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(All prior issues of this
material are obsolete.)

ABUSIVE TAX PROMOTIONS

Student Guide

Internal
Revenue
Service

The IRS Mission

Provide America's Taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Penalty for Unauthorized Inspection of Tax Returns or Tax Return Information

On August 5, 1997, President Clinton signed into law the Taxpayer Browsing Protection Act. The Act adds a new section 7213A to the Internal Revenue Code (Code) that provides a criminal misdemeanor penalty for the willful, unauthorized inspection of tax return information. The penalty is a fine of up to $1,000 and/or imprisonment up to 1 year. It applies to all federal employees, state employees, and contractors who receive federal tax information. Upon conviction, a federal employee is dismissed from employment.

The Act also amends section 7431 of the Code to provide an expanded cause of action for civil damages for unauthorized inspections as well as disclosure of return or return information. Damages are $1,000 or actual damages, whichever is greater.

The expanded cause of action applies to federal employees, state employees, and contractors who knowingly, or by reason of negligence, inspect or disclose returns or return information. However, no liability will arise if the inspection or disclosure results from a good faith, but erroneous, interpretation of section 6103 of the Code (current law) or which is requested by the taxpayer (new). Section 7431 is further amended to require notification of the taxpayer for unlawful inspection or disclosure. Such notification is to be made by the IRS when a person is indicted for the misdemeanor penalty.

The Act's provisions are effective for inspections or disclosures made on or after August 5, 1997.

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Ten Core Ethical Principles*

Honesty
Integrity/Principled
Promise-Keeping
Loyalty
Fairness
Caring and Concern for Others
Respect for Others
Civic Duty
Pursuit of Excellence
Personal Respnsibility/Accountability

Five Principles of Public Service Ethics

Public Service
Objective Judgment
Accountability
Democratic Leadership
Respectability

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Mission of Examination

Examination supports the mission of the Service by maintaining an enforcement presence and encouraging the correct reporting by taxpayers of income, estate, gift, employment, and certain excise taxes in order to instill the highest degree of public confidence in the tax system's integrity, fairness, and efficiency. To accomplish these goals, Examination will:

Measure the degree of voluntary compliance as reflected on filed returns.

Reduce noncompliance by identifying and cost-effectively allocating resources to those returns most in need of examination and taxpayer contact.

Conduct, on a timely basis, quality examinations of tax returns and quality contacts to determine the correct tax liability.

Privacy Principles

Principle 1: Protecting taxpayer privacy and safeguarding confidential taxpayer information is a public trust.

Principle 2: No information will be collected from taxpayers that is not necessary and relevant for tax administration and other legally mandated or authorized purposes.

Principle 3: Information will be collected, to the greatest extent practicable, directly from the taxpayer to which it relates.

Principle 4: Information about taxpayers collected from third parties will be verified to the greatest extent practicable with the taxpayers themselves before action is taken against them.

Principle 5: Personally identifiable taxpayer information will be used only for the purpose for which it was collected, unless other uses are specifically authorized or mandated by law.

Principle 6: Personally identifiable taxpayer information will be disposed of at the end of the retention period required by law or regulation.

Principle 7: Taxpayer information will be kept confidential and will not be discussed with, nor disclosed to, any person within or outside IRS other than as authorized by law and in the performance of official duties.

Principle 8: Browsing, or any unauthorized access of taxpayer information by an IRS employee, constitutes a serious breach of the confidentiality of that information and will not be tolerated.

Principle 9: Requirements governing the accuracy, reliability, completeness, and timeliness of taxpayer information will be such as to ensure fair treatment of all taxpayers.

Principle 10: The privacy rights of taxpayers will be respected at all times and every taxpayer will be treated honestly, fairly, and respectfully.

Privacy Points

1. Collect the necessary information.*

No information will be collected from or about taxpayers that is not necessary and relevant for tax administration. Our approach to information gathering will rely on data, analysis, and objective measures.

2. Treat taxpayers and co-workers with honesty, integrity, and respect.

Every taxpayer will be treated honestly, fairly, and respectfully. IRS employees, whether in a taxpayer's office or home, will refrain from physical searches of a taxpayer's mailbox and unconsented browsing of a taxpayer's mail and records. Privacy protection begins in the workplace. Sensitive employee data must be carefully protected and employees should be treated with honesty, fairness, and respect.

3. Use the information for the purpose for which it was collected.*

Personally identifiable taxpayer information will be used only for the purpose for which it was collected and will be disposed of at the end of the required retention period.

Browsing, or any unauthorized access of taxpayer records, by any IRS employee, constitutes a serious breach of confidentiality of that information and will not be tolerated.

4. Keep information confidential.

Protecting taxpayer privacy and safeguarding confidential taxpayer information is a public trust. Taxpayer data will not be disclosed to any person within or outside the IRS, other than as authorized by law and in the performance of official duties.

*Collection of information in points 1 and 3 refers to gathering of personal data from taxpayers or third party sources.

Protecting Taxpayer Privacy

Protecting taxpayer privacy and safeguarding confidential information is a public trust.

Privacy protection is broader than just confidentiality (disclosure) and security, although it certainly includes confidentiality and security as well.

We recognize that the majority of employees do respect the privacy of taxpayers and other employees. We are asking all IRS personnel to take a careful, introspective look at how they view the privacy of taxpayers, as well as the privacy of other employees. We want to emphasize that even in commonly accepted practices, often unstated, we want employees and managers to reevaluate how they interact with the taxpayer and with each other.

There are several reasons why the IRS needs to be very concerned with the privacy of the American taxpayer:

Voluntary Compliance - Many experts from inside and outside the IRS tell us that people may not voluntarily comply with tax laws if they think their personal information is being abused.

Shareability of Data - With the increased development of integrated information systems within the IRS and accelerating shared data across government, there is an increased risk of an invasion of privacy.

