BDO Memo Is `Smoking Gun' Proving Shelter Fraud, Lawyers Claim

Dec. 9 (Bloomberg) -- Lawyers suing BDO Seidman LLP, the world's No. 5 accounting firm, say they found a ``smoking gun'' memo that shows BDO promoted a tax shelter even after learning the Internal Revenue Service had ruled it was illegal.

BDO, along with Jenkens & Gilchrist, a Dallas-based law firm, and others are accused in a lawsuit of selling sham tax investments to generate millions of dollars in fees. The plaintiffs, who owe back taxes, are seeking damages. In March, Jenkens & Gilchrist agreed to pay $75 million to more than 1,100 people who bought the shelters to settle its part of the case.

After settling, Jenkens gave documents to lawyers for the plaintiffs, according to court papers. In one of them, an Aug. 11, 2000 memo filed with the court, BDO principal Michael Kerekes said of a new IRS pronouncement, ``Our transactions may be potentially-abusive tax shelters under the new rules.''

Plaintiffs' lawyer David Deary says in a legal filing in New York that the Kerekes memo ``is a smoking gun that demonstrates BDO knew it was engaged in a fraudulent scheme.'' According to the complaint, BDO continued to tout the shelter, known as COBRA, after Aug. 11, 2000.

``BDO knew that the tax shelter was invalid yet continued to market it to our clients, emphasizing over and over again that it was a completely valid shelter,'' Deary said in an interview.

Jenkens & Gilchrist previously turned over the Kerekes memo to federal tax investigators, according to U.S. District Judge Shira Scheindlin. She ruled last week that the plaintiffs may use the documents in their suit.

Privileged Communication

New York-based BDO, a member firm of BDO International, said in a statement that it wouldn't comment on the substance of the memo because the document is a privileged communication between attorney and client that shouldn't be allowed into evidence. The firm said it plans to appeal Scheindlin's ruling admitting the memo in the case.

``We plan to defend ourselves vigorously in this lawsuit and will refute the numerous factual inaccuracies contained in the complaint,'' the statement said. BDO added that the plaintiffs ``knew what they were doing.''

U.S. regulators have stepped up oversight of tax shelters. In July more than 1,500 people agreed to pay back taxes and reduced penalties for using another shelter that cost the government at least $6 billion in the late 1990s, the IRS said.

PricewaterhouseCoopers LLP was fined in 2002 for promoting abusive shelters. Ernst & Young paid a $15 million settlement last year. The IRS sued to learn the names of tax shelter customers at BDO and other firms. BDO subsequently provided the names.

$77 Million in Profits

Tax shelters are sophisticated accounting techniques with no underlying economic substance, that are designed to minimize tax liabilities. They are marketed to corporations and high-income individuals by accounting firms and investment banks and often include a letter from a law firm supporting the shelter. Some are illegal. Others skirt the boundaries of the law.

The class-action suit, which was filed in Manhattan last year, claims Jenkens & Gilchrist recruited BDO to market the COBRA shelter to wealthy clients, and BDO teamed up with other firms. The suit says Jenkens & Gilchrist knew it would have more success selling COBRA once a prominent accounting firm was backing it.

COBRA, an acronym for ``Currency Options Bring Reward Alternatives,'' offset capital gains by creating paper losses from currency options trades, the suit says. BDO prospered from selling shelters, the suit says. According to the complaint, profits in the firm's ``Tax Solutions Group'' grew from $2.2 million in 1998 to $77 million in 2000.

`Lack Economic Substance'

The IRS declared COBRA illegal within weeks after Jenkens and BDO began selling it in late 1999, the suit says. On Aug. 11, 2000, after the IRS issued a new notice banning the COBRA shelter using even stronger language, Kerekes drafted his memo to BDO partners and an attorney at another law firm, according to court papers.

``Under the new definition, it seems very probably that our transactions lack economic substance,'' he wrote, explaining why the shelter was deemed illegal.

Even after the latest ruling outlawing COBRA, Kerekes concluded that the IRS declaration didn't cover shelters employed by BDO clients before Aug. 11, 2000, the memo says. According to the suit, BDO continued to offer COBRA and never told existing or new clients about the IRS notice barring its use.

The IRS has since concluded that its prohibition applied to transactions before Aug. 11, 2000, Deary said.

`Not Misled'

BDO said in its statement today that Schiendlin ``has previously determined that the plaintiffs knew what they were doing and were not misled by BDO Seidman.''

In an earlier ruling in April, Scheindlin found evidence that both BDO and the plaintiffs didn't want ``any third party'' to know that the firm was selling tax shelters.

As a result, she said, the firm and the plaintiffs entered into ``extraordinarily vague'' client engagement contracts describing consulting work that was never done, as a cover for the shelters BDO was selling. She said BDO and the plaintiffs ``engaged in mutual fraud.''

In his Aug. 11, 2000 memo, Kerekes refers to those engagement letters, noting that they ``have been structured not to make clear exactly what services we were providing in return for our fee.''

The case is Denney v. Jenkens & Gilchrist, 03-CV-5460, Southern District of New York.