is expected to have a substantial effect on the issuer's or holder's U.S. tax liability. A result will not be considered unreasonable, however, in the absence of an expected substantial effect on the present value of the taxpayer's tax liability.

The anti-abuse rule provides three examples of the application of its principles. The examples illustrating the anti-abuse rule focus on the following situations:

(i) Use of the option rules in Treas. Reg. §1.1272-1(c)(5) to limit the holder's interest income includible in the period prior to the call date;

(ii) Use of a contingent payment debt instrument to substantially reduce the holder's interest income by virtue of the application of Treas. Reg. §1.1275-4(c); and

(iii) Use of a convertible debt instrument to avoid ordinary issue discount.

None of the examples are on point with the facts in the instant case. The facts of the instant case can be distinguished from the examples illustrating abuse since the issuer properly amortizes the loan issuance premium into income as an offset to its otherwise allowable interest expense deductions; and similarly, upon repayment of the loan, income or deduction is properly computed under the provisions of Treas. Reg. §1.163-13 and Treas. Reg. §1.61-12, respectively.

No authority exists applying the anti-abuse provisions to a case outside of the examples provided in the Regulations. Thus, no guidance exists outside of the Regulation examples to apply the anti-abuse rules to the facts of the instant case. In analyzing whether the tax consequences contained herein are unreasonable under Code Sections 163(e), 1271 through 1275, or any related Code Section, it is useful to determine how a different application of the rules might result in a more reasonable calculation of the present value of the issuer's tax liability. For example, the IRS may apply the anti-abuse rule to change the manner in which the issuer computes:

(i) The issue price of the loan;

(ii) The accrual of interest expense and amortization of loan premium; and

(iii) The income or deduction upon retirement of the loan.

It is unlikely the IRS could apply the anti-abuse rule to change the issue price of the loan since the issue price is a statutory determination under Code Section 1273(b)(2), and the IRS has no authority under the anti-abuse regulations to depart from the statute.

However, if the IRS were to change the issue price of the loan, such change would have the effect of understating or overstating the proper measurement of taxpayer's interest expense under the constant yield method prescribed under the OID rules and Regulations. This misstatement would occur due to the difference in the loan's stated interest rate and prevailing market rates.

Furthermore, any increase or decrease in the issue price would impact the calculation of income from the discharge of indebtedness or repurchase premium deduction upon retirement of the loan. An increase by the IRS in the loan's issue price would increase the accrued interest expense during the loan term, but decrease the repurchase premium in the year paid. Similarly, a decrease in the loan's issue price by the IRS would decrease the accrued interest expense during the loan term, and increase the Partnership's repurchase premium deduction in the year the loan is paid. As a result, it appears unlikely that the IRS could apply the anti-abuse rules to the facts of the instant case to achieve a more reasonable tax result.

Based on the existing authority, and the facts and circumstances of the existing case, we are of the opinion that it is more likely than not that the described tax consequences of Investor's issuance of the debt instrument will not have a substantial effect on the issuer's U.S. tax liability that could be construed as unreasonable in light of the purposes of Code Sections 163(e), 1271 through 1275, or any related Code Section.

4. **Application of Partnership Anti-abuse Rules**

In December 1994, the IRS issued Treas. Reg. §1.701-2 (the "Anti-Abuse Regulations") in an effort to stop what it perceived were abuses of the partnership form. These Regulations consist of two broad rules: the "abuse of subchapter K rule" and the "abuse of entity rule."

Notwithstanding literal compliance with the Code and Regulations, the IRS is authorized to recast the transaction for federal tax purposes as it deems appropriate if the requirements of the anti-abuse Regulations are satisfied. The IRS can (1) disregard the partnership in whole or in part; (2) treat one or more partners as not partners; (3) adjust the method of accounting used by the partnership or a partner to clearly reflect the partnership's or the partner's income; (4) reallocate the partnership's income, gain, loss, credit, or deduction; or (5) otherwise adjust or modify the claimed tax treatment. Treas. Reg. §1.701-2(b).

a. Validity of the Regulations

These Regulations were severely criticized by practitioners and commentators when they were adopted as being invalid, and the controversy has not been resolved. It is reasonable to believe that the validity of these Regulations will be challenged in court.

The commentators have argued that the Regulations are invalid because they are vague and lack clear and workable standards.[52] The language of the Regulations is exceedingly broad, and even the inclusion of examples in the final Regulations does not help to elucidate the meaning of the broad terms. Further, it has been argued that the Regulations are invalid as they were adopted in violation of Executive Order 12866. This Executive Order applies to all significant regulatory actions, which includes a Treasury Regulation, that is likely to result in a rule that may (i) have an annual effect on the economy of $ 100 million or more; (ii) adversely affect in a material way the economy or a sector; or (iii) raise novel legal or policy issues. The partnership anti-abuse Regulations satisfy each of these requirements.

Commentators have also asserted that the Regulations are invalid because they are an unconstitutional usurpation of legislative and judicial powers. The Regulations grant the IRS the power to disregard the language of the statute when literal compliance with specific provisions is not consistent with the "intent" of subchapter K, and then creates that intent without relying on anything of Congressional origin. In adopting subchapter K as part of the Internal Revenue Code of 1954 Congress specifically considered and rejected the type of tax avoidance test that appears in the Regulation. See, S. Rep. No.938, 94th Cong., 2d Sess 100 (1976). The courts have held that the IRS does not have the authority to disregard statutory provisions merely to reach the result that the IRS desires. See, Crooks v. Harrelson, 282 U.S. 55 (1930); Comm'r v. Brown, 380 U.S. 504 (1940); Busse v. U.S., 479 F2d 1147 (7th Cir. 1973); Woods Investment Co. v. Comm'r, 85 T.C. 274 (1985). See also, RLC Industries Co. v. Comm'r, 98 T.C. 457 (1992), aff'd 58 F3rd 413 (9th Cir. 1995). Furthermore, the Regulation attempts to supersede the statute and add restrictions not found in subchapter K.

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52 See, e.g., McKee, supra, at ¶1.05; Banoff, Anatomy of an Anti-Abuse Rule: What's Really Wrong with Reg. §1.701-2, 66 Tax Notes 1859 (March 20, 1995); Gouwar, The Proposed Partnership Anti-Abuse Regulation: Treasury Oversteps Its Authority, 11, No.4 Journal of Partnership Taxation 287 (Winter 1995).

Moreover, the Regulation is not based on any specific legislative grant of authority. Consequently, the Regulation would appear to be invalid under Chevron USA, Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984) and Rowan Cos. v. U.S., 452 U.S. 247 (1981). The Regulation usurps judicial power by granting the IRS the power to apply the substantive law on a case by case basis, which is a judicial function. The courts are thus relegated to the role of determining whether the IRS has abused its discretion, rather than hearing the case de novo where the IRS and the taxpayer are on an equal footing.

b. Abuse of Subchapter K Rule

Treas. Reg. §1.701-2(b), the abuse of subchapter K rule, provides that:

> If a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances.

Thus, two requirements must be met to invoke this rule: a principal purpose of the transaction must be to reduce the present value of the partners' aggregate tax liability, and the tax reduction must be inconsistent with the intent of subchapter K.

c. Intent of Subchapter K

The Regulations state that the intent of subchapter K is to permit the conduct of business and investment activities without incurring an entity level tax. Treas. Reg. §1.701-2(a) then provides that the following requirements are implicit in the intent of subchapter K:

1. The partnership must be bona fide and each partnership transaction or series of related transactions must be entered into for a substantial business purpose.[53]

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[53] See, Statement of John Rooney, attorney advisor in the Treasury's Office of Tax Legislative Counsel to the ABA Tax Section on January 29, 1995, reprinted in Sheppard, 66 Tax Notes 776, 778, that "[s]ubstantial business purpose and principal purpose of tax avoidance cannot co-exist."

2. The form of each partnership transaction must be respected under substance over form principles.

3. The tax consequences to each partner of partnership operations and of transactions between the partner and partnership must accurately reflect the partners' economic agreement and clearly reflect the partners' income.

However, because certain provisions of the Code and Regulations were adopted for administrative convenience and other policy objectives, this test will be satisfied if the ultimate results are clearly contemplated by that provision.

The first implicit intent of subchapter K, that a partnership is bona fide and that transactions be entered into for a business purpose, seems to be a restatement of well established principles. See, e.g., Comm'r v. Culbertson, 337 U.S. 733, 741 (1949), Helvering v. Gregory, 69 F. 2d 809 (2d Cir. 1934), and Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 91 (4th Cir. 1985). However, the Regulations do not elaborate on what is meant by these terms, and also insert the term "substantial" in the business purpose requirement. Culbertson held that a partnership would be respected for tax purposes if the parties had joined together to jointly conduct a business and share the profits. As Justice Frankfurter expressed in his concurring opinion:

> In plain English, if an arrangement among men is not an arrangement which puts them all in the same business boat, then they cannot get into the same boat merely to seek the benefits of [partnership tax provisions]. But if they are in the same business boat, although they may have varying rewards and responsibilities, they do not cease to be in it when the tax collector appears.

