Office of Chief Counsel
Internal Revenue Service

Memorandum

CC:PA:APJP:B02:POSTF-147929-01
Number: **200402008**
Release Date: 01/09/2004

UILC: 6700.00

date: December 12, 2003

to: Mark E. O'Leary
Associate Area Counsel
CC:LM:NR:DAL:2

from: Ashton P. Trice
Chief
Branch 2 (Administrative Provisions and Judicial Practice)
CC:PA:APJP:B02

subject: **Application of Section 6700, Promoting Abusive Tax Shelters, to Transactions**

This Chief Counsel Advice responds to your email dated August 28, 2003. In accordance with I.R.C. 6110(k)(3), Chief Counsel Advice may not be used or cited as precedent.

ISSUES

1. When one or more employees of a promoter organize a single entity or engage in a single sale, can a penalty under section 6700 apply separately to each employee and the employer?

2. What activities constitute organizational activities as used in section 6700(a)(1)(A)?

3. What activities constitute participating in the sale of an entity, plan or arrangement under section 6700(a)(1)(B)?

CONCLUSIONS

1. Yes. Generally, courts have applied a separate penalty to each person liable for a penalty under section 6700, even when the same sale or entity was involved

with respect to each penalty. At least one court, however, has allowed only one section 6700 penalty against a partnership and its partners for the same conduct.

2. Organizational activities under section 6700(a)(1)(A) include the performance of any act (directly or through an agent) related to the establishment of an entity, plan or arrangement.

3. Activities that constitute participating (directly or indirectly) in the sale of any interest in an entity, plan or arrangement under section 6700(a)(1)(B) include any marketing activities with respect to an entity, plan or arrangement.

FACTS

In this promoter penalty case, the promoter is an LLC that sold a tax shelter during , , and . In this promotion, employees of the promoter made false statements regarding available tax benefits while engaged in both organizational and sales activities.

Employees in the promoter’s sales department made targeted cold calls to numerous wealthy taxpayers in a position to use large capital losses, i.e., people who sold or who intended to sell appreciated assets. The employees based the pitch on a script that explained to the potential client that there was no need to pay large capital gains because the promoter could show the potential client how to avoid them.

Interested potential clients agreed to meet with a principal of the promoter, who was an employee but also owned an interest in the promoter entity. At that meeting, the principal explains in general terms how to avoid the capital gains tax by using the strategy and stated that there was no risk involved.

Some of the potential clients decided to purchase the information or the “tax strategies” from the promoter by entering into a confidentiality and fee agreement requiring an upfront payment of $ for travel expenses that the promoter expected its employees to incur. Some of the purchasing clients had family members who owned part of the appreciated asset (related clients). Sometimes a client and his related clients would sign a single confidential fee agreement with one upfront fee, and the promoter would structure a single transaction. Other times a related client would enter into a separate fee agreement and pay a separate upfront fee.

For each purchaser, the promoter’s analytical department produced a package that included a that, among other things, stated that capital loss would be recognized by following the strategy. The promoter tailored the presentation for the purchaser and the particular related clients and types of appreciated assets involved. The presentation outlined the steps the client should take in detail with the conclusion that these steps would produce the desired tax consequences.

In the most common form of the transaction, the taxpayer used

. The attorneys who regularly wrote tax opinions on the transactions also drafted partnership agreements, articles of incorporation, by-laws, promissory notes, obtained the Employer Identification Numbers, and handled filings with state authorities.

Each participant in the strategy opened a brokerage account with a margin deposit used to support . The participant granted an employee of the promoter authority to make trades for the account. This permission was the participant's only contact with the promoter's employee responsible for trades on the account. The participant
. Other mid-level employees of the promoter supervised the trades; calculated basis, the promoter's fee, and the sales price for the partnership interest; hedged the trades; and arranged

.
Then those employees returned authority over the brokerage account to the participant.

