Cross-Border Tax Insight
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NORTH AMERICAN TAX SERVICES

Cross-Border Tax Insight

So This is How the Large Firms Get Bigger?

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 late last August[1].

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, 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.

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.

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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. In turn, such individuals would then 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.

1. See IR-2005-83, August 29, 2005

The agreement also 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.

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.

THE PROPOSED FOREIGN INVESTMENT ENTITY ("FIE") RULES-AN UPDATE

BY MICHAEL I. ATLAS, CA, CPA, TEP

On July 18, 2005 the Ministry of Finance tabled the latest version of the proposed FIE rules. Little of substance has changed since the previous version was tabled in 2003.

Most significantly, Finance has not backed-off of the idea that these rules will generally be retroactive to January 1, 2003.

It is important for all accountants dealing with tax matters to have at least a basic understanding of these complex rules.

In general terms a FIE will be a non-resident corporation or trust where more than 50% of the "carrying value" of all of its assets consists of "investment property".

Most offshore mutual funds will be FIEs unless they are resident in a jurisdiction with which Canada has a tax treaty.

In addition, non-resident private corporations will often be FIEs if their assets consist mainly of investment property, other than real estate that is managed by the employees of that corporation. However, if the corporation is a controlled foreign affiliate ("CFA"), the FIE rules will not apply. If the corporation is a foreign affiliate of the taxpayer, but not CFA, the taxpayer may generally elect to treat the corporation as a CFA to avoid being subject to the FIE regime.

Interests in non-resident personal trusts (including estates) may be subject to the FIE rules unless the particular taxpayer's interest is entirely discretionary, or is a right to receive income or capital after the death of a contributor to the trust (or related person) who is still alive.

Once it is determined that a taxpayer's interest in a non-resident trust or corporation is subject to the FIE rules, there are generally three methods that the taxpayer may use to compute income under the FIE regime:

1) **Prescribed interest rate**-Under this method, income is computed annually based on the taxpayer's "designated cost" ("DC") of the interest in the FIE multiplied by the interest rate prescribed to be applicable to tax overpayments (currently 5%). In the absence of an election to use another method, this one must normally be used. For pre-2003 property, the DC will usually be the fair market value on January 1, 2003 plus deemed income inclusions for 2003 and subsequent years. For property acquired after 2002, the DC will generally be equal to the actual cost of the property plus deemed income inclusions for 2003 and subsequent years. However, where a taxpayer acquires an interest in a trust that is a FIE after 2003 without any cost, the fair market value of that interest at the time of acquisition will be added to the DC.

2) **“Mark to market”**-Under this method, year to year increases in the value of the FIE interest are recognized. The resulting gain or loss will be treated as a capital gain or loss only if all or substantially all of that gain or loss is attributable to underlying capital gains or losses. This method will only be available for property that has a readily determined market value (e.g. shares listed on an exchange, or certain units of mutual funds that have a posted retraction value). Pre-2003 gains/losses are not recognized until there is an actual disposition.

3) **“Imputed income”-**Under this method, the taxpayer’s share of the FIE’s income or loss, based on Canadian tax accounting rules, is reported.

The rules also contain measures aimed at avoiding double taxation when there is actual income (e.g. dividends or trust distributions) received from the FIE.

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IRS Announces the 2005 Dirty Dozen

The Internal Revenue Service has a tradition of providing the public with an annual listing of notorious tax scams. For the sake of "amusement" value - for the tax and financial professional - I have reproduced a listing of these scams below.

The "Dirty Dozen" for 2005 includes several new scams that either manipulate laws governing charitable groups, abuse credit counseling services or rely on refuted arguments to claim tax exemptions. The agency also sees the continuing spread of identity theft schemes preying on people through e-mail, the Internet or the phone, sometimes with con artists posing as representatives of the IRS.

Involvement with tax schemes can lead to imprisonment and fines. The IRS routinely pursues and shuts down promoters of these scams. Taxpayers should also remember that anyone pulled into these schemes can face repayment of taxes plus interest and penalties.

The Dirty Dozen

The IRS urges people to avoid these common schemes:

1. **Trust Misuse.** Unscrupulous promoters for years have urged taxpayers to transfer assets into trusts. They promise reduction of income subject to tax, deductions for personal expenses and reduced estate or gift taxes. However, some trusts do not deliver the promised tax benefits, and the IRS is actively examining these arrangements. More than two dozen injunctions have been obtained against promoters since 2001, and numerous promoters and their clients have been prosecuted. As with other arrangements, taxpayers should seek the advice of a trusted professional before entering into a trust.