337 U.S. at 753.

The determination of whether the abuse of subchapter K rule is applicable is based on all of the facts and circumstances, including a comparison of the business purpose for the transaction and the tax benefit. Treas. Reg. §1.701-2(c) contains a non-exclusive list of factors that indicate, but do not establish, that a partnership was formed or availed of with a principal purpose of tax reduction in a manner inconsistent with the intent of subchapter K. The factors are:

1. The present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's business directly.

2. The present value of the partners' aggregate federal tax liability is substantially less than if purportedly separate transactions that are designed to achieve a particular end result are treated as steps in a single transaction. For example, the analysis may show that that it was contemplated that a partner who was necessary to achieve the intended tax results and whose interest was liquidated or disposed of would be a partner only temporarily in order to provide the tax benefits to the remaining partners.

3. One or more partners who are necessary to achieve the claimed tax results either have a nominal interest in the partnership, are substantially protected from any risk of loss from the partnership's activities, or have little or no participation in the profits from the partnership's activities other than a preferred return in the nature of a payment for the use of capital.

4. Substantially all of the partners are related.

5. Partnership items are allocated in accordance with the literal language of Treas. Reg. §§1.704-1 and 1.704-2 but the results are inconsistent with the purpose of Code Section 704(b).

6. The benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained by the contributing partner.

7. The benefits and burdens of ownership of partnership property are in substantial part shifted to the distributee partner before or after the property is actually distributed to the distributee partner.

These factors are difficult to apply, even with the aide of the examples. The first factor appears to be a restatement of the substantiality test of Treas. Reg. §1.704-1(b)(2)(iii). In the instant case, it is difficult to determine how the activities within and without the Partnership would be characterized in order to apply this test.

The second factor appears to be a restatement of the "end-result" formulation of the step transaction doctrine. As discussed below, each transaction was undertaken for independent reasons, no step was dependent on another step, and you were at risk with respect to each transaction. Consequently, this factor should not be present.

The third factor is not present in this case, as no partner has a nominal interest in the Partnership. Treas. Reg. §1.701-2(d)(1), Ex. 1 holds that a 1% interest in a partnership is not nominal. All of the members of the Partnership have interests significantly in excess of 1%. Further, each member shares proportionately in all items of Partnership income, gain or loss, and no partner is substantially protected from risk of loss from the partnership's activities.

The fourth factor is not applicable with respect to Investor. We have been informed that Investor is not related to the other partners.

The fifth factor relates to the allocation of partnership income. Each item of Partnership income, gain, loss, or deduction will be allocated in accordance with the interests in the Partnership, and each partner's capital account will be appropriately charged. There will be no special allocations of any item of income, gain, loss, credit, or deduction.

The sixth factor is also not present in this case. There is no property that has been "nominally" contributed to the Partnership by any partner. Further, all property contributed to the Partnership is owned by the Partnership, and no partner has in substantial part retained the benefits and burdens of ownership of the contributed property. Any assets that you receive from the Partnership will not be the same assets that you contributed.

Finally, seventh factor is also not present. The benefits and burdens of ownership of Partnership property will not be shifted to any distributee partner before the property is actually distributed.

d. Abuse of Entity and Comparable Common Law Approach

The other part of the anti-abuse Regulations, the abuse of entity rule, is found in Treas. Reg. §1.701-2(e). This Regulation provides that the IRS can treat a partnership as an aggregate of its partners "as appropriate to carry out the purpose of any provision" of the Code or Regulations. However, this rule will not apply to the extent that (a) a provision of the Code or Regulations prescribes the treatment of a partnership as an entity and (b) entity treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision. Thus, under Treas. Reg. §1.701-2(e)(2) a partnership may not be so disregarded when a provision of the Code prescribes entity treatment for such a partnership and that treatment and the ultimate tax results, taking into account all relevant facts and circumstances, are clearly contemplated by that provision.

Although there is no authority in point, as discussed above, the partnership provisions themselves (including the Treas. Reg. §1.701-2(a) intent of subchapter K anti-abuse rules) contemplate the use of a partnership as a vehicle to permit taxpayers to conduct joint activities; Code Section 722 by its terms contemplates a that a partner's tax basis in the partner's partnership interest is determined with reference to the tax basis of property contributed by the partner; and the partnership provisions contemplate that there can be disparities between a partner's tax basis in its partnership interest and the partnership's tax basis in its assets (see, e.g., Code Section 754). Furthermore, the examples contained in Treas. Reg. §1.702-1(f) relate to the use of the partnership to gain advantage of its entity status outside of subchapter K.

It should be noted that the IRS has also attempted to disregard a partnership under common law doctrines although a valid partnership was formed under local law. In Comm'r v. Culbertson, supra, the Court stated that whether a partnership existed for tax purposes depends on "whether the partners really and truly intended to join together for the purpose of carrying on the business and sharing in the profits and losses or both."

In PLR 9914006 (12/23/98), a limited liability company ("LLC") was owned by a partnership and a corporation all of the stock of which was owned by the partnership. Under the LLC agreement, the corporation was not entitled to receive any distributions, and did not receive any allocations of income, gain, profit, loss, deduction, credit, or other amount from the LLC. One of the issues in the ruling was whether the LLC was a partnership for tax purposes. The IRS cited Culbertson, supra, and Comm'r v. Tower, 327 U.S. 280 (1946) for the general principles to determine if a partnership exists. The ruling states that "The primary inquiry is whether the parties intended to join together to operate a business and share in its profits and losses." Because the corporation in the ruling had no interest in the profits and losses of the LLC, the IRS concluded that the corporation was not a partner, and that therefore the partnership was the sole owner of the LLC. Under Treas. Reg. §301.7701-3, a single member entity is ignored for tax purposes. The critical issue in this ruling was whether the purported partners joined together to conduct a business and share the profits and losses. In the present situation, Investor and the other members invested in the Partnership with the intent of jointly conducting a an activity (investing) and sharing the profits and losses therefrom.

ASA Investerings Partnership v. Comm'r, 76 TCM (CCH) 325 (1998), appeal pending (DC Cir. December 7, 1998), concerned a substantially similar transaction as in ACM, supra. In ASA Investerings, Allied Signal became a partner in the partnership and claimed a capital loss. The court found that the partnership formed by Allied Signal and ABN, the foreign partner, was not a valid partnership arrangement for U.S. federal income tax purposes. The court based its holding, in part, on what it viewed as the two party's different investment objectives. In the court's view, Allied Signal only wanted the capital losses while ABN was only interested in earning a specified rate of return on its investment. ABN did not want to share in any losses. The court found that Allied Signal was obligated to pay all expenses and guarantee ABN a minimum profit and made all the critical management decisions. As a result, the court concluded that ABN was not a partner in a partnership, but rather was a mere lender. The court noted that Allied Signal agreed to enter into the transaction before it even knew that ABN would be involved.

The Allied Signal case is distinguishable from the transactions undertaken described herein in several key respects. Each member invested in the Partnership in anticipation of realizing profits from the Partnership's investment activities. Investor and the other members all have the potential for profit or loss in respect of their collective investment in the Partnership. No member was guaranteed a particular minimum profit. Each member shares proportionately in the income, gain, loss and deductions of the Partnership, so that there is no issue of recharacterization as in the Allied Signal case. Finally, Investor is not a party to the critical management decisions of the Partnership.

Consequently, it is more likely than not that the IRS would not be successful were it to attempt to disregard the Partnership as an entity under Treas. Reg. §1.701-2(e) or under the common law doctrines discussed above.

5. **Sham Transaction, Economic Substance, and Business Purpose Doctrines**

There are innumerable cases addressing the judicially developed doctrines of "sham transaction", "business purpose", and "economic substance". One of the most recent attempt to synthesize the rules appears in "Appendix II To JCX-82-99: Description And Analysis of Present-Law Rules and Recent Proposals Relating to Corporate Tax Shelters", Prepared by the Staff of the Joint Committee On Taxation, JCX-84-99, November 10, 1999 ("JCT Appendix").

a. "Sham Transaction Doctrine"

With respect to the "sham transaction doctrine", the JCT Appendix describes two types of "shams", "shams in fact" and "shams in substance". The first involves transactions that in fact never occur. As an example, the JCT Appendix cites to Goodstein v. Comm'r, 267 F.2d 127 (1st Cir. 1959), in which assets were never purchased and a loan never incurred by the taxpayer. Reference is also made to ASA Investerings Partnership v. Comm'r, T.C. Memo. 1998-305 , in which a party never actually entered into a partnership formed to effectuate the transaction. It is more likely than not that the Transactions would not constitute one or more "shams in fact", based upon the advise of Presidio that every transaction did in fact occur as described in Part I hereof.