Renewed Interest of the Taxpayer - taxpayers and their representatives in Congress are taking a renewed interest in taxpayer privacy rights. The Big Brother menace seems to be more real to many people now than ever before. Investigations of employees browsing taxpayer files have heightened the fears and concerns of taxpayers and the oversight committees in Congress.

Notices and Disclaimers

The taxpayer and business names shown in this publication are fictitious. They were chosen at random from the names of counties in the United States.

ABUSIVE TAX PROMOTIONS

TABLE OF CONTENTS

Lesson 1

INTRODUCTION

Introduction

Background

This course covers three related IRC sections designed to penalize abusive tax shelter promotions: IRC 6700, 6701, and 7408 (in the Appendix).

Course objective

When you have completed the course, you will be able to apply the law to the promoters of an abusive tax shelter to either penalize them for past conduct and/or prohibit future conduct.

Lesson objectives

At the end of this lesson you will be able to:

1. Describe what IRC 6700, 6701, and 7408 are designed to accomplish.
2. Identify abusive tax shelter promotions to which these sections may be applied.
3. Describe the general process by which these sections are applied to penalize or prohibit such promotions.

Contents

Abusive Promotions and Promoters

What is an abusive promotion?

Although there is no all-inclusive definition of an "abusive tax promotion," the term generally includes any partnership, trust, investment plan, or any other entity or arrangement which is sold to a third party; and is designed to be used or is actually used by that third party in obtaining tax benefits not allowed by law.

Typically these schemes are syndicated or sold via "mass market" methods, either as packages (such as a "business trust" together with a "family trust") or as "units" within a larger scheme (such as ostensible interests in a larger partnership).

The term "abusive tax shelter" is also broad enough to be applied to a number of "sham" arrangements, such as abusive trusts and 1040NR schemes. These "sham" arrangements have no economic reality and are entered into primarily for the purpose of avoiding taxation.

An abusive promotion is any program or arrangement which promises, directly or indirectly, tax benefits not allowed by law. Abusive promotions include programs which rely on:

- False statements about the allowability of tax benefits to participants which are contrary to clearly established law.
- The misuse of disparate sections of the IRC to produce clearly unintended results.
- The intentional manipulation of potential ambiguities of the tax laws in order to improperly claim tax benefits.
- Sham arrangements having no economic significance.
- Gross valuation overstatements that ascribe a value to an asset or service which is at least twice the asset's correct value, and that directly relate the value of the asset is directly related to tax benefits.

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Abusive Promotions and Promoters, Continued

How can abusive promotions be stopped?

There are a variety of tools available to the IRS to stop the promotion of and participation in abusive programs:

- Criminal prosecution of those who organize, promote, assist in the organization or promotion of, sell, or assist in the sale of interests in, the abusive promotion.
- Enjoining, pursuant to IRC 7408, those who organize, promote, assist in the organization or promotion of, sell, or assist in the sales of interests in, the abusive promotion.
- Assessing penalties, pursuant to IRC 6700 and/or 6701, against those who organize, promote, assist in the organization or promotion of, or assist in the sales of interests in, the abusive promotion.

Combined efforts necessary

Successfully combating abusive promotions will require the combined efforts of Examination, Criminal Investigation, Collection, Exempt Organizations, District Counsel, Chief Counsel, and the Tax Division of the Department of Justice.

Alerting the public

One major goal in the abusive promotion area is to alert the public that abusive promotions are being marketed. Another is to alert the public that those who become involved with abusive promotions risk:

- being identified;
- being criminally prosecuted;
- incurring significant tax, interest, and penalty liabilities; and
- the possible loss of their investment.

This may be accomplished through press releases announcing the initiaiton of criminal charges or the institution of a civil injunction suit, as well as by issuing press releases when a criminal conviction or injunction has been obtained.

Our efforts in this area also provide an opportunity for those who become involved in abusive schemes to pay the proper amount of tax, and become compliant.

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Abusive Promotions and Promoters, Continued

Definition of abusive promoter

A promoter is a person who organizes or assists in the organization of a partnership, trust, investment plan, or any other entity or arrangement that is to be sold to a third party and is designed to be used or is actually used by that third party in obtaining tax benefits not allowed by the IRC.

Description of abusive promoter

Promoters are often unlicensed financial advisors (although on occasion they might be a CPA or a lawyer) who are smooth talkers and claim to have in-depth knowledge of tax law. They express sympathy for those who have to pay substantial taxes and play on this dissatisfaction in order to sell the program. The promoter's audience wants to believe the promoter because it is in their economic interest to do so.

Abusive tax schemes are marketed and promoted for profit. Some promoters are quite successful. Promoters today are similar to the promoters who marketed tax shelters in the 1970s and 1980s. Some of the more sophisticated abusive promotions may be marketed by law, accounting, and brokerage firms.

Salesman

A salesman is a person who did not take part in the organization of the abusive tax shelter, but who is or was active in selling the scheme to the public.

Abusive promoter's fees

Promoters and salesmen (this includes not only the person who puts the scheme together or sells it, but also those who assist in creating or selling the scheme) receive their income from marketing these schemes. Promoters usually receive fees at the time the transaction is entered into, and may receive additional fees over time for "services" they allegedly provide (e.g., trust service fees, or disbursement fees). They also may be paid a percentage of the "tax savings" gleaned from the abusive program.

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Abusive Promotions and Promoters, Continued

How do promoters market their schemes?

Abusive programs or schemes are marketed in a variety of ways:

- seminars that target wealthy professionals (e.g., medical professionals) or business owners,
- advertisements in magazines and newspapers,
- word-of mouth, and
- the Internet.

Participants

A participant in an abusive tax shelter scheme typically "purchases" one or more units of the scheme for a sum of money in return for the promise of favorable tax consequences. These consequences are typically expressed in specific terms:

- avoiding the reporting of income,
- the conversion of non-deductible personal expenditures into deductible "business" expenses, or
- a multiple of the purchase price (e.g., "a 10-to-1 write-off").

