

## TALES FROM THE KPMG SKUNK WORKS: THE BASIS-SHIFT OR DEFECTIVE-REDEMPTION SHELTER

By Calvin H. Johnson

Calvin H. Johnson is professor of law at the University of Texas at Austin. This report arises out of his testimony before the U.S. Senate Permanent Subcommittee on Investigation hearings on the role of professionals in the U.S. tax shelter industry. Prof. Johnson has agreed to serve as an expert for plaintiffs who bought KPMG shelters and seek recovery of costs. He thanks James Martens and Samuel Buell for comments on an earlier draft, but acknowledges responsibility for errors.

In this report, Johnson argues that the basis-shift or defective-redemption shelter, called FLIP or OPIS by KPMG, was an early product of KPMG's endeavor to develop complete tax packages that could be sold for multimillion-dollar fees to many customers. The FLIP/OPIS shelter gives a rare opportunity, he says, to see both KPMG internal deliberations and also the profession's many independent evaluations. KPMG said the shelter was likely to prevail, Johnson writes, but the tax profession has reached a consensus that the shelter did not meet professional standards, shown by its acceptance of the IRS's generous settlement offer.

In the FLIP/OPIS shelter, Johnson says, a Cayman Islands straw entity borrowed from a foreign bank, bought the bank's stock, and was redeemed out of the stock a few weeks later. The technical claim was that the basis of the Cayman Islands straw could not be used in the redemption, but was shifted to stock held by a related U.S. taxpayer to produce a large artificial tax loss for that taxpayer. Johnson argues that the basis did not shift, in part because the Cayman Islands entity did not *recapture* any significant fraction of the redeemed shares, so that the redemption was not "essentially equivalent to a dividend." Johnson also argues that various substance-over-form doctrines prevent the loss: Non-bona-fide losses are not allowed; transactions without expectation of pretax profit are not respected; accounting that does not clearly reflect income can be defeated by the IRS; and the step transaction doctrine applies. Prof. Johnson is unwilling to speculate as to how broadly the lessons learned from FLIP/OPIS describe the current professional culture.

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KPMG, the fourth largest accounting firm, is negotiating with the Justice Department over the terms by which it might avoid criminal indictment for its conduct arising out of its tax shelters.<sup>1</sup> From about 1996 through 2003, KPMG had an extensive operation to invent and sell packaged tax shelters. According to the bipartisan report of the Senate Permanent Subcommittee on Investigations:

KPMG devoted substantial resources and maintained an extensive infrastructure to produce a continuing supply of generic tax products to sell to clients, using a process which pressured its tax professionals to generate new ideas, move them quickly through the development process, and approve, at times, illegal or potentially abusive tax shelters.<sup>2</sup>

<sup>1</sup>Lynnley Browning, "KPMG Says Tax Shelters Involved Wrongdoing," *The New York Times*, June 17, 2005, at C1.

<sup>2</sup>Report of the Permanent Subcommittee on Investigations of the U.S. Senate Homeland Security and Governmental Affairs Committee, on the Role of Professional Firms in the U.S. Tax Shelter Industry" at 6 (Feb. 8, 2005) (hereinafter PSI Report). The chair of the Permanent Subcommittee on Investigations is Sen. Norm Coleman, R-Minn., and the report represents his endorsement of the work originated when Sen. Carl Levin, D-Mich., was chair of the subcommittee. The subcommittee held hearings from which its report derives. "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Advisers," Hearings Before the Permanent Subcommittee on Investigations,

(Footnote continued on next page.)

The KPMG operation was looking for polished “turn-key” tax products that could be sold easily to multiple clients.<sup>3</sup> “The business model,” KPMG said internally, “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 [KPMG’s] distribution network.”<sup>4</sup> For a participant who purchased a shelter, KPMG offered a package of completed documents and “basically cookie cutter opinions” following a prototype.<sup>5</sup> A “skunk works” operation was once a secret research lab for developing planes to defeat the Nazis and the Communists.<sup>6</sup> The KPMG tax skunk works dreamed up transactions against our *United States*.

KPMG aggressively promoted its products, pressuring its agents to “sell, sell, sell.”<sup>7</sup> As one KPMG e-mail put it, “We are dealing with ruthless execution, hand-to-hand combat, blocking and tackling. Whatever the mixed metaphor, let’s just do it.”<sup>8</sup> The KPMG customers for the shelters were big-gain taxpayers — identified through KPMG’s nationwide network as having gains larger than \$20 million to shelter.<sup>9</sup> As late as 2003, KPMG listed in its inventory 500 active tax products offered to multiple clients for a fee.<sup>10</sup> Overall, KPMG collected at least \$124 million in fees for its skunk works shelters, which would have eliminated \$10 billion of gain from the tax base had the shelters been successful.<sup>11</sup>

Within KPMG, there was a lot of professional dissent as to whether KPMG shelters worked, which was picked up in the e-mail traffic the Senate subcommittee reproduced.<sup>12</sup> KPMG decided to go ahead with the marketing of its shelters, however, despite the internal dissent, on the assumption that KPMG would receive enough rev-

enue from their sales to offset the risks of litigation. Philip Weisner, the chief of the KPMG National Tax Office, was responsible for supervising the 100 lawyers and at some point he cut off further discussion of the merits of one shelter. Weisner concluded that “our reputation will be used to market the transaction”<sup>13</sup> and that

I do believe the time has come to s\*\*t 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 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.<sup>14</sup>

Weisner identified the shelter as a high-risk operation, trading on KPMG’s reputation, justified by fees reaching almost \$100 million for the shelter at issue and covered by “bells and whistles” limitations on their opinions. Jeffrey Stein, No. 2 man at KPMG,<sup>15</sup> responded:

I think [the expression is] s\*\*t OR get off the pot. I vote for s\*\*t.<sup>16</sup>

And so KPMG offered its shelters to its customers. To avoid indictment, KPMG itself is willing to admit wrongdoing, calling the operations “unlawful conduct”<sup>17</sup> and an embarrassment that should “never happen again.”<sup>18</sup>

KPMG was not alone in marketing packaged shelters. Ernst & Young, Pricewaterhouse Coopers (PwC), and BDO Seidman are being sued for damages by taxpayers who purchased shelters they sold that the IRS has since gone after.<sup>19</sup> PwC is now describing its shelters as an “institutional failure.”<sup>20</sup> Arthur Andersen also sold multimillion-dollar tax schemes, and it too suffered “institutional failure.”

108th Cong., 1st Sess. (Nov. 18 and 20, 2003) (four vols.) (hereinafter PSI Hearings), which included a minority staff report, *id.* at 45 (hereinafter Minority Staff Report).

<sup>3</sup>PSI Report at 132.

<sup>4</sup>Memo of Randy Bickham, Aug. 30, 1998, in 1 PSI Hearings at 858. *See also id.* at 861, calling for a product research and development function with Deutsche Bank and UBS to develop new products.

<sup>5</sup>1 PSI Hearings at 86.

<sup>6</sup>For a description of skunk works operations against the former two targets, see Benn R. Rich and Leo Janos, *Skunk Works* (1994) (describing Lockheed’s skunk works shop that began in 1943 and developed the first American jet, the U-2 spy plane, and stealth fighters).

<sup>7</sup>Minority Staff Report, 1 PSI Hearings at 191-194.

<sup>8</sup>*Id.* at 194.

<sup>9</sup>*See, e.g.*, PSI Report at 125, 1 PSI Hearings at 222 (\$20 million “minimum”).

<sup>10</sup>PSI Report at 79.

<sup>11</sup>PSI Report at 70. KPMG fees were typically 1.25 percent of the tax loss (PSI Report at 72), and 1.25 percent of tax losses of \$9.9 billion would yield the \$124 million fees.

<sup>12</sup>*See, e.g.*, Memorandum from Robert D. Simon, KPMG, to Gregg Ritchie, Randy Bickham, and John Harris, all KPMG, Feb. 23, 1998, reprinted in 2 PSI Hearings at 897; Mark Watson reply to Sen. Coleman, 1 PSI Hearings at 20 (KPMG professionals never resolved their doubts on who was the borrower); 1 PSI Hearings at 180-181 (KPMG professional concluded that results were not more likely than not to be achieved if challenged).

<sup>13</sup>E-mail from Philip Weisner to multiple KPMG National Tax Office professionals (May 10, 1999), Plaintiff’s Exhibit #172.

<sup>14</sup>*Id.*

<sup>15</sup>Minority Staff Report 1 PSI Hearings at 166.

<sup>16</sup>E-mail from Jeffrey Stein to Philip Weisner, (May 10, 1999), 1 PSI Hearings at 181.

<sup>17</sup>“KPMG Statement Regarding Department of Justice Matter,” *The Wall Street Journal*, June 16, 2005.