With respect to the "sham in substance" aspect of the doctrine, the JCT Appendix II cites Yosha v. Comm'r, 861 F2d 494 (7th Cir. 1988) as an example. In Yosha, the taxpayers entered into a series of transactions on the London Metals Exchange ("LME") that were not "shams in fact" because they actually occurred. The taxpayers, however, were fully protected against loss through arrangements by the promoter with the LME brokers, and the transactions were structured so that the taxpayers could not earn a profit from them, i.e. as an economic matter the trades were voided although as a legal and factual matter they occurred. [54] Thus the taxpayers were in the position of economically, or "in substance", never having entered into the transactions. A similar analysis is applied in determining whether a taxpayer is the owner for U.S. federal income tax purposes of a particular asset. Thus, if the taxpayer has none of the economic risk of an owner and none of the economic benefits of an owner, the taxpayer would ordinarily not be treated as the owner, i.e. the taxpayer's economic ownership is voided, and such situations could be viewed as "shams in substance".

In the instant case, we have been advised neither Investor nor Partnership entered into arrangements that voided the economic effects of any of the Transactions. Consequently, it is more likely than not that the Transactions would constitute one or more "shams in substance".

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54 Because the arrangements to protect against loss were arranged by the promoter, the Court was not faced with addressing the effect of bona fida hedging transactions with unrelated parties. Hedges provide by a party involved in the transactions was also viewed as a negative factor in ACM Partnership v. Comm'r, T.C. Memo. 1998-203, aff'd in part and rev'd in part 157 F.3rd 231 (3rd Cir. 1998).

Much confusion about the sham transaction doctrine has arisen because the courts often treat transaction the fail the "economic substance" or "business purpose" doctrines " as "shams". In this regard, the JCT Appendix notes:

> [T]he delineation between [the sham transaction] doctrine (particularly as applied to "shams in substance") and the "economic substance" and the "business purpose" doctrines...is not always clear. Some courts find that if transactions lack economic substance and business purpose, they are "shams" not withstanding that the purported activity actually did occur.

b. <u>Economic Substance and Business Purpose Doctrines</u>

As with respect of the relationship of the sham transaction doctrine to the business purpose and economic substance doctrines, there is some confusion about the relation of the latter two to each other. Again, the JCT Appendix is helpful in trying to clarify the confusion:

> In its common application, the courts use business purpose (in combination with economic substance...) as part of a two-prong test for determining whether a transaction should be disregarded for tax purposes: (1) the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering into the transaction, and (2) the transaction lacks economic substance. [citation omitted]

JCT Appendix, p. __. This language mirrors the language of the 4th Circuit Court of Appeals in <u>Rice's Toyota World, Inc. v. Comm'r</u>, 752 F.2d 89 (4th Cir. 1985).[55] Consequently, to determine whether the Transactions will be respected in the instant case on needs to test the transactions under each prong.

c. <u>Business Purpose</u>

For a transactions to have a business purpose, there must be a business or commercial reason for the taxpayer to engage in the transaction with out regard to tax benefits.

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55 "To treat a transaction as a sham the court must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of profit exists." <u>Rice's Toyota World, Inc. v. Comm'r</u>, 752 F.2d 89, 91 (4th Cir. 1985).

Friedman v. Comm'r, 869 F.2d 785, 792 (4th Cir. 1989); Rice's Toyota World, Inc. v. Comm'r, supra. The existence of such a purpose was recently addressed in United Parcel Service of America, Inc. v. Comm'r, T.C. Memo. 1999-268.

In the United Parcel Service case, the taxpayer tried to avoid taxation with respect to certain fees by restructuring them as insurance Economically, the taxpayer was in substantially the same position as before the restructuring, but through the arrangements was able to exclude the payments from income. The taxpayer made a number of purported commercial reasons for the restructuring of the fees. The taxpayer argued that (i) it was required to restructure the arrangements because such payments would fall afoul of restrictions under some state insurance laws; (ii) it intended to leverage the profits into the creation of a new reinsurer that could become a full-line insurer; (iii) by removing the fees from its operating ratios it could obtain larger rate increases than had it received the fees directly; and (iv) by restructuring the fees it protected its transportation business from the risk increased liabilities. However, the taxpayer offered no credible evidence that the restructuring would in fact achieve goals (i), (ii), and (iv). The Court also found that goal (ii) could have been accomplished by merely making an investment in such a reinsurer.

Similarly, in Winn-Dixie Stores Inc. v. Comm'r, 113 T.C. No. 21 (1999), the Court disallowed interest deductions on policy loans in a COLI program that insured the lives of approximately 30,000 workers. The program resulted in a pre-tax loss for the taxpayer. The taxpayer argued that (i) the program enabled it to fund costs of one of it benefit programs, and (ii) increased the benefits it could offer to its employees under such program. As to (i), the Court found that there was no contemporary evidence that it had purchased the COLI policies to provide such funding; that the COLI policies were not designed to fund such benefits; that the taxpayers CFO never told the entity that was planning the COLI transactions that the purpose was to fund the benefit program; and that projections showed that the cash flow from the program was needed to pay future interest and premiums as opposed to being available t fund the benefits plan. As to (ii), the Court found that the described additional benefits were not related to the COLI program.

In Compaq Computer Corp. v. Comm'r, 113 T.C. No. 17 (1999) the Court disallowed foreign tax credits associated with dividends on certain American Depositary Receipts. Among the factors taken into account was that the officer of the taxpayer in charge of the investments made no inquiry into the commercial aspects of the transactions.

Lastly, among the more recent cases are ACM Partnership v. Comm'r, supra, and Saba Partnership v. Comm'r, T.C. Memo. 1999-359, involving similar transactions. In each case, the Courts found that the purported business purposes of the transactions were unsupported by the evidence and, similar to the foregoing cases, the individuals involved with execution f the transaction did not exhibit behavior consistent with trying to achieve the purported commercial purposes.

The common thread in these cases is that to have the requisite business purpose to support the tax benefits achieved, not only must there be a purported commercial reason for engaging in the various transactions, the transaction must be consistent with such reason, and such reason must be supportable by contemporary evidence, including a showing that the transaction was handled in a business like manner. This analysis is supported by a number of cases.

For example, in Levy v. Comm'r, 91 T.C. 838 (1988), the taxpayers entered into a sale-leaseback of computer equipment for the purported reason of diversifying their business and investments. In upholding the tax benefits the Court stated:

> Based upon our careful examination of the relevant facts and evidence in this case, we conclude that petitioners entered into the transaction in issue for sound business reasons (namely to diversify their investments by entering into a legitimate long-term investment involving the purchase and leaseback of computer equipment). Petitioners approached the decision to enter into this transaction in a businesslike manner. Petitioner's financial advisor thoroughly and in good faith investigated the proposed purchase-leaseback transaction. He prepared cash flow analyses which included the components of the transaction that were critical to earning a profit on the investment. Those components included the current fair market value and projected residual value of the equipment, the fair rental value of the lease, and the rent participation agreement. He explained to petitioners the significance of and risks associated with the projected residual value of the equipment and the rent participation agreement. In addition, he explained to petitioners the tax consequences of the transaction. Petitioners also retained a law firm with expertise in leasing transactions to investigate the financial status and creditworthiness of each participant involved in the transaction, to

> investigate each participant's business reputation, and to handle the legal aspects of this complex transaction.
>
> We are satisfied that petitioners had a good faith and substantial business purpose for entering into the transaction. Petitioners participated in the purchase leaseback transaction only after they were convinced that the investment had a reasonable possibility of producing a profit.

91 T.C. 838, 855-856. Similarly see, Pearlsten v. Comm'r, T.C. Memo. 1989-621; Rubin v. Comm'r, T.C. Memo. 1989-484.

In Carruth Corp. v. Comm'r, 865 F.2d 664 (5th Cir. 1989), aff'g 688 F. Supp.1129 (N.D. Tex. 1987),the issue was whether a charitable contribution would be allowed for a contribution of stock of a controlled corporation to a charity after the dividend was declared, but before the dividend record date. The Court upheld the deduction in part upon finding that lag between the declaration and record dates had a business purpose:

> [Taxpayer] contends that the distinction between the two dates was designed to encourage his nephews... to sell their shares to him....The lag between the declaration date and record date was designed to give the nephews an opportunity to sell. The plan failed in this respect; the nephews held their share.
>
> The district court made factual finding the [taxpayer] wished to buy out his nephews' interests in North Park Incorporated, and that he believed declaration of a dividend might facilitate this objective. We review these findings pursuant to the clearly erroneous standard, and find clear support in the record. With these factual findings in place, we believe it obvious that the distinction between declaration and record date did, as [taxpayer] contends, serve a legitimate business purpose.