Participants may be either individuals or legal entities.

When encountering an abusive program...

When encountering an abusive program, try to identify:

- how the taxpayer became involved in the transaction,
- who advised him/her to do so, and
- who provided the materials necessary to establish the taxpayer's participation in the scheme.

Also attempt to obtain copies of all materials that were utilized by the promoter and copies of all canceled checks used to pay for the taxpayer's participation in the program.

All of the above information will help identify the promoter since the promoter is usually the recipient of the fees.

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Deciding the focus

It is important to decide whether the focus in stopping the abusive trust should be on criminal or civil remedies, or perhaps, in the rare case, both. In dealing with abusive promotions, it is important to focus on each person's role in the scheme and to determine which remedy is best suited to that role. Factors influencing that decision are discussed elsewhere in this guide.

If the decision is to pursue civil remedies, then it is helpful to decide as early as possible whether the thrust of the examination will be to recommend an injunction or to assert penalties:

- IRC 7408 injunctions are effective in dealing with an abusive tax shelter as a whole. They stop a promotion in its tracks, prevent other taxpayers from getting involved, reduce the drain on the Treasury, and save IRS resources.

- Penalties under IRC 6700 and 6701 affect individual promoters and salesmen in the scheme, but normally do not have a wide-ranging impact on the abusive promotion as a whole.

TEFRA

Statutory tools provided in the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) may be used to combat abusive programs. The Senate Finance Committee Report (S. Rep. No. 97-494, 97th Cong., 2d Sess. At 266 (1982) 2 U.S. Code Cong. & Ad. News 781, 1041) noted that, "Abusive tax shelters must be attacked at their source: the organizer and salesman."

The report states, "injunctive relief will better enable the Internal Revenue Service to protect the integrity of the tax laws and to protect potential innocent investors against widespread marketing of such tax schemes." These tools are IRC 6700, 6701, and 7408.

When No Action Is Ultimately Taken

Was it just a wasted effort?

What if no successful IRC 6700, 6701, or 7408 actions are ultimately taken? What if the promoter fails to pay the penalty? What if he ignores the injunction or begins a similar, but not enjoined, scheme? Have you wasted your time?

NO:

- The information gathered (such as an investor list) will make any later examination of the investors' returns much easier.
- If a criminal prosecution is pursued later, the documentation evidencing the promoter's actions in this matter will show knowledge and intent. The loss to the Government, as shown on the investors' returns, may increase the amount of time and penalty under the sentencing guidelines.

Appendix

Exhibits

The Appendix to this text, at the back of the book, contains a wealth of reference material that will prove invaluable in pursuing abusive tax promotions. The law, court cases, Revenue Rulings, Revenue Procedures, and Internal Revenue Manual provisions may all be found there.

Summary

IRC 6700 provides for penalties against persons who sell or organize abusive tax promotions.
IRC 6701 provides for penalties against persons who prepare returns based on abusive tax promotions.
IRC 7408 provides for injunctive action against persons involved in abusive tax promotions.

Lesson 2

Identification and Development of Potential Cases

Introduction

Background

Possible abusive tax promotions may be identified from many sources. The information may come from internal IRS sources and/or external sources. The information will require development to determine whether IRC 6700/6701/7408 action(s) should be considered.

Objectives

At the end of this lesson you will be able to:

1. Identify five internal sources used to identify abusive tax promotions.
2. Identify eight external sources used to identify abusive tax promotions.
3. List five examination coordinators who may be helpful in identifying abusive tax promotions and evaluating the potential compliance impact of the promotion.

Contents

Internal Sources

Five internal sources

Internal Sources	Participant Source	Promoter Source
Examination of a Participant		X
Collection Activity on a Participant		X
Service Center – SS-4 Unit	X	X
Service Center – Classification Unit	X	X
Criminal Investigation Division	X	X

Examination of a participant

You may find that the taxpayer is involved in a tax avoidance scheme during the course of a normal income tax examination. All the information regarding the tax abusive promotion should be secured and referred to the appropriate Exam group.

Collection activity on a participant

Revenue officers may discover a pattern of tax avoidance and/or transfer of assets that appears to be orchestrated by a promoter/preparer. Many abusive promotion schemes call for the establishment of flow-through entities to receive assigned income, management fees, or other forms of income. These entities then pass the income to other entities, domestic or foreign. Frequently assets are transferred to these other entities as part of the scheme. The scattering of assets among entities makes it harder to collect any tax that is due or may become due.

It is important that Collection personnel understand the importance of referring tax avoidance situations to Exam. The establishment of multiple entities and the transfers of assets to them generally without remuneration should be investigated by Exam as well as Collection. The identification of just a single participant can lead to the identification of the abusive promotion.

Continued on next page

Internal Sources, Continued

SS-4 Unit

The SS-4 processing units at the Service Centers have been very helpful in identifying abusive trust promotions. Frequently the SS-4 applications are filed in batches by promoters and the information on the forms provide some valuable information on the promoters and participants involved in an abusive tax arrangement. The SS-4 Units may be able to provide copies of questionable SS-4 applications to examiners. The supervisors of these units could be a valuable source of information regarding promoters and promotions.

Classification Unit

The tax return classification examiners in the Service Centers occasionally identify returns that are claiming unusual tax treatment of an item. Although it is generally only a single return, a group of tax returns with the same characteristics may occasionally be identified. These returns may be traced to a tax return preparer, a tax shelter promoter, or a specific general partner. The information on the returns generally will not be sufficient to immediately initiate an IRC 6700/6701/7408 investigation, but additional development may lead to one.

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Criminal Investigation (CI)

CI also has responsibility for the investigation of abusive shelter promotions. Two databases are maintained to capture information related to these investigations.

One database is maintained for current and closed investigations. A second database, known as the Associate Identity database, is used to record the names of individuals and entities that are associated with an investigation. The fields in these databases allow searches by name, TIN, and address.