<sup>18</sup>Eugene O’Kelly, KPMG chair and CEO (May 12, 2004), PSI report at 81. *See also* Richard Smith, vice chair of tax services for KPMG, in *id.* at 57. (Stating that because of the risk to its reputation and its credibility, “[w]e no longer offer or implement aggressive look-alike tax strategies. In particular, we no longer offer or implement FLIP, OPIS . . . or any similar transactions.”)

<sup>19</sup>*See, e.g.*, Mark Hamblett, “Judge: Tax Shelter Suit Against Sidley Austin, Deutsche Bank May Proceed,” *New York L. J.* (June 22, 2005) (taxpayers’ suit for fraud against Ernst and Young, Deutsche Bank, and Sidley Austin Brown & Wood for COBRA shelter is not dismissed); Sheryl Stratton, “Clients Sue E&Y and Three Law Firms Over Tax Shelter,” *Tax Notes*, Dec. 30, 2002, p. 1649; Sheryl Stratton, “BDO and Deutsche Bank Investor Suits Headed Toward Arbitration,” *Tax Notes*, June 20, 2005, p. 1478.

<sup>20</sup>PSI Report at 100.

This report focuses on one shelter, called the FLIP or OPIS shelter by KPMG, but also known as the basis-shift or defective-redemption shelter. KPMG culture considered the shelter to be fair game to apply against the United States, whereas the tax profession as a whole has reached a consensus, demonstrated by its actions in context, that the shelter did not meet minimum professional standards. KPMG was willing to give an opinion that the shelter was more likely than not to prevail in litigation if challenged by the IRS on audit.<sup>21</sup> The tax profession as a whole has concluded that the shelter did not have a realistic possibility of success when the IRS did in fact challenge the shelter.

The KPMG shelters give us a relatively rare window. The Permanent Subcommittee on Investigations collected almost 400 pages of documentation on the FLIP/OPIS shelter,<sup>22</sup> which included many once-very-confidential KPMG internal conversations. There have also been 450 independent, highly qualified tax counsel who have reached a decision on FLIP/OPIS, and it is unusual to have access to such a large sample of independent events. The professional culture seems to have tolerated “aggressive,” even vicious, shelters that did not meet lawful “realistic possibility-of-success” standards, when the fees justified the risk of mere monetary damages. The standards of what was fair game in tax were not very high.

There are still no reported cases on the FLIP/OPIS tax issues. The Senate subcommittee that collected the extensive documentation did not analyze the tax issues in the shelter. *Tax Notes* has recently published some fine analyses of other shelter transactions, based on the published court opinions.<sup>23</sup> This report attempts to fill in the literature with a discussion of the tax issues in the FLIP/OPIS shelter.

## I. Was FLIP/OPIS Fair Game?

### A. Description of the FLIP/OPIS Basis-Shift Shelter

KPMG initially called the shelter the FLIP — short for “Foreign Leveraged Investment Program” — and then changed the name to OPIS — short for “Offshore Portfolio Investment Strategy” — adding complexity with the changing of the name, but without changing the under-

<sup>21</sup>Section 6662(c)(2)(C)(i)(II) allows a taxpayer to avoid a 20 percent accuracy-related penalty if the taxpayer reasonably believes that the tax treatment was more likely than not the proper treatment. Section references are to the Internal Revenue Code of 1986, as amended, or the regulations thereunder, except as otherwise noted.

<sup>22</sup>1 PSI Hearings at 865-868, 2 PSI Hearings at 869-1239, 3 PSI Hearings at 2678.

<sup>23</sup>Alvin Warren, “Understanding *Long Term Capital*,” *Tax Notes*, Feb. 7, 2005, p. 681; Karen Burke, “*Black & Decker’s* Contingent Liability Shelter: ‘A Thing of Grace and Beauty?’” *Tax Notes*, Jan. 31, 2005, p. 577. Ethan Yale, “Reexamining *Black & Decker’s* Contingent Liability Tax Shelter,” *Tax Notes*, July 11, 2005, p. 223. Lee Sheppard has also been a one-woman institution on shelters. See, e.g., Lee Sheppard, “*LTCM* Case: What They Won’t Do for Money,” *Tax Notes*, Sept. 6, 2004, p. 1006; “Finding Economic Substance in *COLI*,” *Tax Notes*, Apr. 21, 2003, p. 320; “Treasury Shuts Down Baby BOSS Deals,” *Tax Notes*, Aug. 14, 2000, p. 850.

lying logic of the shelter.<sup>24</sup> The shelter is also reasonably called a “defective-redemption” shelter because it required that a redemption of stock from a Cayman Islands entity fail to qualify as a redemption under U.S. tax law.<sup>25</sup> Union Bank of Switzerland (UBS), which provided financing, called it a “UBS redemption trade.”<sup>26</sup> FLIP/OPIS is also commonly called a “basis-shifting shelter” because it depends on the costs of a shell Cayman Islands entity shifting over to become part of the basis of the domestic taxpayer who purchased the shelter. It is also called a “Notice 2001-45 shelter,” after the IRS notice that said it was illegal. KPMG developed the FLIP, but it migrated to PwC when a KPMG professional moved to PwC and began doing copycat deals, and at PwC it was called only FLIP.<sup>27</sup>

FLIP/OPIS was a highly profitable shelter, generating over \$45 million fees for KPMG<sup>28</sup> and \$16 million fees for PwC,<sup>29</sup> but it was not the biggest of KPMG’s shelters. KPMG replaced it in 1999 with another shelter called BLIP or Son-of-BOSS, which generated even more fees.<sup>30</sup> But FLIP/OPIS eliminated reported gain of at least \$3.6 billion before the IRS began rolling up the participants, which is a material amount.

In 2001 the IRS gave notice that the tax benefits claimed by FLIP/OPIS were “not properly allowable for Federal income tax purposes” and identified the FLIP/OPIS as a potentially abusive tax shelter that would have to be registered with the IRS and listed on taxpayers’ returns.<sup>31</sup> The IRS then announced, in 2003, a very generous settlement offer under which participants in FLIP/OPIS would give up 80 percent of their tax losses and would still face full appropriate penalties.<sup>32</sup> The bar has decided overwhelmingly that the chances of prevailing in litigation were thin enough and that the IRS’s offer was generous enough that the shelter is not worth litigating. The IRS has announced that 92 percent of the taxpayers it identified as buying the shelter have taken

<sup>24</sup>OPIS is distinguished from FLIP by the fact the former used derivatives instead of options and a foreign partnership instead of a foreign corporation. Memo of Robert D. Simon of KPMG, 2 PSI Hearings at 891, 893, 896. None of the distinctions are germane to the core logic.

<sup>25</sup>For a defective-redemption gambit in another context, using deep-out-of-the-money options, see Lee Sheppard, “Can Seagram Bail Out of Du Pont Without Capital Gain Tax?,” *Tax Notes*, Apr. 17, 1995, p. 325 (describing Seagram’s claim that redemption by DuPont was dividend, taxed at 7 percent because of dividend received deduction, rather than capital gain taxed at 35 percent, because Seagram retained deep-out-of-the-money option to purchase DuPont stock, which prevented the redemption from being considered substantially disproportionate redemption qualifying as capital gain).

<sup>26</sup>PSI Report at 121.

<sup>27</sup>PSI Report at 95.

<sup>28</sup>1 PSI Hearings at 147.

<sup>29</sup>3 PSI Hearings at 2840.

<sup>30</sup>PSI Report at 17-25. See, e.g., Lee Sheppard, “Treasury Shuts Down Baby BOSS Deals,” *Tax Notes*, Aug. 14, 2000, p. 850.

<sup>31</sup>Notice 2001-45, 2001-33 IRB 129, *Doc 2001-20288*, 2001 TNT 145-7 (July 26, 2001).

<sup>32</sup>Ann. 2002-97, 2002-43 IRB 757, *Doc 2002-22625*, 2002 TNT 194-13 (Oct. 4, 2002).

the IRS settlement offer.<sup>33</sup> FLIP/OPIS transactions are multimillion-dollar transactions, implying that the taxpayers' representatives are top-of-the-bar tax lawyers. The settlements mean that 450 first-class lawyers already have decided independently that FLIP/OPIS will not be upheld if litigated. Substantial tax dollars are still at stake in transactions that have not settled. There have also been malpractice suits by the taxpayers against the professionals participating in the package asking for reimbursement of costs on the argument that FLIP/OPIS was below professional standards.<sup>34</sup>

FLIP is within a family of tax shelters that KPMG called a "loss generator."<sup>35</sup> As UBS candidly described the transaction, "the losses are not real but only tax relevant. The [FLIP/OPIS] uses provisions in the US Tax Code to create a *synthetic* loss."<sup>36</sup> "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."<sup>37</sup> A "loss generator" must have reported losses that are not lost as a matter of fact or economics. Capital gains tax rates were only 20 percent when FLIP/OPIS was offered, and it is a "fool's shelter" to lose \$100 million just to avoid a 20 percent tax (\$20 million) on it. The point of a "loss generator" is artificial accounting losses, that is, reporting loss to one's government without losing it.

