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KPMG to Pay \$456 Million for Criminal Violations In Relation to Largest-Ever Tax Shelter Fraud Case

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

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

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

“Corporate fraud has far-reaching consequences, both to the marketplace and those whose livelihoods depend on companies that maintain honest business practices,” said Attorney General Alberto R. Gonzales. “Today’s agreement requires KPMG to accept responsibility and make amends for its criminal conduct while protecting innocent workers and others from the consequences of a conviction. The stiff financial penalty announced today means that the firm is paying for its conduct, while the guarantees of cooperation, oversight, and meaningful reform will help to ensure that its future business is conducted with honesty and integrity.”

The criminal information and indictment together allege that from 1996 through 2003, KPMG, the nine indicted defendants and others conspired to defraud the IRS by designing, marketing and implementing illegal tax shelters. The charging documents focus on four shelters that the conspirators called FLIP, OPIS, BLIPS and SOS. According to the charges, KPMG, the indicted individuals, and their co-conspirators concocted tax shelter transactions—together with false and fraudulent factual scenarios to support them—and targeted them to wealthy individuals who needed a minimum of \$10 or \$20 million in tax losses so that they would pay fees that were

a percentage of the desired tax loss to KPMG, certain law firms, and others instead of paying billions of dollars in taxes owed to the government. To further the scheme, KPMG, the individual defendants, and their co-conspirators allegedly filed and caused to be filed false and fraudulent tax returns that claimed phony tax losses. KPMG also admitted that its personnel took specific deliberate steps to conceal the existence of the shelters from the IRS by, among other things, failing to register the shelters with the IRS as required by law; fraudulently concealing the shelter losses and income on tax returns; and attempting to hide the shelters using sham attorney–client privilege claims.

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

The agreement provides that prosecution of the criminal charge against KPMG will be deferred until Dec. 31, 2006 if specified conditions—including payment of the \$456 million in fines, restitution, and penalties—are met. The \$456 million penalty includes: \$100 million in civil fines for failure to register the tax shelters with the IRS; \$128 million in criminal fines representing disgorgement of fees earned by KPMG on the four shelters; and \$228 million in criminal restitution representing lost taxes to the IRS as a result of KPMG's intransigence in turning over documents and information to the IRS that caused the statute of limitations to run. If KPMG has fully complied with all the terms of the deferred prosecution agreement at the end of the deferral period, the government will dismiss the criminal information.

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

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

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

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

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

The nine individuals named in the indictment are:

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

The indictment alleges that as part of the conspiracy to defraud the United States, KPMG, the nine defendants and their co-conspirators prepared false and fraudulent documents—including engagement letters, transactional documents, representation letters, and opinion letters—to deceive the IRS if it should learn of the transactions. KPMG, the indicted defendants and their co-conspirators are also charged with preparing false and fraudulent representations that clients were required to make in order to obtain opinion letters from KPMG and law firms—including Ruble’s law firm—that purported to justify using the phony tax shelter losses to offset income or gain. The conspirators allegedly concealed from the IRS the fact that the opinion letters provided by KPMG and the law firms were not independent and were instead prepared by entities involved in the design, marketing and implementation of the shelters. Had the IRS known this, the opinion letters would have been rendered worthless.

KPMG admitted that the opinion letters issued for the FLIP, OPIS, BLIPS and SOS shelters were false and fraudulent in numerous respects, including false claims that transactions were legitimate investments instead of tax shelters; and also false claims that clients were entering into certain transactions making up the shelters for investment purposes or to diversify their portfolios, when these actually served to disguise the shelters. KPMG also admitted that the clients' motivations were to get a tax loss, and with respect to BLIPS, the opinion letters also included false claims about the duration of the transaction and the clients' motivation for terminating the transaction. According to the charges, BLIPS was also based on false claims about the existence and investment purpose of a loan, when these were in fact sham loans that had nothing to do with any investment, and at least one of the banks never even funded the purported loans.

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

Assistant U.S. Attorneys Justin S. Weddle and Stanley J. Okula, Jr.—together with Special Assistant U.S. Attorney and Tax Division Trial Attorney Kevin M. Downing—are in charge of the prosecution. The investigation and prosecution are being supervised by Shirah Neiman, Chief Counsel to the U.S. Attorney for the Southern District of New York. For the IRS, the case was investigated by a team of special agents and revenue agents from the agency's criminal and civil divisions.

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

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