These databases may be of limited use to revenue agents. When a revenue agent needs to determine if a person or entity is being investigated by CI, the revenue agent should contact a special agent and provide the special agent with a request for information to be submitted. A request form has been developed for this purpose (Exhibit 2-1). This enables the special agent to query the databases.

If the query indicates that the submitted information is related to an active CI investigation, the special agent will contact the investigating special agent and provide the investigating special agent with the name and telephone number of the requesting revenue agent. The decision to make contact with the requesting revenue agent is left up to the investigating special agent. The investigating special agent will contact the revenue agent. The information provided may be limited if there is a grand jury investigation being made.

If the query indicates that the submitted information is related to a closed case, the special agent will attempt to contact the investigating special agent and have the investigating special agent contact the requesting revenue agent to provide information about the criminal investigation. The information may be limited if a grand jury investigation was made.

If no hits show up after the databases are searched, the special agent who initiated the search will contact the revenue agent and notify him/her of the search results.

External Sources

Eight external sources

External Sources	Participant Source	Promoter Source
Advertisements – Business Publications and Internet		X
Informants – Promotion Seminar or Sales Meeting	X	X
Public Records	X	X
Participants		X
Professionals – Client Solicited or Purchased Promotion		X
Licensing Authorities	X	X
Other Government Agencies	X	X
Lexis/Nexis Database	X	X

Advertisements

Many promoters target clients by advertising in business or professional magazines. Many promoters use the Internet to market their products. Sales presentations are typically conducted in hotel conference rooms.

Advertisements frequently hint at the tax avoidance motive of their product. The advertisements will not go into detail on how the tax avoidance is going to be accomplished, but will state that it is perfectly legal. A common characteristic of abusive tax promoters is that they are good salespersons. They have the ability to market their schemes no matter how far-fetched the scheme is or how intelligent or sophisticated their potential customers are.

If the promotional materials make the tax savings sound too good to be true, further development may result in an abusive promotion case.

Continued on next page

External Sources, Continued

Informants

Taxpayers frequently provide the Service with information about promotions and tax return preparers that are advocating tax positions that appear to be illegal. This information is generally sent to CI. If CI does not investigate the lead, the information should be passed on to Exam as a prime lead to investigate. If the lead contains detailed identification of the particular preparer/promoter, Service personnel should be cautious about making any additional contact with the informant. Before contact is made there must be an open examination case and a third party contact letter must be issued to the preparer/promoter.

It is not unusual for someone connected with a promoter to have a falling out with the promoter. Reasons may include:

- inadequate compensation
- difference of opinion
- lack of input
- lack of respect
- incompatibility

Whatever the reason, these individuals generally want to get back at the promoter. One effective way is to furnish information to the Service. Informants often understand the structure of the scheme and can explain how it works.

Informants may identify the type of returns that are filed by the participants. They may know the name of the return preparer used by the promoter. If the preparer is identified, internal research may identify all of the filed returns prepared by the preparer. This may lead to the identification of the scheme's participants. Sometimes informants will furnish internal documents such as a list of the participants. Informants can be a tremendous source of information.

Public records

The term "public records" includes many federal, state, and local government records. These records cover the transfer and ownership of assets, records of various taxing authorities, and records of court cases. Such records often may be accessed through the internet or by using commercial databases. In some instances records may be accessed by dealing directly with the governmental agency itself. The records may be confidential and accessed only by persons meeting specific criteria.

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Participants

Participants may have second thoughts about participating in programs that may be abusive. At that point the participant may wish to become compliant by filing amended returns. The participant may use a representative to contact the Service to file the amended returns and pay the additional tax.

The participant may be a very important source of information on both the program and the promoter. The participant may:

- have original promotional documents
- have correspondence from the promoter
- know how the promotion is designed to operate
- know the involved parties
- have information about the defenses the promoter will use to validate the promotion.

A thorough interview of the participant may provide all of the information necessary to request permission to initiate an IRC 6700 investigation.

Licensing authorities

Information may be obtained from federal, state, and local government licensing authorities. This information is limited to professional licenses and to the ownership of assets that require licenses.

Professional licenses are usually issued by state authorities. These license authorities may be used to verify the professional status of parties involved in the promotion. An individual claiming to be an attorney or CPA may have had his/her license suspended. Any claimed professional status by a party to the promotion should be verified. Any proof of license suspension or withdrawal should be documented.

Licenses for assets may be used to track ownership of the assets. If the participant is transferring the ownership of motor vehicles, marine vehicles, or aircraft to various flow-through entities as part of the promotion, the licensing agencies may provide information on the ownership or transfer of ownership of the assets.

Continued on next page

External Sources, Continued

Professionals

This category consists of advisors such as attorneys, accountants, and financial advisors. Sometimes these professionals receive promotional material sent directly to their clients. The clients may bring the material to their advisor when discussing the validity of the promotion.

Promotional material may include:

- written literature
- audiotapes
- videotapes
- and legal opinions explaining the viability of the promotion

In many cases the advisor talks the participant out of being involved with the promotion and the promotional materials are thrown away. Because these materials may be used to develop an IRC 6700/7408 case, outreach training should be considered to educate the professional community about these abusive promotions.

Most professionals do not want their clients participating in these schemes. They are receptive to sending the promotional information to the Service if they know we would like to have it and have a contact point.

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External Sources, Continued

Other government agencies

These agencies are primarily state and federal agencies that conduct investigations of state and federal securities law violations or state income tax agencies.

Securities fraud investigations are usually initiated after an investor comes forward to complain about being defrauded on some type of investment. These schemes may or may not have an income tax benefit built into the investment. These agencies may be contacted to obtain information about the promoter being previously involved in any fraudulent promotions.