LAW AND ANALYSIS

For activities after December 31, 1989, section 6700 of the Code imposes a penalty upon persons who promote abusive tax shelters. In pertinent part, the penalty applies to any person who

(1)(A) organizes (or assists in the organization of) –
(i) a partnership or other entity,
(ii) any investment plan or arrangement, or
(iii) any other plan or arrangement, or

(B) participates (directly or indirectly) in the sale of any interest in, an entity plan or arrangement . . . ,and

(2) makes or furnishes or causes another person to make or furnish (in connection with such organization or sale)-

(A) a statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter. . . .

Multiple Persons Participating in Same Sale or Organization of Same Entity, Plan or Arrangement

Under section 6700, a penalty can apply to "any person" who, directly or indirectly, organizes or assists in the organization of an entity, plan or arrangement or participates in the sale of any interests in the entity, plan or arrangement so long as that person made or furnished, or caused another to make or furnish, a statement[1] with respect to the tax benefits that the person knew or had reason to know was false or fraudulent as to a material matter.[2] United States v. Kaun, 827 F.2d 1144 (7th Cir. 1987); Weir v. United States, 716 F. Supp. 574 (N.D. Ala. 1989).

In In re Tax Refund Litigation v. United States, 766 F. Supp. 1248, 1257 (E.D.N.Y. 1991), aff'd in part and rev'd in part, 989 F.2d 1290 (2d Cir. 1993), the court recognized that a separate section 6700 penalty applies to each separate legal entity that engages in the conduct section 6700 prohibits. The court, however, concluded that the Service could not impose a section 6700 penalty against both a partnership and its partners for the same conduct because it regarded there to be no legal or economic difference between imposing a penalty upon a partnership and imposing a penalty on the partners of the partnership. The court in Bailey Vaught Robertson & Co. v United States, 828 F. Supp 442 (N.D. Tex. 1993), rejected the analysis in In re Tax Refund Litigation and concluded that separate section 6700 penalties were applicable to a partnership and each partner who engaged in the prohibited conduct. The court stated that there was no dispute that the section 6700 penalties were applicable to individuals, and there was nothing in the statute to limit the penalties when an individual happens to be a partner, and both the partner, in his individual capacity, and the partnership violate the terms of the statute. As applied to this case, this reasoning means that the Service may assess the section 6700 penalty against the LLC and the individual members of the LLC for conduct that violates section 6700 even when the conduct of two separate persons relates to the same sale or organization of the same tax shelter. Of course, whether a person who sold or organized a tax shelter otherwise engaged in conduct violative of section 6700 is a separate question.

There are two types of statements that fall within the statutory bar of section 6700(a)(2)(A): statements directly addressing the availability of tax benefits and those concerning factual matters that are relevant to the availability of the tax benefits. See Buttorff, supra; United States v. Petrelli, 704 F. Supp. 122 (N.D. Ohio 1986). In this case it appears that both types of statements occurred, both in the cold calls stating the general availability of tax benefits, and in the presentations tailored to specific clients' situations.

---

[1] A statement can be either written or oral. United States v. Buttorff, 761 F.2d 1056 (5th Cir. 1985).

[2] A matter is material if it has a substantial impact on the decision making process of a reasonably prudent investor. United States v. Buttorff, 761 F.2d 1056, 1061 (5th Cir. 1985). The Service does not need to prove actual reliance by the investor. Id.

Whether the LLC's members', sales persons', attorneys', and agents' false or fraudulent statements as to the availability of tax benefits violated section 6700 requires consideration of the facts and circumstances. The government must show that they knew or had reason to know that the statements they made were false or fraudulent as to a material matter. Section 6700(2)(A). The courts often look to three factors to determine whether a person had the requisite scienter to violate section 6700: 1) the extent of the person's reliance on knowledgeable professionals; 2) the person's level of sophistication and education; 3) the person's familiarity with tax matters. See, e.g., United States v. Estate Preservation Services, 202 F.3d 1093, 1103 (9th Cir. 2000). While these factors are not always dispositive of the issue, they help the Service and the courts focus on the relevant facts and circumstances. In addition, although section 6700 does not impose a duty of inquiry, it "allows imputation of knowledge" as long as it is "commensurate with the level of comprehension required by the [person's] role in the transaction. United States v. Campbell, 891 F.2d 1317, 1321-22 (5th Cir. 1990). Thus, the greater the person's involvement in the transaction, the more likely it is that the person knew or had reason to know that the statements he made, or caused others to make, were false or fraudulent. H.R. Rep. 101-247 at 1397 (1989).