The FLIP/OPIS shelter depends technically on the cost basis of a Cayman Islands entity shifting over to a related U.S. taxpayer after the Cayman Islands entity was redeemed out. For each purchaser, a shell Cayman Islands corporation or partnership was set up that was related, within the constructive ownership rules of section 318, to the U.S. taxpayer who purchased the shelter. The Cayman Islands entity bought stock of a foreign bank, either Deutsche Bank or UBS, with funds borrowed on a nonrecourse basis from the same bank, in the amount of the artificial loss to be generated. A few weeks later, the same bank redeemed all the stock, and the Cayman Islands entity repaid the bank with the redemption

proceeds. The redemption, however, purported to fail to qualify as a redemption under U.S. tax law.

A shareholder giving up shares in a failed redemption has a dividend rather than a sale or exchange and can not use its basis in the redeemed shares against the redemption proceeds. FLIP/OPIS rests on the claim that the basis of the Cayman Islands entity that could not be used in the redemption transferred over to bank stock owned by the related U.S. taxpayer who had purchased the shelter. The U.S. taxpayer thus purportedly had an excess, built-in loss on his bank stock by the amount of the original borrowed cost basis of the Cayman Islands entity. The U.S. taxpayer reported the excess loss on the sale of his bank stock. According to KPMG's rather cackling description of its own work, "OPIS is a *clever* application of the section 302 [redemption] rules in a context that was *not* intended."<sup>38</sup>

This report first examines the core basis-shift claim and then looks at a series of equitable substance-over-form doctrines. It concludes that the shelter does not have a realistic possibility — defined as a one-in-three chance — of prevailing on the merits in litigation, either because the core technical claim will fail or because the equitable doctrines will defeat it.

Let us assume a hypothetical FLIP/OPIS transaction set up to generate a \$100 million loss. An American customer we will call simply Taxpayer or U.S. Taxpayer sold his business for cash in 1998 and would have reported \$100 million of capital gain from the cash without the shelter. Taxpayer is approached by a KPMG accountant and buys into the deal, agreeing to pay \$7 million in fees. The 7 percent fees are split among the parties that made the sale possible: (1) KPMG, which originated the transaction and gave Taxpayer an opinion that it worked, (2) either Deutsche Bank or UBS, the bank that financed it, (3) an implementer who executed the transactions, including setting up and operating the Cayman Islands entity, and (4) a law firm, usually Brown & Wood, that gave a second opinion that the shelter worked.<sup>39</sup>

KPMG set up a new Cayman Islands entity (let us call Cayman) for each U.S. taxpayer who bought the shelter. Cayman is not subject to U.S. tax. The Cayman Islands is a tax haven without any corporate or income tax, so Cayman also pays no tax at home. U.S. Taxpayer is considered to own 85 percent of Cayman, under constructive ownership rules used in redemptions, because as part of the FLIP package U.S. Taxpayer buys options to buy stock or partnership interests in Cayman.<sup>40</sup> The option to buy 85 percent of Cayman was apparently more expensive than it was worth, but served as a means of delivery of the fees, 7 percent of the tax loss, as well as to establish that Cayman and U.S. Taxpayer were related.<sup>41</sup>

<sup>33</sup>*Id.*

<sup>34</sup>*See, e.g., Loftin v. KPMG*, 2002 U.S. Dist. LEXIS 26909 (S.D. Fla. 2002); *Jacoboni v. KPMG LLP*, 314 F. Supp.2d 1172 (M.D. Fla. 2004). For a recent survey of shelter investor suits, see Susan Simmonds, "Year In Review — Shelter Cases Highlight Uncertain Outcomes," *Tax Notes*, Jan. 3, 2005, p. 45. The author has agreed to serve as an expert witness for investors suing KPMG for damages arising out of their purchase of FLIP/OPIS shelters.

<sup>35</sup>KPMG partner Jeffrey Eisheid, quoted at 1 PSI Hearings at 149 n.4. *See also* PSI Report at 25 (FLIP is a loss generator); 1 PSI Hearings at 5, 255, 505 (defining or using "loss generator").

<sup>36</sup>E-mail from Cris Donegan of USB in 2 PSI Hearings at 879 (emphasis added).

<sup>37</sup>UBS internal document dated November 13, 1997, "Description of the UBS 'Redemption' Structure," quoted in PSI Report at 121; *see also* UBS internal document dated March 1, 1999, "Equities Large/Heavily Structured Transaction Approval," with attachment entitled, "U.S. Capital Loss Scheme — UBS 'Redemption trades,'" quoted in PSI Report at 121. ("The essence . . . 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.")

<sup>38</sup>KPMG, presentation points for OPIS, June 1998, 2 PSI Hearings at 938.

<sup>39</sup>1 PSI Hearings at 230

<sup>40</sup>*See, e.g.*, 2 PSI Hearings at 990; section 318(a)(4) (providing for ownership of optioned stock).

<sup>41</sup>KPMG e-mail, March 1998, re: *Simon Says*, in 1 PSI Hearings at 441 ("option was really illusory and stood out more like

(Footnote continued on next page.)

Assume that Cayman borrowed \$100 million in cash from UBS in mid-1998 to buy UBS shares. Two months later, UBS redeemed all of the UBS stock from Cayman for the market price, and Cayman used the proceeds of the sale to repay the loan. The \$100 million cash never in fact left UBS's hands, from loan through repayment, but there were electronic entries for loan, issuance of stock, redemption back, and repayment of the loan.

For \$100 million, Cayman acquired only a trivial fraction of the UBS shares. UBS stock prices fluctuated wildly in 1998, from a high of 657 Swiss francs per share to a low of 270 Swiss francs, but even at the depths of the price, the borrowed \$100 million bought only one quarter of 1 percent of UBS's outstanding stock.<sup>42</sup> Let assume a figure within that range, that is, that Cayman acquired 434,000 shares at 338 Swiss francs because, with 217,000,000 UBS shares outstanding in 1998, that would mean that Cayman acquired exactly 0.2 percent of UBS's outstanding shares.

The FLIP/OPIS shelter rests on the claim that Cayman is not entitled to use its \$100 million basis on the resale of 434,000 UBS shares back to UBS and that its basis shifts over to the taxpayers under regulations allowing an "appropriate adjustment to basis." Taxpayer as a part of the package purchased a modest amount of UBS stock, say 1,000 shares, and the entire \$100 million Cayman cost was purportedly added to Taxpayer's basis for the shares, such that Taxpayer recognized the \$100 million loss when he sold his 1,000 UBS shares by the end of 1998.

There were real losses in the FLIP/OPIS. Taxpayer paid fees of \$7 million, which were lost. UBS stock collapsed in mid-1998 because UBS was implicated in the Long Term Capital Holding collapse.<sup>43</sup> But Cayman borrowed on a nonrecourse basis so it did not care. UBS bought back its stock for a cheaper price that matched its loss on the loan and lost no cash.

The OPIS shelter also takes full advantage of a tax shelter strategy of using complexity as a defensive camouflage to preclude meaningful review of the transaction.<sup>44</sup> Complexity has a tendency to intimidate and deter any outside review. Still, the core of the deal, ignoring the

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a sore thumb since no one in his right mind would pay such an exorbitant price for such a warrant").

<sup>42</sup>US \$100 million converted into 147 million Swiss francs on June 30, 1998, <http://www.iccf.com/history.php3>. UBS shares fluctuated from 270 to 657 Swiss francs per share in 1998 so Cayman could buy between 147 million/270 and 147 million/657 or between 224,000 and 544,000 shares. UBS had 217 million shares outstanding (weighted average) in 1998, meaning Cayman bought between 0.224/217 or 10 one-hundredths of 1 percent and .544/217 or 25 one-hundredths of 1 percent. UBS Annual Report, note 9 to Financial Statement, and share information [http://www.ubs.com/1/ShowMedia/investors/financialhistory/reporting/annualreports/1998?contentId=32746&name=financial98\\_e.pdf](http://www.ubs.com/1/ShowMedia/investors/financialhistory/reporting/annualreports/1998?contentId=32746&name=financial98_e.pdf) at 130.

<sup>43</sup>UBS 1998 annual report at 131.