State income tax agencies are another good source of information. The abusive promotion will impact state tax revenues just as it effects federal tax revenues. The state authorities may encounter and identify abusive promotions before the Service is able to find them. The district fed-state coordinator should encourage state officials to notify the service as soon as an abusive promotion is identified and provide the information they have developed about the promotion. This assistance will help identify the program, promoter, and participants. Contact your Fed/State Coordinator for additional infromation.

Lexis/Nexis database

The Lexis/Nexis database is one of the best sources of information. Its databases contain many of the external sources of information that have been covered in this section. It contains public records, license files, litigation, corporate information, addresses, and telephone numbers.

Initial Development of Potential Cases

Planning and Special Programs (PSP)

PSP is responsible for the identification and coordination of various programs covering non-compliant taxpayers, identified problem issues, abusive promotion schemes, and other compliance areas. These areas are usually assigned to specific coordinators who monitor the cases and assist agents in the field with the examination of cases under their coordinated area. The following key PSP coordinators should be involved in the initial identification and development of potential abusive tax promotion cases:

- Frivolous Filer & Non-Filer Coordinator
- Trust Coordinator
- Compliance Initiative Coordinator
- Return Preparer Coordinator
- MACS Coordinator

Frivolous Filer & Non-Filer Coordinator

These coordinators deal with compliance-challenged taxpayers. They are familiar with the abusive schemes used by this category of taxpayer and the promoters that create the schemes. They are aware of the typical rhetoric used and the actions taken when these schemes are challenged by the Service. Their expertise would be valuable in reviewing promotional material used in the abusive promotion. Their experience with promoters and sellers may help in identifying additional parties related to a promotion.

Trust Coordinator

These coordinators are responsible for selecting fiduciary returns for examination and assisting examiners with the unique issues associated with those examination. In recent years numerous promoters have been assisting taxpayers with the creation and use of domestic and foreign trusts as a means of tax avoidance and evasion. They are familiar with the many abusive schemes being marketed and may assist in the identification of a particular promotion or promoter. They may be able to identify participants currently under examination. They may also be able to associate specific return preparers or tax representatives associated with a particular promotion or promoter.

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Compliance Initiative Coordinator

These coordinators are responsible for monitoring and coordinating national and local compliance initiative projects (CIP), formerly known as information gathering projects (IGP). Taxpayers are identified through MACS research and returns are sent to the field as CIP cases. These returns are given special project codes and are monitored on a quarterly basis. The coordinator has detailed information on all of the national CIPs and can contact other coordinators nationwide.

Return Preparer Coordinator

A portion of an abusive promotion package is frequently identified as a result of return classification. It is possible to take this one piece of the puzzle and find additional information about the entire promotion by using the preparer information and the address shown on the return. Promoters will either prepare all of the promotion returns or they will engage a preparer to complete the promotion returns.

The Returns Preparer Coordinator is authorized to use the IDRS command code RPVUE. This code will prepare a list of all returns prepared nationwide by the preparer during a specific processing year. The RPVUE will list every Form 1040, 1120 or 1120S, 1041, and 1065 prepared and will show the EIN, SSN, and DLN for each return prepared.

Using the TIN information on the list, related packages of returns may be established by using the addresses shown on the returns. Usually, most of the returns in the scheme for a specific participant will have the same address. That address will have some type of connection to the participant.

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MACS Coordinator

Recent abusive promotion schemes usually use some type of assignment of income to reduce the participant's income. This makes it harder to identify the participants. The only common trait in identifying the participants is that their income usually decreases in large amounts over a 3-year period.

The MACS Coordinator can generate a 3 year analysis of the following types of returns; Forms 1040, 1120, 1120S, 1065, and 1041. Other research can be made with respect to SSNs, names and addresses, and market segment. This research is usually limited to information for a particular district.

Exhibit 2-2 is a MACS Research Request.

Summary

There are many internal and external sources that may help identify potential cases.
PSP and 5 key coordinators may also assist in identifying cases.

Exercises

Exercise 1

What are the five primary internal sources for identification of an abusive tax promotion?

Exercise 2

List five primary external sources for identification of an abusive tax promotion.

Exercise 3

List the five key Examination Coordinators that may assist in the identification and initial development of a potential abusive tax promotion case.

Answers to Exercises

Exercise 1

The five internal sources for identification are:

1. Examination Activity.
2. Collection Activity.
3. Service Center SS-4 Unit.
4. Service Center Classification Unit.
5. Criminal Investigations Division.

Exercise 2

Eight common external sources for identification of abusive promotions are:

1. Advertisements.
2. Informants.
3. Public Records.
4. Participants.
5. Licensing Authorities.
6. Professionals.
7. Other Agencies.
8. Lexis/Nexis.

Exercise 3

The five PSP coordinators are:

1. Frivolous Return & Non-Filer Coordinators.
2. Trust Coordinator.
3. Compliance Initiative Coordinator.
4. Returns Preparer Coordinator.
5. MACS Coordinator.

Exhibit 2-1

Request for Information from CI

Requestor Information: Date of Request:

Name:	Title:	POD:
Group #:	Voice ( ) - Telephone #:	Fax ( ) - Telephone #:

Please research the CI investigation and associate identity databases for the information listed below: If there is a hit during the search, please have the investigating special agent contact the requestor. The requested information is related to an examination of an abusive shelter promotion.

Names to be researched	Related CI Special Agent

TINs to be researched	Related CI Special Agent

Addresses to be researched	Related CI Special Agent

Exhibit 2-2

MACS RESEARCH REQUEST
Local Approval

Requester:		Date:	
Group:	POD:	Telephone #	
Manager's Signature: *(If not on AIMS)*		Date:	
PSP/Service Center Compliance Signature:		Date:	

National Approval (if required)

Prior to accessing the MACS database, National Office signature approval is required for all research. Research requests not requiring National approval are: minor modifications to the original request per the IRM; case building for returns already on AIMS; dif classification; subsequent repetitive profiling requests; access to the demo database; periodic validity testing of new data or program updates; and form 5346 and other referrals (i.e. CID, Collection, etc.).
Forms can be faxed to (631) 447-4479 – telephone number (631) 447-4435.