Lastly, it should be noted that a transaction can have an appropriate business purpose even if the transaction itself does not generate a profit. See, Caruth v. Comm'r, supra; Horn v. Comm'r, 968 F.2d 1229 (D.C. Cir. 1992).

d. Economic Substance

It is well established that a transaction or series of transactions will not be respected for tax purposes unless the transaction or transactions have economic substance separate and distinct from the economic benefit derived from tax reduction. Gregory v. Helvering, 293 U.S. 465 (1935). Transactions failing to meet this standard lack the requisite "economic substance" (often interpreted as a having a reasonable possibility of pre-tax profit) will not be respected for tax purposes. However, the Supreme Court has held that a transaction should be respected if it has "economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached." Frank Lyon Co. v. U.S., 435 U.S. 561, 583-584 (1978). Thus, transactions have been upheld where the transactions were designed to achieve a tax benefit, but were endowed with positive pretax economics. See, e.g., Northern Indiana Public Service Company v. Comm'r, supra.

A recent decision articulated the standard slightly differently:

> A transaction has economic substance when it is the kind of transaction that some people enter into without a tax motive, even though the people fighting to defend the tax advantages of the transaction might not or would not have undertaken it but for the prospect of such advantages—may indeed have had no other interest in the transaction."

Yosha v. Comm'r, 861 F.2d 494, 499 (7th Cir. 1988).

It should be noted that a taxpayer need not be correct in its judgment of possible economic benefits, only reasonable or rational. Profit motive depends on the taxpayer's subjective and good faith intent to earn a profit. Finoli v. Comm'r, 86 T.C. 697, 722 (1986). The fact that a venture fails to produce a profit in the anticipated amount or at all does not indicate that the venture was not profit-motivated. King v. U.S., 545 F.2d 700, 708 (10th Cir. 1976). However, that profit potential cannot be illusory. In ACM Partnership v. Comm'r, supra, the Tax Court found that at the time it entered into the partnership, the taxpayer's only real opportunity to earn a profit was through an increase in the credit quality of the issuers of certain notes, or a 400-500 basis point increase in 3-month LIBOR interest rates. The court found no impact of credit quality was possible as the lenders were extremely highly rated at the time of the transaction. Moreover, the court did a 6-year review of 3-month LIBOR rates and did not find an increase of even 300 basis points in the necessary time frame. Since the analysis of the historical data showed no reasonable basis for expecting a profit, the court ruled against the taxpayer. "We do not suggest that a taxpayer refrain from using the tax laws to the taxpayer's advantage. In this case, however, the taxpayer desired to take advantage of a loss that was not economically inherent in the object of the sale, but which the taxpayer created artificially through the manipulation and abuse of the tax laws. A taxpayer is not entitled to recognize a phantom loss from a transaction that lacks economic substance". In its analysis, the Third Circuit focused upon the foregoing finding of the Tax Court, stating:

> Tax losses such as these, which are purely an artifact of tax accounting methods and which do not correspond to any actual economic losses, do not constitute the type of 'bona fide' losses that are deductible under the Internal Revenue Code and regulations."

The Third Circuit also noted:

> [O]n November 3, 1989, [the partnership] invested $175 million of its cash in private placement Citicorp notes paying just three basis points more than the cash was earning on deposit, then sold the same notes 24 days later for consideration equal to their purchase price, in a transaction whose terms had been finalized by November 10, 1989, one week after ACM acquired the notes. These transactions . . . offset one another and with no net effect on ACM's financial position.

See, also Saba Partnership v. Comm'r, supra; Merryman v. Comm'r, 873 F.2d 879 (5th Cir. 1989) (conduit partnership without economic substance disregarded).

In Compaq Computer Corp. v. Comm'r, supra, in addition to finding no business purpose for the transactions, the Tax Court also found a lack of economic substance. This was because as the transactions were designed and executed, the taxpayer was bound to suffer a pre-tax loss. The Tax Court reached a similar conclusion for the same reason in Winn-Dixie Stores Inc. v. Comm'r, supra.

From these cases it appears that the "substance" necessary to meet the requirements of the "economic substance" doctrine is somewhat different from the "substance" required under the "sham in substance" doctrine. As discussed above, the latter requires that the transaction have the economic consequences consistent with what the transaction purports to be -

Does the taxpayer really have the economic incidents of ownership if the taxpayer purports to own the asset. The former requires that, having passed the "sham in substance" test, the transaction make economic sense – Does the have a reasonable possibility of economically benefiting from the transaction without regard to tax benefits.

Despite being inconsistent with the economic substance cases, one case has suggested that there must be not only a reasonable possibility of making a profit, but the possibility must relate to a profit that is greater than de minimis. See, Sheldon v. Comm'r, 94 T.C. 738 (1990).56 Other decisions have indicated that the should consider whether the profit motive for a transaction was greater or less than the tax motive. See, e.g., Fox v. Comm'r, 82 T.C. 1001 (1994); Estate of Baron v. Comm'r, 83 T.C. 542 (1984), aff'd, 798 F.2d 65 (2d Cir. 1986). However, a transaction should not be under the economic substance doctrine merely because its principal purpose was to achieve tax benefits. . See, e.g., Northern Indiana Public Service Company v. Comm'r, supra. Congress has precluded such a broad test for all disallowance by incorporating such a principal purpose test into specific Code Sections such as Code Section 269. Long-standing judicial authority has also recognized that "any one may so arrange his affairs that his taxes shall be as low as possible" Helvering v. Gregory, 69 F. 2d 809 (2d Cir. 1934). See, also Cottage Savings Association v. Comm'r, discussed above, involving a transaction executed solely for tax purposes.

e. **Conclusion**

Based upon the representations provided by Investor and Partnership in II, above, it is more likely than not that the Transactions will have the requisite economic substance and business purpose to be respected under the authorities discussed above.

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56 On December 23, 1997, the IRS issued Notice 98-5, announcing that the IRS will issue Regulations effective on and after such date dealing with foreign taxes paid or accrued in connection with certain abusive transactions. Such transactions were described as those in which the anticipated economic benefits are insubstantial in relationship to the anticipated tax benefits. It is currently uncertain as to when or whether such Regulations will be issued, the criteria they will establish with respect to the insubstantiality of anticipated economic benefits, or whether such Regulations will have application beyond the area of foreign taxes.

6. Code Section 165(c)(2)

Notwithstanding that the transactions described herein have the requisite economic substance, where applicable, Code Section 165(c) imposes additional limitations on the ability of individuals to claim losses.[57] Because Partnership is a pass through entity these rules have to be taken into account for determining whether such losses would be available to Investor and like wise, Investor's member.

If an individual incurs a loss from the disposition of the assets in the individual's trade or business, Code Section 165(c)(1) generally permits the allowance of such loss. In determining whether such a business exists, the courts have required that the criteria of Code Section 183 be met. See, Farmer v. Comm'r, T.C. Memo 1994-342.

Code Section 183(a) and Treas. Reg. §1.183-1 requires that the activities with respect to which the loss relates be activities engaged in for profit. There has been substantial litigation regarding whether such motive exists. These cases have established that a taxpayer need only have a good faith expectation of earning a profit from the activities undertaken. See, e.g., Burger v. Comm'r, 809 F.2d 355 (7th Cir. 1987); Johnson v. U.S., 11 Cl. Ct. 17 (1986).

If an individual incurs a loss from the assets in a transaction which does not involve the individual's trade or business, Code Section 165(c)(2) and Treas. Reg. §1.165-1(e) require, like Code Section 183(a) and Treas. Reg. §1.183-1, that the loss be incurred in a transaction entered into for profit. Thus, these statutory and regulatory provisions mirror the Code Section 183 standard.

Notwithstanding the parallel nature of Code Section 183(a) and Code Section 165(c)(2), the courts have imposed a judicial gloss that appears to create a standard higher than that imposed by the statutes, i.e., that the taxpayer's profit motive be the "primary" motive for entering into the transaction. The first case that did so was Fox v. Comm'r, 82 T.C. 1001 (1987). The Tax Court in Fox derived this primary profit motive test from a footnote in Helvering v. National Grocery Co., 304 U.S. 282, 289 n.5, reh'g denied, 305 U.S. 669 (1938), which involved

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57 In the case of a partnership (or entity treated as a partnership) this test is applied at the partnership level.

the constitutionality of the imposition of the accumulated earnings tax. The footnote stated in relevant part:

> Similarly, the deductibility of losses under [Code Section 165(c)(2)] may depend upon whether the taxpayer's motive in entering into the transaction was *primarily* profit. [emphasis added].