<sup>44</sup>See, e.g., Staff of the Joint Committee on Taxation, *I Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations*, 23 (complexity is used as an ally to preclude meaningful view); Sheldon D. Pollock and Jay Soled, "Tax Professionals Behaving Badly," *Tax Notes*, Oct. 11, 2004, p. 201 (saying that complexity

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complexities and fluctuations, is very simple: Taxpayers bought \$100 million worth of artificial accounting losses at a price of \$7 million in fees. At the 20 percent capital gains tax rate, the losses would have been worth \$20 million.

## B. The Heart of the Shelter

**1. The basis shift.** In Notice 2001-45, the IRS announced that it would disallow the losses in basis-shifting shelters like FLIP/OPIS because "(1) the redemption does not result in a dividend (and consequently there is no basis shift) because, viewing the transaction as a whole, the redemption results in a reduction of interest in the redeeming corporation to which section 302(b) applies; (2) the basis shift is not a 'proper adjustment' as contemplated by section 1.302-2(c)."<sup>45</sup> Both IRS claims seem meritorious, as applied to our hypothetical.

The claim that the \$100 million cost that Cayman borrowed to buy 0.2 percent of the stock of UBS shifted over to U.S. Taxpayers depends, first, on the premise that Cayman itself is not entitled to use its \$100 million cost basis when it was redeemed out of UBS. Section 302(a) and (b)(3) provide together that a "complete redemption" is an exchange in which a shareholder may use basis,<sup>46</sup> but section 302(c) requires that the tax status of the redemption be tested by looking not just to the UBS shares Cayman in fact owned but also to shares Cayman constructively owned.<sup>47</sup> Under the constructive ownership rules, Cayman was deemed to own all the UBS stock in fact owned by Taxpayer. U.S. Taxpayer was deemed to be an 85 percent shareholder of Cayman by reason of its purchase of warrants to buy Cayman stock. Cayman was considered to own the UBS stock actually owned by the plaintiffs.<sup>48</sup>

Just as Cayman was redeemed out of UBS, the American purchasers bought an option, under the package, to buy the same number of UBS shares, 434,000, that Cayman was redeemed out of. Because optioned stock is considered to be constructively owned, without regard to whether exercise of the option was a realistic prospect or not, and because Cayman owned everything Taxpayer owned, Cayman was not completely redeemed out under section 302. Indeed, Cayman had no reduction of its ownership of UBS once constructive ownership was considered.

Section 302(a) and (b)(1) provide that a redemption is a sale or exchange if it is "not essentially equivalent to a dividend." In *United States v. Davis*,<sup>49</sup> the Supreme Court held that a redemption that transfers money to the shareholders without any change in their percentage ownership of the equity of the corporation was not in

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serves no purpose other than to hide practitioners' handiwork from the prying eyes of the overworked tax collectors).

<sup>45</sup>2001-33 IRB 129.

<sup>46</sup>Section 302(b)(3) and (d).

<sup>47</sup>Section 302(c) (mandating constructive ownership rules) and referring to section 318(a)(4) (providing for ownership of optioned stock).

<sup>48</sup>Section 318(a)(3) (providing for constructive ownership by Cayman of stock held by Taxpayer).

<sup>49</sup>397 U.S. 301 (1970).

substance a sale, and would be taxed as a dividend without use of basis. The redemption in *Davis* from a shareholder who started as and remained a 100 percent shareholder was essentially equivalent to a dividend and had no resemblance to a sale disposing of an interest. To be a sale on which basis is used, the Court said, “a redemption must result in a meaningful reduction of the shareholder’s proportionate interest in the corporation.”<sup>50</sup> In *Davis*, the shareholder may have given up pieces of paper, but he recaptured all fractional value he gave up and remained the 100 percent owner after the redemption.

Under the FLIP/OPIS shelter, Taxpayer’s purchased options to buy 434,000 UBS shares (0.2 percent), just as Cayman was redeemed out of its shares. When the plaintiffs’ new option purchase is taken into account, and their new shares are considered owned by Cayman, Cayman maintained the same fractional interest in UBS under section 318. KPMG and Brown & Wood therefore concluded that the Cayman redemptions were not qualified under U.S. law as “a sale or exchange” and that Cayman could not use its basis in the redeemed stock against what under U.S. tax law was a dividend.<sup>51</sup> Because Cayman was immune from U.S. tax, its inability to use basis for U.S. tax purposes had no possible effect on Cayman. But an assumption that Cayman could not use its basis, had it been a U.S. taxpayer, is a necessary premise for the next step in the basis-shift argument.

When a redemption is a complete redemption in fact, but a dividend in law because of constructive ownership, the redeemed shareholder does not get to use its cost basis against the redemption and also has no remaining stock to which basis can be attached. That might lead to the inequity of double tax because the basis disappears in cases in which basis is necessary to describe the full situation. Assume, for instance, that a husband makes \$1,000 and invests it in stock of a corporation otherwise owned by his wife and the stock is later redeemed for \$1,000. The wife continues to own all of the remaining stock of the corporation after the redemption. Because spouses are treated as constructively owning each others’ stock,<sup>52</sup> the husband constructively owns all of the stock of the corporation, even after the redemption, and therefore has no reduction of his fractional interest in the corporation, even though he has given up the stock certificates. The \$1,000 is accordingly treated as a dividend, taxed in full without recognition of the husband’s cost. The husband thus would pay tax on the \$1,000 salary he made, and also on the \$1,000 redemption proceeds, which are in a meaningful sense just a refund or return of the salary he invested. The husband would own no more stock to which his basis could attach so that the \$1,000 cost basis would never be recognized and the husband’s basis would simply disappear.

The regulations on redemptions *equitably* prevent the injustice of disappearing basis and double tax in such a case by providing that if an amount received in a

redemption is treated as a dividend, “proper adjustment of the basis of the remaining stock will be made.”<sup>53</sup> The regulations give an example under which the husband’s \$1,000 basis in his stock would be added to his wife’s basis in her stock and the entire basis would be recognized when the wife sells her stock.<sup>54</sup> In FLIP/OPIS, the argument is that the \$100 million basis that Cayman had in UBS stock, similarly shifted over to U.S. Taxpayer, by analogy to the basis shift from husband to wife in the regulation example. When the plaintiffs sold their stock and option interest in UBS they generated an artificial capital loss that was used to eliminate real gain the Taxpayer reported from the otherwise taxable sale of their business.

**2. Failure of the technical claim.** KPMG’s claim failed technically because the UBS redemption from Cayman was an exchange redemption in which Cayman was itself entitled to use its basis in the UBS stock. Even if Cayman was not entitled to use its basis, moreover, the shift of \$100 million basis from Cayman to the plaintiffs was not a proper or equitable adjustment.

**a. The redemption was not essentially equivalent to a dividend.** Section 302(a) and (b)(1) together provide that a redemption is a sale if it is “not essentially equivalent to a dividend” within the meaning of section 302(b)(1). The 1998 redemption by UBS from Cayman was not essentially equivalent to a dividend because Cayman did not *recapture* enough of the percentage of its UBS stock it gave up when the redeemed UBS shares ceased to be outstanding UBS stock, even given Cayman’s constructive ownership of U.S. Taxpayer’s UBS stock.

Shares have meaning only according to the fractional interest of the corporation that the shares represent: 100 shares might represent all or only one-millionth of the corporation. Distributions are dividends if the shareholder does not give up any of its fractional interest in the corporation, and they are like sales of stock only in so far as the shareholder loses fractional interest.

Analytically, every redemption — a purchase by a corporation of its own stock — is a two-step process. By giving up the shares, the shareholder gives up a fractional interest in the corporation represented by the shares surrendered. But by the redemption, the shares then cease to be outstanding and the reduction of the outstanding shares means that all shares that remain outstanding automatically grow to represent a larger fractional interest in the whole corporation. For example, if 20 percent of a corporation’s shares are redeemed, the remaining 80 percent will automatically come to represent 100 percent. If a corporation’s outstanding shares were represented as a pie chart or circle, the pie would always and automatically complete the circle, that is, the remaining slices would expand to fill in any slice lost by redemption of outstanding certificates. By the automatic completion of the circle, a shareholder who owns shares after the redemption has an increase in the fractional interest represented by retained shares. The shareholder

<sup>50</sup>397 U.S. at 313.

<sup>51</sup>Section 301.

<sup>52</sup>Section 318(a)(1)(A)(ii).

<sup>53</sup>Treas. reg. section 1.302-2(c).

<sup>54</sup>Treas. reg. section 1.302-2(c) Example (2).

who gave up certificates in the redemption *recaptures* part or all of what it has lost by holding onto the shares that grow in fractional interest.