National Office Signature_____Date:_____

TYPE OF RESEARCH REQUESTED

SSN Research	
Name/Address Research	
Market Segment Research	
Facsimile of Return	

INFORMATION REQUESTED

TYPE OF RETURN		*TAX PERIOD*	
IMF 1040		Most Recent Year	
BMF 1120		Three Year Return	
1120s		Other	
1065		*PLEASE:*	
		Send MACS Profiling (No Names)	
TMF 1041		Send MACS Listing (Names)	
OTHER		Establish MACS Rtns. On ERCS	

INFORMATION WANTED: (Explain as precisely as you can what information you would like.)

Is the information being requested for a formal Compliance Initiative Project (CIP) or a Return Preparer Project?
Yes ☐ No ☐
If Yes, attach copy of CIP or return preparer project authorization.

SEND REQUESTED INFORMATION TO:

FOR ADMINISTRATIVE USE ONLY

Date Received: Date Assigned: MACS Control Number:
Assigned To: MACS Filter Name:

Lesson 3

INFORMATION GATHERING ON POTENTIAL 6700 LEADS

Introduction

Background

After information has been gathered from internal and external sources, it must be analyzed to determine the next course of action. In many cases this information may be sufficient to immediately request a 6700/7408 action. At other times it may be necessary to initiate income tax examinations of the investors and/or the promoter.

Objectives

At the end of this lesson you will be able to:

1. Identify the information needed to request a 6700/7408 investigation.
2. List the primary reasons for examining the income tax returns of an investor/participant.
3. Identify the type of information regarding the promotion that can be secured from the examination of the investor/participant.
4. Compare the pros and cons of conducting an examination of the promoter's income tax returns.
5. Identify the type of information regarding the promotion that can be secured from the examination of the promoter.
6. Refute the common defense arguments used by promoters of abusive tax schemes.

Contents

Evidence for IRC 6700/7408 Investigations

Rev Proc. 83-78

Evidence that would support the recommendation to inititate an IRC 6700/7408 investigation is listed in Rev. Proc. 83-78, Sec. 3 (see Appendix).

The information needed by the IRC 6700 committee to determine if an investigation of the promotion is warranted includes:

1. The organizational structure and role of various parties in the promotion.
2. The past activity of the promoter.
3. The type of tax shelter involved.
4. The size of the promotion.
5. The tax deductions or credits claimed.
6. The regional or national impact of the promotion.

Participant Examinations

Why conduct examinations of investors/ participants?

To secure information to support a 6700/7408 referral, it may be necessary to conduct an examination of one or more investors/participants. The reasons for examining a sample of investor/participant income tax returns are to:

1. Correct any improper tax treatment of any items on the examined returns.
2. Verify that abusive tax positions are being claimed by investor/participants.
3. Secure promotional materials and testimony regarding the promotion.
4. Establish a basis for estimating the loss of tax revenues caused by the promotion.

Continued on next page

Participant Examinations, Continued

Information secured from participants

The primary purpose of any income tax examination is to determine the correct tax liability. Securing documentation and information regarding the potentially abusive promotion is only a secondary purpose.

Information that may be secured from examination of client returns includes:

1. If the investor/participant claimed the abusive tax attributes of the promotion.
2. How the promotional organization is structured.
3. The identity of the primary promoters of the tax shelter.
4. How the investor/participant first became associated with the promoter.
5. What method of advertising or marketing is used by the promotion.
6. Any legal analysis of the tax structure provided by the promoter.
7. Copies of promotional brochures and instructions on the operation of the tax shelter.
8. Actual cost of purchasing the tax shelter.
9. Audit representation and audit strategy of promoters.
10. Location of bank accounts used by the promoters.

IDRS research

Investors/participants often attempt to disguise their identity and relationship to their abusive promotion entities. They may act as an agent of the entity or use friends or promoters as agents.

Sometimes the address listed on the investor/participant return is his or her residence or business; sometimes it may be the promoter's address. This address may help in finding returns related to the investor/participant or the promoter. Research may be needed to determine the identity of the primary investor/participant if there are additional related returns. Lexis, IDRS, and public records are only a few of the research tools available.

Continued on next page

Starting the examination

An approved appointment letter should be modified to meet the needs of the promotion. If the participant is filing a joint return, an appointment letter should be sent to each taxpayer. An Information Document Request (IDR), Form 4564, should be sent with the appointment letter. A sample IDR is included as Exhibit 3-1.

If the participant does not honor the scheduled appointment or provide the information requested in the IDR, a second request should be made and the request should include a notice that third parties may be contacted to secure information. This notice is currently provided by a version of Letter 3164. If the participant is filing a joint return, Letter 3164 must be sent to both spouses.

You should be alert to attempts by the taxpayer to delay the examination or have the audit transferred to another IRS office. Local guidelines regarding requests for transfers of cases should be followed. If the participant resides in the district and maintains his/her business operations or employment within the district, the examination should made in that district. Transferring the case for the benefit of the preparer and/or promoter should not be considered.

Continued on next page

Initial interview It is extremely important to treat every contact as if it is the only contact that will ever be made with the taxpayer/participant. The initial interview may be the only opportunity to gather detailed information from the participant about the formation of the entity/entities, the operation of the entity, and the purchase of the abusive promotion package.

Exhibit 3-2 is a set of questions that may be used in a participant examination. Modify the questions to fit the facts and situation involved in the examination. Documentation of responses and asking appropriate follow-up questions are extremely important.

The following are tips to keep in mind when performing interviews:

1. Safety is always the first consideration. If unsure of safety, consider bringing the interviewee into the office or take a fellow agent or group manager to the appointment. A special agent should not participate because the case could result in a criminal referral and there would be an inference that CI had a role.