In addition, the Tax Court in Fox relied on an earlier Tax Court case involving the deductibility of a loss under Code Section 165(c)(2), Smith v. Comm'r, 78 T.C. 350 (1982). In Smith, however, the Tax Court did not impose the "primary" test articulated in Fox, but rather stated at p. 391:

> The mere fact that petitioners may have had a strong tax avoidance motive in entering into their commodity tax straddles does not in itself result in a disallowance of petitioners' losses under Section 165(c)(2), *provided petitioners also had a non-tax profit motive for their investments at the time*, See, Knetsch v. U. S., 172 Ct. Cl. 378, 348, F. 2d 932, 936-937 (1965). *Such hope of deriving an economic profit aside from the tax benefits need not be reasonable so long as it is bona fide.* See, Bessenyey v. Comm'r, 45 T.C. 261, 274 (1965), aff'd 379 F.2d 252 (2nd Cir. 1967). [emphasis added].

Both the Fox and Smith cases, as well as the bulk of subsequent cases involving the application of the "primary" standard, arose in connection with commodities straddle transactions in which looking at the transactions as a whole, the taxpayer had little or no opportunity to earn any meaningful profit.[58] In addition many of the decisions were Memoranda

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58 The Tax Court in Sheldon v. Comm'r, 94 T.C. 738 (1990) applied these principles wherein certain of the transactions before the Court the taxpayer demonstrated that it could have made a profit. The Tax Court denied the claimed deductions stating that: "[i]n instances where intermediate repos would have or did generate some form of [positive] carry, these amounts were nominal, either fixed or short term and stable and, in any event merely reduced the fixed losses by relatively insignificant amounts." It is uncertain whether the Sheldon case has added an additional dimension to the economic profit motive analysis by, effectively, requiring a profit to be greater than "de minimus" or "nominal". In assessing this point it should be noted that the Tax Court ultimately found that even what nominal profit there was in Sheldon was absorbed by losses on related and, arguably, integrated transactions. 94 T.C. 738, 768 and 769. See also, Est. of Baron v. Comm'r, 83 T.C. 542, aff'd 798 F.2d 65 (2d Cir. 1986).

decisions of the Tax Court.[59] Neither the Knetsch case nor the Bessenyey case cited by the Tax Court in Smith required the profit motive of the taxpayer to be the primary standard for engaging in the transactions in issue, although the Knetsch decision did refer to the National Grocery Co. Supreme Court decision discussed above.

When a court has thoughtfully attempted to deal with the primary standard, the results have often yielded confusion. For example in Nickson v. Comm'r, 962 F.2d 973, 976 (10th Cir. 1992), a case involving the application of Code Section 183, the court first appeared to apply the primary standard by requiring that the taxpayer engage in the transaction with the "dominant hope and intent to realizing a profit", but then went on to provide that "the determination crucial to the instant case [is]-whether the taxpayers had an actual and honest profit objective." See also, Nickerson v. Comm'r, 700 F.2d 402, 404 (7th Cir. 1973). This confusion in part may be due to the fact that in Fox v. Comm'r, supra, which first applied the primary standard in the context of Code Section 162(c)(2), the taxpayer's had little or no opportunity to make more than a relatively small fixed economic profit from the commodity straddle transactions into which the taxpayer entered. Such a situation is unlike the instant case in which, based on the advice we have the Investor entered into the transactions with the reasonable possibility of making a reasonable profit from investment in the Partnership. Such a profit potential is more analogous to the situation in Smith v. Comm'r on which the Fox case relies. Although the matter cannot be exactly free from doubt because of the factual nature of the inquiry, on balance, it is more likely than not that the requisite profit motive exists to support the deduction of any loss on the disposition of the distributed assets under Code Section 165(c)(2).

7. Step Transaction Doctrine

In determining the tax consequences of a series of events, the courts use a step transaction analysis to determine what is the transaction to which the tax law should be applied. The step transaction doctrine combines and treats a series of separate steps "as a single transaction if they are in substance integrated, interdependent, and focused toward a particular end result." Bittker & Lokken, Federal Taxation of Income, Estates and Gifts (2d ed.), ¶4.3.5. The courts have articulated three different formulations of the step transaction doctrine: the "binding

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59 In assessing whether the requisite profit motive exists, all of the fees incurred in engaging in the transactions will have to be taken into account. See, ACM Partnership v. Comm'r, supra.

commitment" test, the "interdependence" test, and the "end result" test. Penrod v. Comm'r, 88 T.C. 1415, 1429 (1987). The IRS could attempt to apply the step transaction doctrine in a number of ways. For example, the IRS could attempt to collapse all of the steps and disregard the Loan and the Partnership. Alternatively, the IRS could attempt to collapse the Investor's redemption from the Partnership and the Partnership's repayment of the Loan to treat the Loan, including the payment of the prepayment penalty, to treat the repayment as occurring simultaneously with the redemption, which could result in a reduced tax basis in the foreign currency to the Investor.[60]

Under the "binding commitment" test, a series of transactions is amalgamated only if there is a binding legal commitment to undertake each of the steps. Comm'r v. Gordon, 391 U.S. 83, 96 (1968). It is more likely than not that this formulation would not apply to the transactions above, because Investor was not bound in any way to incur any obligation under the Loan, to make any contribution to the Partnership, or to withdraw from the Partnership.

Under the "interdependence" test, a series of transactions are integrated only if the steps are "so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series." Manhattan Building Co. v. Comm'r, 27 T.C. 1032, 1042 (1957), acq., 1957-2 CB 5. The interdependence test focuses on the relationship between the steps, and whether the first step would have occurred without the second. For example, in Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517 (10th Cir. 1991), the court applied the interdependence test to integrate two purportedly independent transactions and deny the claimed loss because the two agreements were, by their terms, dependent on each other. Unlike the factual situation in Associated Wholesale Grocers, each transaction set out above (Investor's purchase of the Options, Investor's investment in the Partnership, and Investor's withdrawal from the Partnership) was independently undertaken by Investor, and each transaction presented Investor with the potential for economic gain or loss. See also, McDonalds Restaurants of Illinois, Inc. v. Comm'r, 688 F.2d 520, 524 (7th Cir. 1982); Security Industrial Insurance Co. v. United States, 702 F.2d 1234 (5th Cir. 1983). Where each step has independent economic significance, the courts will not integrate the steps. Redding v. Comm'r, 630 F.2d 1169 (7th Cir. 1980), cert. denied, 450 U.S. 913 (1981). In Rev. Rul. 79-250, 1979-2 CB 256, the

[60] See footnote 32.

IRS agreed, but also inserted a requirement that each step must be "undertaken for valid business purposes and not mere avoidance of taxes."

Based upon the foregoing, it is more likely than not that each step undertaken by Investor and Partnership would be viewed as independent from the others and, consequently, that the "interdependence" formulation of the step transaction doctrine would not be applicable to the transactions. Furthermore, even adopting the position of the IRS in Rev. Rul. 79-250, based on the representations made to us, each of the transactions undertaken by you and the Partnership will be supported by a reasonable expectation of profit.

The "end-result" formulation integrates a series of transactions into a single transaction "when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result." King Enterprises, Inc. v United States, 418 F.2d 511, 516 (Ct. Cl. 1969). The courts, however, have limited the expansive scope of the end-result test.

In Esmark, Inc. v. Comm'r, 90 T.C. 171 (1988), aff'd without published opinion, 886 F.2d 1318 (7th Cir. 1989), the taxpayer wanted to dispose of certain businesses owned by one of its subsidiaries. Mobil, an unrelated company, acquired a portion of Esmark's outstanding shares from the public in a tender offer, and then tendered these shares to Esmark in exchange for stock of a wholly-owned subsidiary of Esmark. Under the law at the time, the exchange of the subsidiary's stock for the Esmark shares was tax-free at the corporate level. By contrast, a sale of the subsidiary's stock for cash, which could then have been used to buy back the Esmark shares, was taxable at the corporate level.

Although it recognized that the reduction of taxes was a significant factor in structuring the transaction, that Mobil's tender offer was part of an overall plan, and that Mobil, not Esmark, had borne the economic cost of the tender offer, the Tax Court held that Mobil's ownership of the Esmark shares, "however transitory," must be respected, and the transaction treated as a redemption of the Esmark shares. In rejecting the IRS's attempt to apply the step transaction doctrine to recast the transactions, the court stated:

> That Mobil's tender offer was but part of an overall plan is not in dispute. The existence of an overall plan does not alone, however, justify application of the step-transaction doctrine. Whether invoked as a result of the "binding commitment,"

> "interdependence, " or "end result" tests, the doctrine combines a series of individually meaningless steps into a single transaction. In this case, respondent has pointed to no meaningless or unnecessary steps that should be ignored.
>
> Respondent proposes to recharacterize the tender offer/redemption as a sale of the Vickers shares to Mobil followed by a self-tender. This recharacterization does not simply combine steps; it invents new ones. Courts have refused to apply the step-transaction doctrine in this manner.