It has been suggested that the law might bifurcate every redemption into a sale part, representing the lost fractional interest, and a dividend part, representing disbursement without a reduction of fractional interest because the redeemed stock was recaptured.<sup>55</sup> Thus, if a shareholder (or spouse) owns 60 percent of the corporation after a redemption of the shareholder, the redemption represents a real drop in fractional interest to the extent of 40 percent of what was given up and a distribution without reduction of fractional interest to the extent of 60 percent of what was given up.<sup>56</sup> The law does not bifurcate a redemption, but it does insist that the redemption be *primarily* a reduction of fractional interest to qualify as a sale or exchange. Thus section 302(b)(2)(B) insists that the shareholder own less than 50 percent of the shares of a corporation, which ensures that the redemption is not *primarily* recaptured.

So consistently, under recapture, the IRS has been willing to rule that if a shareholder holds a trivial percent of the stock after the redemption, the redemption itself can qualify for a sale or exchange even when the drop in fractional interest is too small to qualify as a substantial (20 percent) drop in percentage ownership because the recapture is so small. For example, in Rev. Rul. 76-385, a shareholder reduced his interest in a public corporation from 0.0001118 percent to 0.0001081 percent. A drop by 0.00001 percent is not itself a meaningful reduction. Nonetheless, the shareholder with 0.0001081 percent after the redemption had just that trivial 0.0001081 percent fraction of what he gave up recaptured by the cancellation of his shares.<sup>57</sup> The redemption, the IRS ruled, therefore qualified as a sale or exchange on which use of basis was allowed.

Cayman's ownership of UBS stock after the redemption represented only a trivial 0.2 percent of the outstanding stock of UBS. Even with constructive ownership under section 318, Cayman recaptured only that 0.2 percent of the UBS stock it gave up. The redemption from Cayman was 99.8 percent, — that is, overwhelmingly — a drop in interest, which is a sale, and not “essentially equivalent to a dividend.” Only the trivial 0.2 percent represents a payment without reduction of interest, and that trivia is ignored in redemption analysis. Thus, under sections 302(b)(1) and 302(a), Cayman could use its \$100 million basis in its own redemption. Because Cayman could use its basis offshore in its own redemption, none of the basis was available to shift over to U.S. Taxpayers.

Surrenders of certificates by other shareholders in a coordinated redemption can also increase the recapture. In a pro rata redemption, for example, each shareholder gives up shares, but gives up no fractional interest in the corporation because recapture by reason of growth of

remaining shares leaves each shareholder in the same fractional position. Redemptions or reductions in interest of other shareholders will increase the recapture of redeemed shares because the pie has further to go to complete the circle. For example, in Rev. Rul. 81-289,<sup>58</sup> the corporation offered to redeem stock from its public shareholders for cash, and the taxpayer took the offer. The taxpayer itself held less than 1 percent of the stock after the redemption. But other shareholders took up the redemption offer as well, some giving up a larger fraction than the taxpayer had, and considering all the stock that ceased to be outstanding, the taxpayer lost no fractional interest by reason of the redemption. The taxpayer *recaptured* by cancellation of shares by all shareholders who took the corporation's offer more than it lost by transfer of certificates. The IRS appropriately ruled that the shareholder had no sale. Applying the principle of Rev. Rul. 81-289 to Cayman yields a conclusion that Cayman still had a sale. U.S. Taxpayer held only 0.2 percent of UBS. But that means that Cayman lost 99.8 percent of the shares it transferred to UBS, which makes the redemption still not essentially a dividend but a sale. To deny Cayman its use of its basis would upset settled, usually pro-taxpayer, rights to use basis.

Under section 1091, a taxpayer's loss on the sale of a security is suspended if the taxpayer replaces the security by repurchase within 30 days before or after the sale. Cayman is immune from section 1091 because the constructive ownership rules are different, so that replacement by a U.S. taxpayer would not be a wash sale. Section 302(b)(1) is not a wash sale rule, or a paltry imitation of one, so that purchases by redeeming shareholders increase the recapture of the redeemed shares, but do not themselves deny uncaptured losses that occurred in the redemption. Cayman increased its interest in UBS, by reason of Taxpayer's purchase of options for 0.2 percent of the UBS stock. But it is the *recapture*, not the purchases, that make the redemption not a sale, and Cayman, even after the new option, still had recapture only at the insubstantial level of 0.2 percent. That taxpayers constructively bought UBS shares that are attributed to Cayman does not make the Cayman redemptions anything like a dividend.

“Essentially equivalent to a dividend” was also written as a standard to allow the courts to describe the transaction fairly, and it is not a technical, formal line. Judged by the full evidence, the redemption is a sale or exchange under section 302(b)(1) because so little of the redemption is recaptured. Thus, Cayman used its basis in the (tax-exempt) Cayman Islands and basis did not move off the islands.

**b. Only proper adjustments to basis.** Even if the redemption of the UBS stock held by Cayman had been a dividend, Cayman's basis should not shift over to U.S. taxpayers. Treas. reg. section 1.302-2(b) on redemptions provides only for what it calls “proper” adjustments to basis when a redemption is treated as a dividend. “Proper” is a normative term and any shift of basis from one taxpayer arises only as a rule of equity to ensure that

<sup>55</sup>Matthew Zinn and Mark Silverman, “Redemptions of Stock Under Section 302(b)(1),” 32 *Tax Lawyer* 71, 104-106 (1978).

<sup>56</sup>Joseph Doloboff et al., *Redemptions*, 767-2d, [BNA] *Tax Management Portfolios* A-87-88 (2002).

<sup>57</sup>Rev. Rul. 76-385, 1976-2 C.B. 92.

<sup>58</sup>Rev. Rul. 81-289, 1981-2 C.B. 82.

justice is done. Equity will never create a loophole or abuse. Cayman never lost the \$100 million it borrowed and repaid. U.S. Taxpayer did not lose \$100 million either. Adjusting Taxpayer's basis for UBS stock upward by \$100 million is a highly *improper* adjustment. The \$100 million extra basis is excess, representing fictional cost the taxpayer never had, and the extra \$100 million claimed loss from that basis is artifice, creative accounting, describing a loss that never happened. There is *no* argument by the taxpayers that the basis shift is necessary in equity or to prevent injustice.

As the Supreme Court has said (for other provisions but applicable here), "the statutory scheme for the taxation . . . was intended to achieve tax *neutrality*, not to provide these [taxpayers] a tax advantage."<sup>59</sup> The redemption system of section 302 was devised by the best tax minds of America, deliberating over an extended period of time, just for the purpose of describing the shareholder fairly.<sup>60</sup> As Learned Hand famously said in *Gregory v. Helvering*, a taxpayer may arrange his affairs to avoid or evade tax, but the issue for a court is whether "Congress intended to cover such a transaction."<sup>61</sup> KPMG itself described the \$100 million in FLIP/OPIS as an application of section 302 in a way *not intended* by Congress.<sup>62</sup>

**3. Appropriate skepticism as to other technical requirements.** KPMG internal documents raised doubts on other technical issues. Apparently there was a delay by UBS in making the disbursement of funds to the Cayman borrowers for the FLIP, which raised real questions within KPMG as to whether Cayman ever became the owner of the UBS stock.<sup>63</sup> In our hypothetical, moreover, UBS was not willing to lend \$100 million to Cayman free and clear, but only so as to allow reinvestment in UBS stock, with the proceeds always remaining within UBS. Given Cayman's limited liability, moreover, no one could get hurt when the value of the collateral — UBS stock — declined. UBS could lose none of the \$100 million loan because it gained whatever it lost on the loan it regained by being able to buy its stock back at a reduced price. KPMG worried internally that bank control was too great for Cayman to be unconsidered to have unfettered command of the cash.<sup>64</sup> If the facts — the \$100 million never left UBS — are recharacterized to ignore the loan, purchase, redemption, and repayment, the shelter fails from the start because Cayman never has any basis to shift or ownership of UBS stock.

The author of another internal memorandum worried that participants might have controlling equity in their

Cayman corporations by reason of their options to buy 85 percent of Cayman, which would lead to the conclusion that FLIP participants had \$100 million dividend income when UBS shares were redeemed.<sup>65</sup> That would have been a disaster: \$100 million ordinary income, offset only by capital loss. The memorandum also worried that the Cayman Islands corporations (like Cayman) "remain extremely vulnerable to the argument that it is a sham."<sup>66</sup>

I would expect a neutral court to lean strongly against a participant in FLIP/OPIS on every contested issue of law. The FLIP/OPIS transaction is an "abusive tax shelter," defined here as a "transaction designed to give deductions in an amount large enough to reduce . . . taxes in a sum greater than the net consideration or cost . . . of the entire operation."<sup>67</sup> Those shelters are free on net to the participating purchaser and will expand infinitely to erase any and all tax, except and unless restrained by the courts. The shelter cost participants 7 percent of the tax loss, plus or minus fluctuations in UBS stock prices, and would benefit taxpayers in the amount of 20 percent of the tax loss at 1998 capital gains rates. Because this is an abusive tax shelter, the courts will use court doctrines to take away the artificial \$100 million loss on the specifics of the transaction.