2. **Frivolous Arguments**. Promoters have been known to make the following outlandish claims: that the Sixteenth Amendment concerning congressional power to lay and collect income taxes was never ratified; that wages are not income; that filing a return and paying taxes are merely voluntary; and that being required to file Form 1040 violates the Fifth Amendment right against self-incrimination or the Fourth Amendment right to privacy. Such arguments are false and have been thrown out of court. While taxpayers have the right to contest their tax liabilities in court, no one has the right to disobey the law

3. **Return Preparer Fraud.** Dishonest return preparers can cause many headaches for taxpayers who fall victim to their ploys. Such preparers derive financial gain by skimming a portion of their clients' refunds and charging inflated fees for return preparation services. They attract new clients by promising large refunds. Taxpayers should choose carefully when hiring a tax preparer. No matter who prepares the return, the taxpayer is ultimately responsible for its accuracy. Since 2002, the courts have issued injunctions ordering dozens of individuals to cease preparing returns, and the Department of Justice has filed complaints against dozens of others, which are pending in court.to low-income customers with debt problems, are charging debtors large fees, while providing little or no counseling.

4. **Credit Counseling Agencies.** Taxpayers should be careful with credit counseling organizations that claim: they can fix credit ratings, push debt payment agreements or charge high fees, monthly service charges or mandatory "contributions" that may add to debt. The IRS Tax Exempt and Government Entities Division has made auditing credit counseling organizations a priority because some of these tax-exempt organizations, which are intended to provide education to low-income customers with debt problems, are charging debtors large fees, while providing little or no counseling.

5. **"Claim of Right" Doctrine.** In this scheme, a taxpayer files a return and attempts to take a deduction equal to the entire amount of his or her wages. The promoter advises the taxpayer to label the deduction as "a necessary expense for the production of income" or "compensation for personal services actually rendered." This so-called deduction is based on a misinterpretation of the Internal Revenue Code and has no basis in law.

6.. **"No Gain" Deduction.** Similar to "Claim of Right," filers attempt to eliminate their entire adjusted gross income (AGI) by deducting it on Schedule A. The filer lists his or her AGI under the Schedule A section labeled "Other Miscellaneous Deductions" and attaches a statement to the return, referring to court documents and including the words "No Gain Realized."

7. **Corporation Sole.** Since September 2004, the Department of Justice has obtained six injunctions against promoters of this scheme and filed complaints against 11 others. Participants apply for incorporation under the pretext of being a "bishop" or "overseer" of a one-person, phony religious organization or society with the idea that this entitles the individual to exemption from federal income taxes as a nonprofit, religious organization.

When used as intended, Corporation Sole statutes enable religious leaders to separate themselves legally from the control and ownership of church assets. But the rules have been twisted at seminars where taxpayers are charged fees of $1,000 or more and incorrectly told that Corporation Sole laws provide a "legal" way to escape paying federal income taxes, child support and other personal debts.

8. **Identity Theft.** It pays to be choosy when it comes to disclosing personal information. Identity thieves have used stolen personal data to access financial accounts, run up charges on credit cards and apply for new loans. The IRS is aware of several identity theft scams involving taxes. In one case, fraudsters sent bank customers fictitious correspondence and IRS forms in an attempt to trick them into disclosing their personal financial data. In another, abusive tax preparers used clients' Social Security numbers and other information to file false tax returns without the clients' knowledge. Sometimes scammers pose as the IRS itself. Last year the IRS shut down a scheme in which perpetrators used e-mail to announce to unsuspecting taxpayers that they were "under audit" and could set matters right by divulging sensitive financial information on an official-looking Web site. Taxpayers should note the IRS does not use e-mail to contact them about issues related to their accounts.

9. **Abuse of Charitable Organizations and Deductions.** The IRS has observed an increase in the use of tax-exempt organizations to improperly shield income or assets from taxation. This can occur, for example, when a taxpayer moves assets or income to a tax-exempt supporting organization or donor-advised fund but maintains control over the assets or income, thereby obtaining a tax deduction without transferring a commensurate benefit to charity.

10. **Offshore Transactions.** Despite a crackdown on the practice by the IRS and state tax agencies, individuals continue to try to avoid U.S. taxes by illegally hiding income in offshore bank and brokerage accounts or using offshore credit cards, wire transfers, foreign trusts, employee leasing schemes, private annuities or life insurance to do so. The IRS, along with the tax agencies of U.S. states and possessions, continues to aggressively pursue taxpayers and promoters involved in such abusive transactions.

11. **Zero Return.** Promoters instruct taxpayers to enter all zeros on their federal income tax filings.