90 T.C. at 195-197. (Emphasis added.) The court further noted that each of the steps "had permanent economic consequences," and could not be combined. 90 T.C. at 198.See also, Grove v. Comm'r, 490 F2d 241 (2d Cir. 1973) and Carrington v. Comm'r, 476 F2d 704 (5th Cir. 1973). The Tax Court recently reaffirmed the Esmark step transaction analysis. Turner Broadcasting Company v. Comm'r, 1 11 T.C. 315 No. 18 (December 23, 1998).

The IRS agrees that the step transaction doctrine does not permit the creation of new steps or the reordering of existing steps. See, Rev. Rul. 78-197, 1978-1 CB 83. In each of PLR 8815003 (December 11, 1987); PLR 8738003 (May 22, 1987); PLR 8735007 (May 18, 1987); and PLR 8735006 (May 18, 1987), an unrelated underwriter acquired a corporation's outstanding debt, exchanged that debt for other securities of the corporation, and then sold such other securities to the public. In each technical advice memorandum, the IRS held that the step transaction doctrine cannot be applied to reverse the order of the transactions.

More recently, in True v. U.S., 190 F.3rd 1165 (10th Cir. 1999) the Court of Appeals affirmed the District Court's summary judgement in favor of the IRS regarding the integration of one series of transactions under the "end result" formulation of the step transaction, where the evidence clearly showed that the end result was the sole outcome intended to be achieved by entering into the transactions from the outset. With respect to such series of transactions, the Court of Appeals also concluded that such integration would be appropriate under the "mutual interdependence" formulation as well, because the facts showed that each of the steps would have been fruitless without the others. The Court of Appeals, however, reversed the District Court's summary judgement integrating another series of transactions. The Court of Appeals concluded that there was a factual issue under the "end result" formulation, because the evidence created a genuine factual issue as to whether the end result achieved was the sole intended result from the outset. The Court of Appeals concluded that there similarly was a factual issue under the "mutual interdependence" formulation, because it appeared that the each of the steps might have economic significance on its own. The conclusion that can be drawn from the True decision appears to be that if the facts demonstrate that at the time of entering into series of transactions an investor has in mind a sole outcome and no other outcome can be discerned, a court can apply the "end-result" formulation of the step transaction doctrine to disregard intermediate steps, particularly if those intermediate steps had so little economic significance on their own to fall within the "mutual interdependence" formulation.

In both Salomon, Inc v. United States, 976 F.2d 837 (2d Cir. 1992) and Walt Disney, Inc. v. United States, 4 F.3d 735 (9th Cir. 1993), the issue was whether a transfer of assets to a subsidiary as part of a divisive "D" reorganization resulted in the recapture of investment credit. While both courts seemed to apply the "end result" formulation to integrate the transfer of assets and subsequent spin-off, each court cited facts that would indicate a "binding commitment" or "mutual independence" test. In Walt Disney, the court cited an overall intention for the steps to occur, and the fact that the company had a legal obligation to transfer the assets and distribute the stock. In Salomon, the court based its conclusion in part on the fact that at the time of the asset transfer the taxpayer intended to spin-off the stock, establishing the interdependent nature of the steps.

Investor was placed at risk with respect to each its investments prior to, during and after the investment in the Partnership. Consequently, based on Esmark, it is more likely than not that the "end result" formulation of the step-transaction doctrine would not apply to the transactions described above.

Based on this the foregoing analysis, it is more likely than not that the step transaction doctrine would not apply to the transactions described above, because each transaction undertaken by Investor had independent economic significance and placed Investor at risk.

This opinion does not address, and is not intended to address any tax issues, whether U.S. Federal, state, local or foreign, other than those specifically addressed herein. This opinion is being issued to the addressees solely for the addressees' use and the use of the addressees' professional advisors to determine the amount, if any, of the addressee's U.S. federal income liability. The addressees or the addressees' professional advisors may not use this opinion for any other purpose without our prior written consent. We are relying upon the relevant provisions of the Code, the Regulations thereunder, and the judicial and administrative interpretations thereof, which are subject to change or modification by subsequent legislative, regulatory, administrative, or judicial decisions. Any such changes also could have an effect on the validity of our conclusions. Unless you specifically request otherwise, we will not update our advice for subsequent changes or modifications to the law and Regulations or to the judicial and administrative interpretations thereof.

Very truly yours,

Brown & Wood LLP

kpmg Peat Marwick LLP

To Doug Ammerman
Orange County

Date August 30, 1998

From Randy Bickham
Silicon Valley

Steno
Ref c:\data\ammerman.doc

cc

Tax Products Practice

The following summarizes my thoughts on how to best structure the PFP Tax Products Practice. The underlying logic reflects a combination of my initial views and the collective views of others within the PFP Practice based upon recent discussions.

The key points are as follows:

- Strategic Direction of the Business
- Internal Organizational Structure
- Personal Considerations

Strategic Direction of the Business

The goal is to create a $100 million business over a three year period built around creating and marketing "capital market-based" tax products to high wealth individuals. In reaching the $100 million, the plan is revenues of $30 million in FY'99, $60 million in FY'00, and $100 million in FY'01. As discussed later in the memo, the business model is premised on closing 100 deals annually. A business model based upon 100 deals can be developed and managed by two people. On a broad conceptual level, one person's focus must be on strategy and the development of institutional channels whereby there is a continuum of high-end tax products. The other person's focus is on optimizing and managing the PFP distribution channels.

The market for our products can be segmented as follows: products with a price-point of $250,000 to $1 million and those products with fee potentials of $1 to $5 million. The business plan assumes that the Practice will be initially created through the lower-tier priced products in that our access to this market is greater based upon the current structure of the PFP distribution network. However, in order to realize the $100 million three year plan, we must also be a significant participant in the $1 to $5 million market segment.

The structure of the existing tax products market for high-wealth individuals is extremely fragmented with no dominant market leader. Unlike the publicly-traded corporate tax products sector where the investment banking firms (e.g., Goldman Sachs and Merrill Lynch) dominate the market, there has been minimal market penetration by the existing participants in the high-wealth individual market sector. The reason for this phenomenon is that to date the high-wealth individual market has been served by small boutique tax product groups and accounting firms that are merely "dabbling" in that they are not seriously devoting resources to the effort. In light of this fragmentation, we can dominant the market in three years by investing in the organizational structure to support a $100 million business.

The business model is based upon the simple concept of investing in the development of a portfolio of elegant, high-value tax products and then maximizing the return on this investment though the PFP distribution network. The associated business strategy is premised upon two integral concepts: the establishment of strategic alliances to develop and market products and capitalizing upon the existing PFP distribution network. The conclusion to externalize substantive functions through participation in strategic alliances is based upon the premise that this approach provides the most expeditious strategy for establishing a predominant position in the targeted market. Such alliances will allow us to greatly accelerate the process of establishing a branded image for both the Practice and its products, access technical expertise not available to us internally and establish market relationships that are critical to developing the Practice.

As to branding and how we are perceived within the target market, the objective is to brand the Practice as being one which is KPMG-centric with concentric strategic alliances. These alliances will be established with institutions that have exemplary reputations in the capital transactions markets. Our ability to negotiate strategic alliances which are KPMG-centric is based upon our ability to invest the funds required to expertise and productize a large portfolio of tax products and the PFP distribution network's success to date in high-wealth individual market sector.

The existing alliances with Deutsche Bank and Brown & Wood exemplify this approach. We have used the existing OPIS product as the mechanism for establishing close strategic relationships with Deutsche Bank and with Brown & Wood at both an institutional level and with key individuals within the organizations. In that the product development focus is on products which require the use of relatively complex financial securities and third party financing, these relationships are critical to our future success. The strategy is to co-develop products with Deutsche Bank and Brown & Wood and sell into the $1 to $5 million market segment on a joint basis. I have discussed the strategy of joint development and marketing with both institutions. The respective participants from each institution has agreed to commit the resources to participate in our internal product development group as well as to become active participants in the marketing process.

Organizationally, the next level of concentric relationships is with boutique tax products groups such as Presidio Advisors. Our lead relationship at this organizational level is currently with Presidio and we expect that Presidio will continue to be our "vendor of choice". In order to insure that we have access to a portfolio of ideas, we are also establishing secondary relationships with other boutique tax products groups. The business model as it relates to these firms is akin to that of a venture capitalist. We apprise them of the products that we need to complete our product portfolio so as create a pipeline of product idea inflow to us. This model effectively replicates the economics and structure of a venture capitalist establishing an inflow of business plans from which he will choose the optimal investment opportunities. In return, these boutique groups will have access to our distribution network to in effect monetize their ideas.