### C. The Paramount Substance-Over-Form Doctrines

Tax law also has several traditional equitable doctrines that prevent abuse and calculate tax by looking through the form of a transaction to its substance. The doctrines overlap and the expressions of the doctrines vary considerably. Indeed, the doctrines are not so much technical or formal rules as standards or tools to allow the courts to ignore artifice, reach equity, and defeat abuse. Congress has praised the courts for "a commendable tendency to look through the mere form of the transaction into its substance."<sup>68</sup> Denial of the tax losses is "over-determined," that is, FLIP/OPIS is likely to lose on each of the tax doctrines listed below. Loss on any one issue would be sufficient to deny the claimed loss.

**1. Artificial loss.** Section 165 allows a deduction only for losses that a taxpayer has really suffered. The regulations under section 165 have long provided that deductions are allowable only when the taxpayer has sustained a "bona fide" loss as determined by its "[s]ubstance and not mere form."<sup>69</sup> The courts must examine "whether the substance of those transactions was consistent with their form," because a transaction that is "devoid of economic substance . . . *simply is not recognized* for federal taxation purposes."<sup>70</sup> The absence of a bona fide loss is fatal to the claim.

<sup>59</sup>*Portland Golf Club v. Commissioner*, 497 U.S. 154, 163 (1990).

<sup>60</sup>*See, e.g.*, Edwin S. Cohen et al., "The Internal Revenue Code of 1954: Corporate Distributions, Organizations, and Reorganizations," 68 *Harv. L. Rev.* 393, 396-401 (1954-1955).

<sup>61</sup>*Gregory v. Helvering*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd* 293 U.S. 465 (1935).

<sup>62</sup>KPMG, Presentation Points for OPIS, June 1998, 2 PSI Hearings at 938 (emphasis added).

<sup>63</sup>E-mail of Jeffrey Stein, March 14, 1998, 2 PSI Hearings at 908.

<sup>64</sup>E-mail of Stephen Rosenthal, May 7, 1999, in 4 PSI Hearings at 3468.

<sup>65</sup>Memorandum from Robert D. Simon, KPMG, to Gregg Ritchie, Randy Bickham, and John Harris, all KPMG, Feb. 23, 1998, reprinted in 2 PSI Hearings at 892.

<sup>66</sup>*Id.* at 897.

<sup>67</sup>*Emmons v. Commissioner*, 31 T.C. 26, 31 (1958).

<sup>68</sup>H. Rep. No. 704, 73 Cong., 2d Sess. 13 (1934) (praising *Gregory v. Helvering*).

<sup>69</sup>*Cottage Savings Association v. Commissioner*, 499 U.S. 554, 567-68 (1991); Treas. reg. section 1.165-1(b)(1960).

<sup>70</sup>*ACM Partnership v. Commissioner*, 157 F.3d 231, 245-46, Doc 98-31128, 98 TNT 202-7 (1998) (emphasis added).

The taxpayers did not in economic substance suffer a bona fide loss of the \$100 million they claimed under KPMG's FLIP/OPIS shelter. Indeed, Cayman did not lose either: It simply borrowed \$100 million, invested it for some weeks in UBS stock, sold the stock back, and returned the borrowed proceeds. It had no bona fide loss to shift.

KPMG's internal documents confess that FLIP has no defense to the argument that the losses were not bona fide. In a February 19, 1998, review of OPIS, Robert Simon of KPMG criticized KPMG's justification for OPIS because:

No further attempt has been made to quantify why I.R.C. section 165 should not apply to deny the loss. Instead the argument is again made that because the law is uncertain, we win.<sup>71</sup>

One of the KPMG recipients, who was not identified, responded:

As we discussed in our conference call, there simply is *nothing else to say on this topic*. I believe John . . . 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."<sup>72</sup> (Emphasis added.)

Treating a doctrine for which KPMG has no defense and no response as just "one element" of why the strategy is "more likely than not" displays a rather cavalier attitude toward what "more likely than not to succeed if challenged by the IRS in court" means.

**2. Inevitable pretax loss.** The courts have long taken responsibility to ensure that Potemkin villages erected just for tax do not destroy the tax base.<sup>73</sup> One of the signs by which the courts identify the transactions that have meaning only for tax is that they are profit-losing transactions in absence of tax. The taxpayer must have a "reasonable expectation" of pretax profits to give economic substance to the transaction.<sup>74</sup>

<sup>71</sup>Memorandum from Robert D. Simon, KPMG, to Gregg Ritchie, Randy Bickham, and John Harris, all KPMG, Feb. 23, 1998, *reprinted* in 2 PSI Hearings at 897.

<sup>72</sup>*Id.* at 897-98.

<sup>73</sup>*American Heritage Dictionary of the English Language* (4th ed. 2000) (defining "Potemkin village" as "[s]omething that appears elaborate and impressive but in actual fact lacks substance," after Grigori Aleksandrovich Potemkin, Russian finance minister, who had elaborate fake villages constructed for Catherine the Great's tours of the Ukraine and the Crimea).

<sup>74</sup>*Knetsch v. United States*, 364 U.S. 361, 366 (1960) (saying that claimed losses that reflected no loss in beneficial or economic position are disallowed as objective shams); *Rice's Toyota World Inc. v. Commissioner*, 752 F.2d 89, 94 (4th Cir. 1985) (saying that economic substance test "requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits"); *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998) (saying losses are not deductible if they arose from a transaction "entered into without expectation of economic profit and [with] no purpose beyond creating tax deductions."); *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966) (saying that "transactions without purpose, substance, or utility apart from their anticipated tax consequences" and no "realistic expectation of economic profit" are

(Footnote continued in next column.)

The usual gambit to avoid application of the pretax profit doctrine is to "throw an oil well" or similarly high volatility investment into a transaction.<sup>75</sup> If the thrown-in investment is volatile enough, it *might* appreciate by enough to cover the fees of the transaction.

The appreciation in UBS stock has to be substantial to overcome the 7 percent fees of the transaction. Cayman typically holds UBS stock for only about two months, and 7 percent over two months is like an annualized return of (1+7 percent)<sup>6</sup> or 150 percent of the amount invested, plus a year of ordinary interest. That is not impossible, but it is not the kind of pretax reality that businessmen ordinarily rely on. If the 150 percent appreciation were reliably knowable, the market would have already bid up the price of UBS to take away the extraordinary appreciation before Cayman bought the stock. The chances of appreciation are also offset by chances of loss and UBS stock declined for much of 1998.

UBS was marketable stock with a track record of volatility. That means that under Black-Scholes option pricing, it is possible to appraise the value of an option to purchase UBS stock over a two-month period like Taxpayer's pretax position. The volatility on UBS stock is not a mysterious wildcat oil well, but a quantifiable value, and the taxpayers paid more than was necessary for the option. In any event, if the true purpose of the investment was to speculate on the appreciation of UBS stock, there were countless better transactions with less costs and risks by which Taxpayer could have done that. The Cayman investments were not the stuff of substance that businessmen usually rely on in absence of tax.

The participation of Taxpayer as the purchaser of the deal does nothing to certify that the deal had pretax meaning. A taxpayer purchasing the shelter would go forward even under the expectation that the transaction would lose money in absence of tax, as long as the artificial accounting losses are available, and KPMG assured participants the loss would be available. U.S. taxpayers were purchasing capital losses of \$100 million, that were worth \$20 million at 1998 capital gains rates. They were, of course, willing to pay \$7 million fees and contributions for those tax losses if they were available. The FLIP/OPIS is a tax deal, with a camouflage of some not very important investment in UBS stock.

**3. Clear reflection of income.** Section 446(b) allows deductions only under a method of accounting that clearly reflects income, in the opinion of the commissioner.<sup>76</sup> Tax losses that fail to reflect income but are mere timing inaccuracies are sometimes tolerated within the conventions of an administrable national tax system, whereas those same inaccuracies are cut off when the

not respected for tax purposes); *Sheldon v. Commissioner*, 94 T.C. 738 (1990) (holding that a small potential profit cannot justify a huge tax benefit).

<sup>75</sup>See Treas. reg. section 1.183-2(c) Example (5)(1972) (wildcat oil well drilling is not likely to find profitable oil deposit, but the activity is not a not-for-profit activity because of the big payoff in rare cases).

<sup>76</sup>Section 446(b).

errors would otherwise lead to permanent artificial exemptions or losses.<sup>77</sup> The \$100 million artificial tax loss claimed by Taxpayer in the FLIP/OPIS shelter was a permanent artificial loss. The loss failed under section 446(b).