12 .**Employment Tax Evasion.** The IRS has seen a number of illegal schemes that instruct employers not to withhold federal income tax or other employment taxes from wages paid to their employees. Such advice is based on an incorrect interpretation of Section 861 and other parts of the tax law and has been refuted in court. Recent cases have resulted in criminal convictions, and the courts have issued injunctions against more than a dozen persons ordering them to stop promoting the scheme. Employer participants can also be held responsible for back payments of employment taxes, plus penalties and interest. It is worth noting that employees who have nothing withheld from their wages are still responsible for payment of their personal taxes.

Cost of Obtaining MBA May be Deductible as Business Expense

A taxpayer's[2] MBA-related expenses were deductible under §162, the Tax Court held.

An individual could deduct the cost of obtaining his master's degree in business administration (MBA) as a business expense even though it helped him move up the corporate ladder.

Generally, educational expenses are not deductible business expenses if the degree sought is a minimum educational requirement for the individual's employment or if it prepares the individual for a new trade or business[3].

However, an MBA was not a minimum requirement for the taxpayer's employment. The taxpayer was hired to sell sports-related products because of his experience in sports medicine and, after a period of time, he performed management, marketing and finance-related tasks. In spite of the fact, that the taxpayer's boss encouraged the taxpayer to obtain an MBA, speculating that it might help him advance through the company – this did not amount to a requirement that the taxpayer get an MBA as a condition of being promoted. Nor did the fact that the taxpayer actually advanced while he progressed through his MBA program establish the degree as a minimum requirement for his promotions.

2. See D.R. Allemeier, Jr., T.C. Memo. 2005-207
3. Under Regs. § 1. 162-5 (a), educational expenses are deductible if the education maintains or improves skills required by the individual in his or her employment. Under Regs. § 1. 162-5(b), however, no deduction is allowed if the taxpayer's expense is for education that enables him or her to meet the minimum educational requirements for qualification in his or her employment or if the education leads to qualifying the taxpayer for a new trade or business.

Moreover, the MBA did not prepare the taxpayer for a new trade or business since he was already performing managerial and financial tasks before he entered the MBA program. The MBA may have expedited the individual's rise within the company, it did not however, change the basic nature of his duties. Although a degree that qualifies an individual for a professional certification or license (such as a law degree) may prepare one for a new trade or business, an MBA is different in that it does not qualify one for a professional certification or license.

The taxpayer could not claim certain business deductions for travel and meals due to lost records. Credit card statements and entries in the taxpayer's personal calendar were insufficient to show the business purpose of his expenses. However, his failure to satisfy substantiation requirements did not justify an accuracy-related penalty. There is an exception for the accuracy-related penalty if the taxpayer acted in good faith and had reasonable cause. The taxpayer in this case proved that he made most of the expenditures he claimed as deductions, and his failure to tie them to a business purpose was due to his loss of records.

Joseph Soussan founded (Toronto based) ***North American Tax Services*** in 1998. Since 1997, he is a member of the Certified General Accountants' Association of Ontario. He completed the CICA In-Depth Tax Course in 2000, and obtained CPA certification in 1998 from the state of Delaware. He is currently a licensed CPA in the state of New Hampshire. Joseph maintains a keen interest in taxation of cross-border investments.

His firm is dedicated to providing both U.S. (primarily) and Canadian tax expertise (as applicable to international tax situations), tax–related educational services, and technical writing assistance to Canadian accounting and law firms. Joseph has lectured for several organizations and companies on cross-border tax matters. Furthermore, Joseph is the author of "*Cross-Border Tax Insight*" – a tax based newsletter that is sent to other tax practitioners in North America and is made available on his website at www.usatax.ca.

He currently practices exclusively in the areas of both cross-border corporate and personal taxation. He has, to date, provided extensive consulting and compliance services to the following firms in Toronto and Montreal: Deloitte and Touche, Ernst and Young, Cross-Border Tax Services, Horwath Orenstein LLP, and other local CA firms.

Call Joseph today and find out how he can be of help to your firm or clients!

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U.S. Tax Seminars for Canadian Professionals –

Joseph is currently accepting speaking engagements to lecture/present on the following matters:

a) US personal tax – 2005 – changes –impact on US citizens in Canada or Canadians working/investing in the US (An introduction to/or intermediate level).
b) US Corporate Tax Basics and Compliance (Introduction to intermediate).
c) US Gift and Estate Tax - what every practitioner needs to know!
d) Researching US Federal Tax Law – sources, techniques, overview to the US legal system and IRS structure, including tax administration and tax practice issues.

Please request a course outline/seminar proposal for any of the above-mentioned topics to confirm suitability for your association or organization. Please note I may be able to speak on topics that are not listed above.

If you are interested in attending a seminar for any of the above topics, please advise, and we will keep you posted as to dates and locations.