From a KPMG organizational perspective, the business should be viewed as a complement and an extension of the general charter of the PFP Practice; the development of leveraged tax strategies for high-wealth individuals throughout capital investment lifecycles. Our focus is the creation of tax products for optimizing returns at end of the investment cycle, i.e., preserving accumulated wealth by tax minimization.

The Practice should be funded and managed through PFP and linked with broad organization initiatives such as FCS. As to such organizational linkages, whereas there exists no common basepoints relating to the marketing function in light of our strategy being based upon selling in to the high-wealth individual market, there could be benefits associated with a FCS linkage in the product development area. However, organizational independence is critical to our business model in light of the following considerations:

- In order to brand the Practice within the high-wealth individual market segment, we must strictly focus on this market at an organizational level and have the autonomy to negotiate alliances which solely benefit our Practice.

- We must have the independence to develop compensation policies that conform to market norms. In light of the disproportionately large profit contributions that can be realized in the tax products area, key players are highly compensated. Market norms within financial institutions are base salaries of $750,000 to $1 million with significant incentive compensation packages. Accordingly, in order to maintain our core management group and to be in a position to attract quality people within the industry, we must compensate on a commensurate basis.

- We must also have the independence to directly incentivize the individuals involved in product development and marketing commensurate with their specific contributions to the profitability of the PFP Practice. The simple observation being that if we can develop a $100 million business within PFP that has 80 to 90 percent margins, all participants in the process should benefit.

Internal Organizational Structure

Relative to its $100 million potential, the management team needed to develop and run the business and the resources that must be deployed to support it are extraordinarily modest. The reason for this conclusion is that the business could generate $100 million in revenue based upon doing approximately 100 deals annually. Using the OPIS product as base for extrapolation, the following model can be derived to demonstrate the phenomenon based upon the assumption that future products will replicate the economics of OPIS and that we are able to effectively penetrate the $1 to $5 million dollar market segment.

Notional Deal Amt	Number of Deals	Avg KPMG Fee	Total Revenues
$5.00 billion	82	$750,000	$61,500,000
$1.25 billion	14	$1,500,000	$18,000,000
$1.25 billion	6	$3,000,000	$18,000,000
$7.50 billion	102		$100,500,000

[The current "run rate" for the OPIS product is an average KPMG fee of $750,000 per deal. If we have had a normalized sales cycle for the product this year covering 6 months, we could have closed approximately 60 deals.]

The internal operating structure to support the business must incorporate the following functions:

1. A strategic management function to define the operating strategy for the business in

terms of market focus, resulting product mix, marketing plans for products (e.g., lifecycling of products, timing of replacement products, etc,)

2. A product R&D function which is based upon working with Deutsche Bank, Brown & Wood, boutique tax product groups and other institutions to develop a pipeline of product ideas for our consideration (the counterpart of the venture capitalist having a inflow of business plans to consider for investment).

3. An internal product development function which will take the selected product ideas and determine whether we can opine on the concept on a "more likely than not" basis, write the associated opinion letter, manage the opinion letter through the DPP opinion review process, and package the product for marketing. The optimal size for the group is 6 people. Once an idea has been accepted by the group, one person will be selected to be the product owner and will be responsible for taking the product through the technical review process and packaging it for marketing.

   The initial thoughts on the participants in the group are:
   - Randy Bickham
   - Jeff Eischeid
   - Tracie Henderson
   - David Rivkin
   - Shannon Liston
   - Jack Nuckolls

   In addition to the six permanent group members, Mark Watson should be asked to participate in order to provide a linkage to the Innovative Strategies Group. This linkage is important so as to benefit from group synergies and to avoid duplicative efforts.

4. The sales and marketing function will be effectively orchestrated through two separate groups. The PFP partner/manager group will be responsible for finding and managing the closing of deals. The CaTS group will be responsible for formal presentations of products to target buyers and supporting the PFP partner/manager group in closing deals. If the assumption is that we will close 100 deals annually, then we would need approximately 10 people in the CaTS marketing group. The assumption being that 10 people could give 150 to 200 presentations to be in a position to close 100 deals.

The initial thoughts on the CaTS group participants are:
Randy Bickham
Jeff Eischeid
Tracie Henderson
David Rivkin
Carl Hastings
Deke Carbo
Dale Baumann
Mike Watkins
Bob Pederson
(TBD)

As the above discussion indicates, there are two discrete management functions that are critical to the success of our business, one with an external focus and the other internal: managing the external alliance network so as to maintain a continuum of quality product ideas/and the subsequent internal productization process and managing the CaTS/PFP distribution channel/and the internal groups which can significantly impact product distribution such as DPP. Whereas Jeff and I believe that it will take our collaborative efforts to build the business envisioned, we have concluded that I should focus on developing and managing external alliances/product development and Jeff should focus on maximizing the potential of the CaTS/PFP distribution network.

Personal Considerations

- Position within the Practice. I need an interim title to effectively communicate to both our joint venture partners and the market my responsibilities and level of authority within the Practice. My suggested solution is Managing Director – Capital Strategies, whereas Jeff would be the Partner-in-Charge of the CaTS group. As to a long-term solution, I assume that based upon our discussions that if the Practice grows as expected I would be offered an equity partnership position in FY '99.

- Reporting relationships. As discussed, I will report directly to you in a national role.

- Compensation. My view is that my compensation for this year is a function of two components, (1) the success of the OPIS product through the first part of October 1998 and (2) my contribution to developing a tax products business around the base that has been established with OPIS. As to the first component, please be mindful of the following observations:

- If Gregg Ritchie and I had not championed the OPIS product, neither OPIS nor the CaTS group would exist today. Gregg was critical to the process in terms of dealing with internal organizational impediments, primarily DPP. My contribution was product design and development, sufficiently differentiating the OPIS product from the FLIP product which was taken off the market by DPP. As a result of the product development process, we became the product owner as compared to the FLIP product which considered to be owned by Presidio.

- I was responsible for KPMG's position that we should not register OPIS as a tax shelter and insisted that we make the business case with DPP. This was of significant benefit in marketing the OPIS product and will establish the direction with respect to KPMG's position on future tax products.

- The PFP plan assumes $20 million of revenue from the OPIS product. One month ago, Deutsche Bank only had the capacity to do $800 million in OPIS deals, resulting in approximately $10 million in KPMG fees. Presidio was unable to negotiate additional Deutsche Bank capacity. I met with Deutsche Bank in New York and convinced them of the necessity of increasing their internal deal capacity and of the need to effectively contract capacity from another financial institution, Commerzbank. We now have the capacity to do a sufficient level of deals so as to meet plan. The existing capacity number will allow for us to generate approximately $25 million in KPMG fees.

- We have only booked $500 million in deals to date. Over the next six weeks, we must book $1.5 billion in deals to realize the $25 million in fees. It is going to take a herculean management effort by Jeff and myself to accomplish this result.

My sense of an appropriate amount of compensation for managing OPIS through the current cycle is 2.5% of the revenue generated. Consequently, should we achieve our plan number of $20 million for OPIS, I will receive a bonus of $500,000. As to my contribution in creating and managing our future tax products business, I believe that the "2.5% of revenue generated" approach is equally appropriate. To provide a perspective on evaluating "2.5% of revenue generated" in the context of the tax products business, generally there are 350-400 bps to be allocated to the institutions participating in most capital market-based tax products. KPMG typically is allocated 125-150 bps. The "2.5% of revenue generated" equates to less than 5 bps.

Effectively, I am willing to undertake a position which will significantly impact the profitability of the PFP Practice with a compensation package which is structured around a relatively low amount of base compensation in return for a significant incentive component. If my belief in the future of the business is correct, KPMG will become the dominant participant in a highly profitable market and I will be in a position to earn a significant level of compensation. In the event that I am wrong, KPMG has minimal downside in light of its modest investment in the venture.

new

From:	Jeffrey A Eischeid
Sent:	Monday, September 14, 1998 12:30 PM
To:	Larry DeLap
Subject:	OPIS
Importance:	High

Larry - please call me at your earliest convenience. Work: 404/222-3180; Home: 770/956-0174.

I have a very practical problem that I'd like your thoughts on. I spoke with Jim Carney a short while ago. He'd like to run a background check on the principals of Quadra before approving the Level I alliance. I have provided him the requisite social security numbers. Unfortunately, in talking with Gail Williams, it is clear this process will take a minimum of 7 to 10 business days. The fundamental question is what, if anything, I can do during this background check period. I'm confident that there will be no unforeseen problems.