**4. Step transaction doctrine.** Under the step transaction doctrine, the courts determine the meaning of a transaction for tax purposes by looking at the whole transaction from start to finish, collapsing the interim steps into the whole. “The tax consequences of an interrelated series of transactions are not to be determined by viewing each of them in isolation but by considering them together as component parts of an overall plan.”<sup>78</sup> Taxpayers “cannot compel a court to characterize the transaction solely upon the basis of a concentration on one facet of it when the totality of circumstances determines its tax status.”<sup>79</sup> The dominant judicial rule for testing whether steps may be collapsed is what has been called the “end result test,”<sup>80</sup> under which steps will be collapsed if they are “component parts of an overall plan.”<sup>81</sup> The doctrine is a subset of the general perspective that taxation depends on the substance of a transaction rather than the form.

KPMG’s internal documents show that KPMG accountants believed that the step transaction doctrine destroyed the FLIP. In an e-mail to his sales team, Gregg Ritchie reminded them that they were not to leave FLIP promotional materials with clients because it would “DESTROY any chance the client may have to avoid the step transaction doctrine.”<sup>82</sup>

If we collapse the steps between UBS and Cayman, there is no borrowing, no purchase of stock, and no redemption and repayment, only the \$100 million staying in the UBS vaults. Nothing rode on the Cayman purchase and sale back of UBS stock, except the generation of a claimed \$100 million loss that didn’t really happen.

<sup>77</sup>*Hillsboro National Bank v. Commissioner*, 460 U.S. 370, 395, 402 (1983) (corporate taxpayer loses the deduction of cattle feed not consumed, in what would otherwise be a tax-free liquidation, because permanent deduction of feed not yet lost is “unwarranted”); *Commissioner v. Kluckenberg*, 309 F.2d 202 (9th Cir. 1962) (cash method of accounting for completed contracts anticipated that all income that has been earned will eventually be taxable to him who earned it regardless of the accounting method involved, and cash method does not reflect income and is not permissible under section 446(b) when it leads to permanent avoidance of tax); *Palmer v. Commissioner*, 267 F.2d 434 (9th Cir. 1959) (completed contract method of accounting for major construction contracts failed to reflect income under section 446(b) standard when construction company contributed the contracts to corporation under section 351 and would have avoided taxable income permanently).

<sup>78</sup>*Crenshaw v. United States*, 450 F.2d 472, 475 (5th Cir. 1971) (citations omitted), *cert. denied* 408 U.S. 921 (1972).

<sup>79</sup>*Id.* at 477.

<sup>80</sup>See Stephen S. Bowen, “The End Result Test,” 72 *Taxes* 722, 724 (1994) (“[T]he end result test is very much the order of the day[.]”). See also *Security Indus. Ins. Co. v. United States*, 702 F.2d 1234 (5th Cir. 1983); *King Enters. v. United States*, 418 F.2d 511 (Cl. Ct. 1969); *Penrod v. Commissioner*, 88 T.C. 1415 (1987).

<sup>81</sup>*Crenshaw*, 450 F.2d at 475 (citations omitted).

<sup>82</sup>E-mail from Gregg Ritchie to his sales staff, June 1998, 1 PSI Hearings at 866.

If we collapse the steps in the overall transaction into its overall plan, FLIP/OPIS is nothing but the purchase of tax losses. The taxpayer expected to bear a net cost of 7 percent of the tax losses, plus or minus fluctuations. Viewing the transaction according to its net cash flow — \$7 million of costs for capital losses of \$100 million worth \$20 million at capital gains rates — is the best way to see the overall substance.

## II. FLIP/OPIS and Professional Standards

KPMG gave an opinion to taxpayers that the tax benefits in FLIP/OPIS were more likely than not to prevail against an IRS challenge. There was a second opinion on the shelters, usually from the law firm then known as Brown & Wood, with the same conclusion. The lawyers who have accepted the IRS settlement offer on behalf of their clients, however, did not think that they were likely to prevail in litigation and the settlements indicate that the FLIP/OPIS does not comply with minimum professional standards.

### A. The One-in-Three Chance Test

Since 1989 section 6694 has penalized any return preparer for an understatement of tax due to a position for which there was not a realistic possibility being sustained on its merits if challenged by the IRS.<sup>83</sup> The realistic-possibility-of-prevailing standard requires that a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a *one in three*, or greater, likelihood of being sustained on its merits.<sup>84</sup> Consistently, the Treasury secretary is authorized to disbar from tax practice before the department any accountant who violates Circular 230 standards and Circular 230 requires that a practitioner may not advise a client to take a position on a tax return, or prepare the portion of a tax return on which a position is taken, unless the practitioner determines that the position has a one-in-three realistic possibility of success if challenged.<sup>85</sup> Thus the one-in-three realistic possibility of success test sets the minimum standards that a professional practicing before the IRS must comply with.

In making the one-in-three determination under both section 6694 and Circular 230, the possibility that the position will not be challenged by the IRS is not to be taken into account. Thus, in making the determination as to whether the position will be sustained *on the merits*, the adviser may not consider the “audit lottery” factor that the taxpayer’s return may not be audited or the “dumb agent” factor that the issue may not be identified on audit.<sup>86</sup>

<sup>83</sup>Section 6694(a). See committee reports on Omnibus Budget Reconciliation Act of 1989, Pub. L. 101-239, section 7732, amending section 6694(a).

<sup>84</sup>Treas. reg. section 1.6694-2(b)(1), as amended by T.D. 8382 (Dec. 12, 1991).

<sup>85</sup>Circular 230, section 10.34(a), 1994-2 C.B. 415 (realistic possibility standard required), section 10.34(d)(1)(realistic possibility defined as a one-in-three chance of success).

<sup>86</sup>Treas. reg. section 1.6694-2(b)(1) (1991); section 10.34(d)(1) (1994).

The realistic-possibility-of-success standard also seems to be the standard at which accountants confess malpractice and civil liability to taxpayers who buy the shelter. In 2000 the committee of the American Institute of Certified Public Accountants authorized to set standards for the accounting profession on tax services set the realistic-possibility-of-success standard as the “enforceable” standard for CPAs.<sup>87</sup> Before the 2000 promulgation of the AICPA Statement on Standards for Tax Services, the AICPA statements were said to be only educational and advisory in nature, although they were used by courts for malpractice and disciplinary proceedings.<sup>88</sup> In its 2000 revision, the AICPA Statement on Standards for Tax Services conceded that breach of the standard would be grounds for state disciplinary organizations and for malpractice actions.<sup>89</sup> Both Circular 230 and section 6694 are concerned first about breach of a practitioner’s duty to the U.S. government. The AICPA Statement of Standards for Tax Services uses the realistic-possibility-of-success standard to measure the duty of the accountant to his client, as well.

There are differences between the AICPA expression of realistic possibility of success and the Circular 230 and section 6674 statement, but the differences are not material here. The AICPA announced that it would prefer not to quantify the realistic possibility standard and so it does not repeat the one-in-three chances of success number.<sup>90</sup> The difference is not intended to be material, however, because the AICPA testified that “[a]lthough the AICPA . . . prefer[s] not to assign mathematical probabilities to the realistic possibility standard, nevertheless, [the] profession subscribe[s] to the standard.”<sup>91</sup>

If an item is disclosed or flagged to the IRS on the tax return as questionable, then an accountant may advise

<sup>87</sup>Statement on Standards for Tax Services No. 1, “Tax Return Positions,” AICPA, Tax Executive Committee, *Statements on Standards for Tax Services*, at 6, para. 6, <http://www.aicpa.org/download/tax/SSTSfinal.pdf> (2000).

<sup>88</sup>*Id.* at para. 4.

<sup>89</sup>*Id.* at para. 4.

<sup>90</sup>AICPA, Tax Division, Comments on Notice 90-20 Regarding Accuracy Related and Preparer Penalties, Submitted to the Internal Revenue Service (June 1, 1990), *Doc 90-5186*, 90 *TNT* 153-14 (July 24, 1990) (expressing view that a mathematical approach is inappropriate because determination of odds is impossible).

<sup>91</sup>Michael Mares (AICPA Tax Executive Committee), AICPA’s Testimony at Second Day of Finance Committee Hearing on IRS Reform, *Doc 98-4491*, 98 *TNT* 20-23, at para. 16 (Jan. 29, 1998).