2. Taxpayers may request immunity from criminal prosecution. If so, state that the examination constitutes a civil audit of tax liability and that an examiner has no authority to grant immunity. **Do not assure the taxpayer that their records will be used solely for civil purposes.**

3. If the taxpayers invoke their Fifth Amendment rights, they must invoke these rights for each question. In other words, each interview question should still be asked and the taxpayer must invoke their Fifth Amendment right in response to each question. **A blanket invocation of the Fifth Amendment cannot be made.** *United States v. Brown*, 918 F.2d 82, 84 (9th Cir. 1990).

   If a trust is involved, the Fifth Amendment privilege does not apply to individuals in a representative capacity, which is the case for a trustee of a trust. Trustees must produce trust records, even if they feel that in doing so they may be incriminated. *United States v. Blackman*, 72 F.3d 1418 (9th Cir. 1995).

Continued on next page

Initial interview, continued

4. Inform the taxpayer that in the event of no cooperation, the Service can make a determination regarding the tax liability based on the information available. Discuss the statutory requirements contained in IRC 7601 and 7602 (found in the Appendix) and the taxpayer's responsibility found in IRC 6001, 6011 and 6012. Inform the taxpayer that to deny access to the records will only delay the examination. It should be made clear that the taxpayer's refusal to cooperate will not prohibit us from determining the correct tax liability.

   IRC 7601 and 7602 authorize the Service to examine books, papers, records, or other data, which may be relevant or material to a tax examination. The Supreme Court, in *United States v. Euge*, 444 U.S. 706 (1980), broadly construed the Service's power under IRC 7602, and has concluded that a taxpayer is under an obligation to produce any information that may be relevant to a legitimate revenue purpose.

   The taxpayer's responsibility to produce records is described in IRC 6001. The taxpayer's responsibility to file returns is described in IRC 6011, 6012.

5. Attempt to determine how the taxpayer became involved in the abusive promotion by asking open-ended questions. Ask follow-up questions to obtain details. Try to secure copies of promotional material.

6. Document the interview. Take a few minutes after the interview to make sure that all responses are accurately and completely recorded. In addition, for pre-written questionnaires, document any questions not asked as well as questions for which no response is received. Consider asking the interviewee to sign the interview notes and to initial each page. Form 2311 Affidavit (Exhibit 3-3) could be prepare and signed by the interviewee.

7. IRC 7602(a)(2) provides the authority to put witnesses under oath.

8. Maintain detailed case history sheets. Be sure to document all actions taken as well as all contacts made.

Continued on next page

Initial interview, continued

9. If the taxpayer asks to tape-record the interview, you must also record the meeting. Audio recordings are permitted under the conditions of IRM 4245. Video recording and recording of telephone conversations are not permitted.

10. Taxpayers involved in abusive promotions have been known to request that Service employees complete a Public Servant's Questionnaire. Alternatively, questions of the same nature could be asked in the form of a letter. You are required to respond only to reasonable questions.

11. Treat all of the persons and entities involved in an abusive promotion as third parties and follow third-party notification procedures.

If the participant may claim that he/she does not know anything about the business since it was transferred to another entity involved in the promotion, ask these questions:

1. Why was the business/investment transferred?

2. After the transfer, what is the participant's source of income? How does it differ from the source of income prior to the transfer?

3. Who controls the revenue and why?

4. Who makes the day-to-day business decisions and how is this "decision-maker" compensated?

5. How was the "decision-maker" hired?

6. Who maintains the documents and records of the business?

Continued on next page

Participant Examinations, Continued

Control the examination

Be sure to set a reasonable appointment date for the initial meeting. Allow adequate response time on the IDR. If the participant asks for additional time to organize his/her records, grant a reasonable amount based upon the facts of the case. It is important for the Service to maintain a favorable position in terms of cooperation with the participant. Follow up on all deadlines for requested information.

If the participant ultimately decides not to cooperate, the fact that the Service dealt reasonably with the participant will strengthen the Service's position in summons enforcement litigation. Documentation of all contacts and other examination activity becomes important in summons enforcement litigation.

If, after reasonable extension requests have been granted and the participant has failed to cooperate, discuss with your group manager the issuance of a summons for the participant's testimony and the records previously requested by the IDR. If the participant is filing a joint return, a separate summons should be issued to the participant's spouse for testimony and records. Additional information on summons is found in a later lesson.

Promoter Examinations

Pros and cons of examining the promoter

There is no requirement that the promoter's income tax returns be examined prior to, concurrently, or after the completion of an IRC 6700/7408 case. A request to initiate a 6700 examination can be made without regard to the promoter's income tax examination. There may be some benefits to initiating an income tax examination on the promoter before a 6700 referral is made. However, there also are a number of reasons that an income tax examination may not be beneficial or may even damage the ultimate case against the promoter.

The following chart lists some of the pros and cons of conducting an income tax examination of the promoter prior to or concurrently with an IRC 6700/7408 investigation.

PROS	CONS
May secure documentation and information about promotion directly from the source.	Promoter may be more difficult to get information from than a participant – causing delays.
May obtain all the necessary personal and business history from audit interview.	May not consent to an interview – causing delays.
May secure client list from review of client files or from summoned deposit records.	May refuse to provide client information and may file petition to quash bank summonses – causing delays.
May determine the relationship of various entities and other parties involved in promotion.	May not disclose information about the other entities and parties.
Audit may result in large collectible tax deficiencies.	Promoter may already have huge uncollected tax liabilities.
Promoter may agree or pay proposed deficiency.	Civil examination may be detrimental to any possible criminal case against the promoter.
Promoter's audit defense strategies will be determined.	Audit techniques may be exposed and promoter may coach participants on how to frustrate examiner.

Continued on next page

Starting the examination

Much of the information discussed in reference to the investor/participant examination would also be applicable to the examination of the promoter's income tax returns. If the promoter's personal income tax return is examined, simultaneous examinations probably will need to be completed on the various business entities that are associated with the promoter and the promotion.