If I am to capitalize on the existing market opportunity, I must move very quickly. In terms of KPMG fees, I am estimating the following: $3.8 million of "certain" fees; another $4.6 million of "probable" fees, based on existing client commitments; and finally another $6.6 of "possible" fees, based on ICV's. These fees relate to approximately $1.3 billion in notional losses for approximately 25 clients.

As you know, we have historically taken the position that there must be a minimum 90 day holding period for the long position. To achieve this holding period in 1998, the trades would have to be executed no later than October 2nd. In order to execute trades, the accounts must be opened and the requisite paperwork prepared. This process typically takes at least a week. Thus, it's relatively unlikely that a transaction can be commenced after September 25th. Obviously, before a trade could even be commenced, the client must be introduced to Quadra and Quadra must convince the client of the reasonable possibility of earning a reasonable profit on the UBS trades.

If we can take no action until a formal alliance is approved, we may as well not start - at least if such approval is not expected until September 23rd (7 days) or September 29th (10 days). Can you help?? I'd like to begin the investment process and line up the trades on the assumption that the alliance will in fact be approved. We, after all, have a relatively long history of doing these trades with them. If a surprise occurs during the background checks, we can always pull the plug on the trades.

Jeff

Permanent Subcommittee on Investigations
EXHIBIT #92

Zaudtke, David P

From:	Gregg W. Ritchie
Sent:	Monday, June 08, 1998 11:20 PM
To:	Jeffrey A. Eischeid; Tracie K. Henderson; Dale R. Baumann; Neil J. Tendler; B. Michael Watkins; John H Gardner; Timothy P. Speiss; Richard J. Bloom; Deke G. Carbo; Mark Watson; David P. Zaudtke; Robert A. Pedersen; Robert M. Jordan; Robin M. Paule; John M Nuckolls; Shannon L Liston; Harvey L. Armstrong; Jeffrey Zysik; Randall S Bickham
Cc:	Douglas K. Ammerman; Dennis A. Ito
Subject:	Re[2]: OPIS

Please be reminded that you should NOT leave this material with clients or targets under any circumstances. Not only will this unduely harm our ability to keep the product confidential, it will DESTROY any chance the client may have to avoid the step transaction doctrine.

______________________ Reply Separator ______________________

Subject: Re: OPIS
Author: Randall S Bickham at KPMG_Silicon_Valley2
Date: 6/7/98 3:34 PM

Knowing that everyone is as excited as I am about finally reaching closure with DPP on the OPIS product, I have updated the slides that we used in Dallas so that they can be used on an interim basis in marketing presentations. I will work with Jeff Zysik this week in finalizing a presentation to be housed in our CaTS KMAN Toolkit.

The slides are quite detailed in terms of technical explanation. Should a potential buyer wish to discuss the technical aspects at a greater depth, you should consider suggesting a conference call with me to make the best use of your time, effectively to maximize your marketing time versus having to waste time on technical stuff.

Finally, Gregg had some kind words in the attached as to my efforts in getting OPIS to market. Everyone should be aware of the masterful efforts expended by Gregg in effectively managing the KPMG organization so as to receive the required sign-offs that we were seeking both at a product level and as to policy.

Randy

______________________ Reply Separator
____

Subject: OPIS
Author: Gregg W. Ritchie at KPMG_Warner_Center
Date: 6/4/98 10:41 PM

I am pleased to tell you that the technical conclusions of the OPIS product have been approved by DPP Tax. The strategy has been approved based on virtually the same facts we presented to you in our technical session on April 20th. I plan to hold a 1 hour conference call next week to remind all of us of the details of the strategy and key points that we must communicate to prospective investors. I encourage you to review the material that Randy gave you at our meeting in Dallas prior to making contact with clients.

Jeff Zysik has led the effort in making our case for NOT registering the product as a tax shelter. Based on a memo prepared by Mark Ely, Eve Elgin, and Jeff Z. I expect that Larry will agree that the product does not meet the requirements of section 6111 relative to its

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Permanent Subcommittee on Investigations
EXHIBIT #93

XX-001932

registration. Assuming this news comes tomorrow, we should be immediately able to begin our marketing efforts.

The product tool kit is almost ready to go. I am working with Larry on the final touches of our engagement letter. You should note that Larry's current thinking is that all engagement letters must be sent to him for approval prior to execution by clients. I will post the new engagement letter on KMAN as soon as it is ready. We must not vary from the language in the sample letter (especially with respect to indemnification, etc) without advance approval from DPP.

You should also note the newest version of the Nondisclosure Agreement which will be posted on KMAN this weekend. You must ensure that all clients and targets execute this agreement prior to presenting the strategy to them. Furthermore, while we will, under limited circumstances, allow outside advisors to participate in reviewing the strategy, you should only do so with my or Randy Bickham's advance approval. If you believe this will be required for the client to execute the strategy, we will make a business decision relative to the specific individual and/or Firm involved. As a general rule, we should strenuously resist sharing this strategy with outside advisors. I am certain that we have a short time frame to market this strategy before legislation will be effective to shut it down. Accordingly, the less publicity, the longer the strategy may be available.

Presidio is meeting next week in New York with Brown & Wood to finalize the legal documents required to execute the strategy. I will let you know when they are ready to receive wire transfers from clients who want to open the trading strategy. We have indicated to DPP that each client will receive an analysis of the investment results expected given anticipated price increases BEFORE the client engages us. In general, client presentations should be coordinated with Presidio so that they may hear the investment strategy from them in the initial visit. John Larson and Kerry Moskalik have each of your names and will only respond to you for client visits (not other KPMG partners/employees). We need your help to keep control of the distribution of this strategy.

Several of you have asked whether it is appropriate for us to consider the payment of a referral fee with respect to the strategy. Per my conversation with Larry DeLap, referral fees are to be discouraged, but may be considered in exceptional cases. Any such fees which are contemplated must be approved in advance. Please send me a message with the facts and reasons why you believe such a fee would be in our best interests and the amount of the proposed fee. I will discuss it with you and DeLap to determine if we should make an exception.

I want to again acknowledge the exceptional efforts that Randy Bickham made in order to make this product a reality. The strategy was in the morgue and Randy, through his exceptional technical and writing skills and determination brought it back to life. Jeff Zysik has also played a critical role in bringing the resources of WNT and the TIC to bear on this product. Many thanks to Jeff for all of your efforts.

I know that I have forgotten something important in this message. I would appreciate your immediate attention to reviving the contacts you have made over the last few months and putting this product into our clients hands.

One final note of interest. Quadra Capital Advisors signed our confidentiality agreement today and will be presenting some of their proprietary strategies to us in the next few days.

new

From: DeLap, Larry
Sent: Thursday, January 21, 1999 5:13 PM
To: Eischeid, Jeffrey A
Cc: Watson, Mark T
Subject: FW: Grantor trust reporting

Jeff -

Please send me the memorandum to which Mark refers.

Larry

-----Original Message-----
From: Watson, Mark T
Sent: Thursday, January 21, 1999 3:05 PM
To: Eischeid, Jeffrey A; Baumann, Dale R; Bickham, Randall S; Bloom, Richard J; Branan, Carolyn B; Carbo, Deke G; Fergus, Terrence P; Gardner, John H; Hastng, Carl D; Henderson, Tracie K; Jordan, Robert M; Liston, Shannon L; Nuckols, John M; Pace, Katherine A; Paule, Robin M; Pedersen, Robert A; Poage, Ray M; Rivkin, David; Slattery, Daniel M; Speiss, Timothy P; Spitz, William L; Tendler, Neil J; Watkins, B M; Wissel, Kyle; Zaudtke, David P; Zysik, Jeffrey C
Subject: RE: Grantor trust reporting

You should all know that I do not agree with the conclusion reached in the attached memo that capital gains can be netted at the trust level. I believe we are filing misleading, and perhaps false, returns by taking this reporting position.

-----Original Message-----
From: Eischeid, Jeffrey A
Sent: Thursday, January 21, 1999 2:12 PM
To: Baumann, Dale; Bickham, Randall; Bloom, Richard; Branan, Carolyn; Carbo, Deke; Eischeid, Jeffrey; Fergus, Terrance; Gardner, John; Hastng, Carl; Henderson, Tracie; Jordan, Robert; Liston, Shannon; Nuckols, John; Pace, Katherine; Paule, Robin; Pedersen, Robert; Poage, Ray; Rivkin, David; Slattery, Daniel; Speiss, Timothy; Spitz, William; Tendler, Neil; Watkins, B; Watson, Mark; Wissel, Kyle; Zaudtke, David; Zysik, Jeffrey
Subject: Grantor trust reporting

I believe this is the latest version. Don't forget the statute of limitations issue Tracie raised.

Jeff

<< File: grantor.doc >>