There are other differences between the AICPA and the Circular 230 test that are not germane here. For Circular 230 and section 6674, the adviser may not rely on treatises, although he or she may rely on the authorities cited, whereas under Statement of Standards for Tax Services No. 1, the adviser may rely on a well-reasoned treatise. Leonard Podolin, “AICPA Tax Division Comments on Penalty Regs,” *Doc 91-4639*, 91 *TNT* 124-22, at para. 10 (1991)(arguing that “the range of authorities for 1.6694 should be broadened to include well-reasoned treatises and articles which are commonly used in professional tax research and often cited by the courts.”). That difference is not relevant here.

the taxpayer to take the position if there is a “reasonable basis” for the position.<sup>92</sup> It has been suggested that the reasonable basis standard should be quantified as somewhere between a 5 percent and 20 percent chance of success.<sup>93</sup> Cynically, the reasonable basis standard has also been interpreted by practitioners more loosely as equivalent to “anything the taxpayer could say without laughing out loud.”<sup>94</sup> Clients do not generally like to have their tax claims flagged for audit as questionable, especially for those claims like the FLIP/OPIS losses that are indeed highly questionable, because that increases the likelihood that the IRS will in fact find and challenge the questionable item. There is no indication that the FLIP/OPIS losses were disclosed on a return anywhere.

## B. One-in-Three Applied to Outcomes

Probability is an objective term with exact implications about results. “More likely than not” means that if it were possible to run identical experiments exactly like the FLIP/OPIS a very large number of times, the number of taxpayer victories would approach 50 percent of the taxpayers or money involved, with the results coming closer to 50 percent the greater the number of experiments. Realistic possibility of success implies that 33.33 percent or more of taxpayers would prevail and that no more than 66-2/3 percent of the taxpayers would lose to the IRS, with the results coming closer to one-third prevailing and two-thirds losing the greater the number of experiments in the sample.

For FLIP/OPIS, we have the results of a large sample of experimental outcomes in the form of cases that have already been settled. FLIP/OPIS cases are always large dollar cases, given that the target customers had \$20 million or more gain to shelter, so we can presume that the taxpayers were ably represented by experienced, well-respected counsel zealously loyal to their clients’ interest. The IRS has identified 488 basis-shifting or Notice 2001-45 shelters and 92 percent of them have taken the IRS offer to settle.<sup>95</sup> If FLIP/OPIS had a “more likely than not chance of succeeding” when contested, 50 percent of the cases should have come down in favor of the taxpayer. If FLIP/OPIS had a “realistic possibility of success,” at least a third of the cases should have come down in favor of the taxpayer. Given the settlements so far, the taxpayer can prevail in no more than 8 percent of the cases.

We can also compare KPMG’s and Brown & Wood’s conclusion with the position of the 450 independent tax

<sup>92</sup>Section 6694(a)(3) by reference to section 6662(d)(2)(B)(ii).

<sup>93</sup>Sheldon Banoff, “Penalty Percentages Prognosticators Perplex Practitioner,” *Tax Notes*, Dec. 6, 1993, p. 1271 (reporting that reputable CPAs use “reasonable basis” to mean between 5 percent and 20 percent chance of success); U.S. Joint Committee on Taxation, Interest and Penalty Study (JCS-3-99)(1999) at Table 7 (reasonable basis means 20 percent chance of success); Burgess J.W. Raby and William Raby, “Reasonable Basis” vs. Other Tax Opinion Standards,” *Tax Notes*, Dec. 9, 1996, p. 1209 (reasonable basis means 15 percent to 20 percent).

<sup>94</sup>Lee A. Sheppard, “Is There Constructive Thinking About Corporate Tax Shelters?” *Tax Notes*, May 10, 1999, p. 782.

<sup>95</sup>Ann. 2002-97, 2002-43 IRB 757.

attorneys who in fact had to decide whether to challenge the IRS on the merits of the shelter. In 2002 the IRS announced a settlement offer for basis-shifting shelters under which the taxpayer was required to give up 80 percent of the basis-shift loss and 80 percent of the costs of the transaction. Penalties were not waived. An attorney who thought KPMG and Brown & Wood were correct on the merits of FLIP or OPIS would have refused the settlement. Indeed, in a typical hypothetical calculation, taxpayer's representatives would have gone forward if they thought they had more than an 18 percent to 25 percent chance of succeeding.<sup>96</sup> The 18 percent to 25 percent is a ceiling: The chances of success could well have been 2 percent to 15 percent, consistent with the settlements. The consensus of the legal profession, that is, the assessment of the 450 independent tax counsel who had to make a real decision, was that FLIP/OPIS was not more likely than not to succeed and did not have a realistic possibility of success if challenged.

### III. Concluding Remarks

KPMG seems to have lost its internal compass as what was fair game to do to our country. By February 1998, FLIP/OPIS had been subjected to scathing internal criticism at KPMG. KPMG counsel internally criticized the KPMG opinion as not handling the argument that the FLIP loss was a sham: "No further attempt has been made to quantify why IRC § 165 should not apply to deny the loss. Instead, the argument is again made that because the law is uncertain, we win."<sup>97</sup> Indeed, KPMG has no defense against the argument that the loss was a sham and yet KPMG went forward with the opinions for FLIP without disclosing its internal criticisms. In a closely related shelter, KPMG's question internally was whether it was receiving enough fees and internally its judgment was that the fees were high enough to assume what

would be a huge risk. As long as KPMG was paid "a lot of money for our opinion" and "put enough bells and whistles" on the opinion, it should undertake the recognized high risk.<sup>98</sup> KPMG presents itself in public as a model of "integrity, objectivity and robust independence in everything we do."<sup>99</sup> KPMG's internal operations, however, had evolved into what has been called a "culture of deception."<sup>100</sup> Internally KPMG was selling shelters that were below professional standards because the fees were large enough.

We do not have the luxury of seeing the internal debates and e-mails, or the settlement results, for current tax planning. It is thus speculation to say how far the lessons of FLIP/OPIS and the other KPMG shelters extend to the current culture. Still, the KPMG skunk works shelters tell us what was considered "fair game" against The United States as of two to three years ago, among professionals who appeared respectable, and it is difficult to see why the standards of "fair game" should have shifted very much since then. It seems likely that professionals continue to be willing to issue opinions that various tax benefits are more likely than not to prevail, even for plans without a realistic possibility of success if challenged. Aggressive, even vicious, tax planning has probably not disappeared. Certainly the motive to avoid tax, on the multimillion-dollar level, has not dissipated.

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 that is believed and practiced by 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.<sup>101</sup>

We cannot 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 ever and to tell their clients that it would be too dangerous to tolerate errors in tax on the down side.

<sup>96</sup>The settlement required payments of 80 percent of the tax at issue (T). Contesting the liability is assumed to incur litigation costs of 5 percent of T (\$800,000 for \$16 million tax). Prevailing in the contest would incur no further liability. Losing after failing to settle requires payments of 100 percent of T. Where X is the chances of losing, the break-even equation is settlement = contest expectation or

(1)  $80\% * T = 5\% T + X\% * T + (1-X)\% * 0$ , which simplifies to

(1A)  $75/100$  or  $75\% = X\%$ .

If the chances of success are greater than (1-X) percent or 25 percent, the right side of equation (1A), contesting the liability, has a higher expected value.

Penalties are assessed under the settlement offer according to the merits of each case, which implies the penalties would be the same with or without settlement. If we assume 40 percent civil penalties, the equation in (1) becomes

(2)  $80\% * T + 40\% T = 5\% * T + X\% T * 140\% + (1-X)\% * 0$   
which simplifies to

(2A)  $115\%/140\% = 82\% = X\%$ .

Taxpayer would not have settled considering the maximum penalties if he thought he had a greater than 18 percent chance of succeeding.

<sup>97</sup>Memorandum from Robert D. Simon, KPMG, to Gregg Ritchie, Randy Bickham, and John Harris, all KPMG, Feb. 23, 1998, in 4 PSI Hearings at 892.

<sup>98</sup>E-mail of Philip J. Weisner, May 10, 1999, to Jeff Lanning and circulation list, 1 PSI Hearings at 625.

<sup>99</sup>Message from the chairman, Mike Rake, KPMG International, 2003 Annual Report at 3.

<sup>100</sup>Sen. Carl Levin, D. Mich., quoted in Kenneth Gary, "KPMG Chief Financial Officer Steps Down," *Tax Notes*, July 12, 2004, p. 127.

<sup>101</sup>Oliver Wendell Holmes Jr., "The Path of the Law," 10 *Harv. L. Rev.* 457, 459 (1896).

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. The audit rates are low and IRS auditors do not catch every issue they should beat. The penalty necessary to make it in the interest of a bad man to report tax accurately with only a 1 percent chance of correction must be a no-fault penalty of 100 times the deficiency or 10,000 percent.<sup>102</sup> 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 — but criminal penalties are not all that likely. Minor penalties, say on the order of 10 percent or 20 percent, are not going to do it. With penalties at the 10 percent to 20 percent level, the bad man is going to win this war.

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<sup>102</sup>The seminal work is Michael Allingham and Agnar Sandmo, "Income Tax Evasion: A Theoretical Analysis," 11 *J. of Pub. Econ.* 325 ( Nov. 1972).