To the extent that the organizers or sellers of a tax shelter made, or caused to be made, false or fraudulent statements that they knew or had reason to know were false or fraudulent as to the availability of tax benefits, the Service may penalize each of them under section 6700. Actual application of the penalty to each of these persons will require a facts and circumstances analysis of their involvement in the promotion and whether they knew or had reason to know that their statements as to the availability of the tax benefits were false or fraudulent. For example, in the case of the salespersons making cold calls, the government would have to show that they had the requisite sophistication and knowledge to know that the pitch they gave contained false or fraudulent statements as to the tax benefits available in the program provided by the LLC.

ORGANIZATIONAL ACTIVITIES UNDER SECTION 6700(a)(1)(A)

There are no regulations defining what conduct constitutes the organization of an entity, plan or arrangement described in section 6700(a)(1)(A). By analogy, however, we believe that regulations under section 6111 are instructive. Those regulations describe a person principally responsible for organizing a tax shelter as "any person who discovers, creates, investigates, or initiates the investment, devises the business or financial plans for the investment, or carries out those plans through negotiations or transaction with others." Treas. Reg. § 301.6111-1T:A-27. We believe that the same definition applies to a person who organizes an entity, plan, or arrangement (collectively, "tax shelter") within the meaning of section 6700(a)(1)(A). Similarly, a person assists in the organization of a tax shelter if the person performs any act (directly or through an agent) related to the establishment of the tax shelter, including the following:

> (1) Preparation of any document establishing the tax shelter (for example, articles of incorporation, a trust instrument, or a partnership agreement);
>
> (2) Preparation of any document in connection with the registration (or exemption from registration) of the tax shelter with any federal, state, or local government body;
>
> (3) Preparation of a prospectus, offering memorandum, financial statement, or other statement describing the tax shelter;
>
> (4) Preparation of a tax or other legal opinion relating to the tax shelter;
>
> (5) Preparation of an appraisal relating to the tax shelter;
>
> (6) Negotiation or other participation on behalf of the tax shelter in the purchase of any property relating to the tax shelter.

Treas. Reg. §301.6111-1T:A-28. We believe that this same definition applies with equal force under section 6700(a)(1)(A).

PARTICIPATING IN THE SALE OF A PLAN UNDER SECTION 6700(a)(1)(B)

Section 6700 penalizes persons for participating directly or indirectly in the sale of any interest in an entity, plan or arrangement. Here, again, we find the regulations under section 6111 instructive by analogy. Treas. Reg. § 301.6111-1T:A-31 provides that participation in the sale of a tax shelter includes any marketing activities (directly or through an agent) with respect to an investment, including the following:

> (1) Direct contact with a prospective purchaser of an interest, or with a representative or agent of a prospective purchaser, but only if the contact relates to the possible purchase of an interest in the tax shelter;
>
> (2) Solicitation of investors using the mail, telephone, or other means, or by placing an advertisement for the tax shelter in a newspaper, magazine, o other publication or medium;
>
> (3) Instructing or advising salesperson regarding the tax shelter or sales presentations.

Accordingly, sales activities can include cold calls, preparation of promotional material, target sales pitches, and the offering documents and reports that contain statements that are false or fraudulent as to any matter material to the availability of tax benefits from the transaction. See United States v. Raymond, 228 F.3d 804 (7th Cir. 2000)

(court found that advertisements placed in newspapers made the representations that payment of income tax is a voluntary activity and that individuals cannot be legally compelled to file tax returns or submit to tax investigations or penalties were fraudulent statements designed to promote the sale of the groups tax avoidance scheme); United States v. Kaun, 827 F.2d 1144, 1149-50 (7th Cir. 1987) (speeches made by Kaun and the pamphlets he extolled subjected him to the promoter penalty under section 6700).

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please contact Branch 2 of Administrative Provisions and Judicial Practice if you have any further questions.