If an income tax examination is going to be conducted at the same time as the IRC 6700 investigation, IRM 42(17)(11).62 (7) (see Appendix) suggests that the same examiner should perform the IRC 6700 investigation and the income tax examination. However, if the case is large and difficult, the IRC 6700 penalty investigation should be assigned to one agent and the income tax examination should be assigned to another agent.

Scope of the examination

The scope of the examination should be limited and closed quickly if the promoter:

- is not utilizing any abusive promotions,
- is reporting the income from the promotion scheme, and
- has no other tax issues are identified on the return.

The scope of the examination should be expanded if it appears as if the promoter:

- has been involved in his/her promotions or similar promotions,
- has paid little or no income tax, and
- owns assets that can be seized for collection purposes.

In either case the examination is only one source of evidence to support the 6700/7408 investigation. Referral of the promoter to the 6700 committee should not be delayed or discontinued solely on the basis of the promoter's income tax investigation.

Common Defenses

Common arguments

Abusive tax promotions frequently include audit defenses. These normally take the form of taxpayer correspondence containing frivolous questions and unfounded allegations or constitutional reasons for not providing records and testimony. This correspondence is usually sent in response to examination requests. The promoters market these defenses as a means of delaying the examination and they claim that delays will frustrate you and result in the examination being discontinued.

These audit defenses may also serve as the basis for not complying with IRS summonses. IRS summonses are issued under federal statutory authority, so only privileges recognized under federal law (e.g., attorney-client, marital) will be considered as a defense in summons enforcement. *United States v. Zolin*, 491 U.S. 562 (1989).

Continued on next page

Common Defenses, Continued

Responses

You are not expected to respond to audit defense questions of positions on a point by point basis. Attempts to respond usually result in the taxpayer's disagreeing with the answers and asking you to consider additional frivolous positions. Many offices have prepared standardized acknowledgements of the audit defense letters. These responses may include the following information:

- Publication 1, *Your Rights as a Taxpayer*
- Publication 5, *Your Appeal Rights and How to Prepare a Protest If You Don't Agree*
- Publication 594, *The Collection Process*
- Publication 1669, *Collection Appeal Rights*
- Form 12153, *Request for a Collection Due Process Hearing*
- Notice 609, *Privacy Act Notice*

Since audit defense tactics are designed to avoid keeping appointments or providing records, you usually do not have to respond to audit defense arguments in person or spontaneously. However, occasionally the need for responses does arise. Exhibit 3-4 has been prepared for responding to Constitutional arguments and Exhibit 3-5 can be used when responding to issues of authority and responsibility.

All correspondence received should be reviewed for allegations of violations of Section 1203(b) allegations. Letters containing such allegations should be provided to management.

District Counsel should be contacted if you have questions about any of the correspondence received.

Summary

Conducting income tax examinations on investor/participants may prove useful in gathering evidence on the promotion.
Consideration should be given to the pros and cons of conducting an examination of the promoter's income tax returns prior to or concurrently with the IRC 6700/7408 investigation.

Exercises

Exercise 1

What six topics of information are needed by the IRC 6700 committee to determine if an investigation of a promotion is warranted?

Exercise 2

What kind of information can be secured about a promotion from examining a investor/participant? List six items.

Exercise 3

If a taxpayer requests immunity from criminal prosecution, you should assure the taxpayer that this is not a criminal investigation and the information secured will only be used for civil purposes. True or False?

Exercise 4

If a taxpayer invokes a Fifth Amendment right for failing to answer interview questions, the interview should be terminated and no further questions should be asked. True or False?

Exercise 5

List five pros and cons for examining the promoter's tax returns.

Answers to Exercises

Exercise 1

The six topics include:

1. The organizational structure & role of various parties in the promotion.
2. The past activity of the promoter.
3. The type of tax shelter involved.
4. The size of the promotion.
5. The tax deductions or credits claimed.
6. The regional or national impact.

Exercise 2

The information that may be secured from examination of investor/participants includes:

1. Whether or not the investor claimed the abusive tax features of the promotion.
2. How the promotion organization is structured.
3. The identity of the primary promoters of the shelter.
4. How the promoters meet potential clients.
5. What methods of marketing the shelter are used by the promotion
6. Legal opinions provided to the clients by the promoter.
7. Copies of all the promotional brochures and operation manuals used by the promotion.
8. Cost of the tax shelter package.
9. Audit strategy of the promoters.
10. Location of the promoters bank accounts.

Exercise 3

False.
You should state that he/she does not have the authority to grant immunity. However, no guarantees should be made that the examination will not result in criminal prosecution or that the information obtained during the examination will not be used for criminal prosecution. It is possible that the information may later be used to criminally prosecute the taxpayer/participant or the tax shelter promoter.

Continued on next page

Exercise 4

False.
You should continue to ask all the questions and allow the taxpayer to claim the Fifth on those questions that he does not wish to answer. Frequently the taxpayer will answer many of the questions.

Exercise 5

The pros include:

1. Can secure documentation and information from the source.
2. Can get personal and business history directly from promoter.
3. Can secure client list from books or bank records.
4. Can determine relationship of related entities and individuals.
5. Promoter's own tax can may be resolved in tax court before participants.
6. Audit may result in large collectible tax deficiencies.
7. Promoter may agree and pay tax deficiency.
8. Promoter's audit defense strategy can be determined.

The cons include:

1. The promoter may refuse to cooperate.
2. The promoter may not consent to an interview.
3. The promoter probably will fight any attempts to get information regarding his clients.
4. The promoter may not disclose any information about other related entities and parties.
5. The promoter's own tax case may be resolved without a published court decision.
6. The promoter may already have huge uncollectible tax liabilities.
7. The civil examination may be somewhat detrimental to any possible criminal prosecution of the promoter.
8. The examination audit techniques will be exposed and the promoter may coach his clients on how to impede the tax examination.

Exhibit 3-1

Form 4564	Department of the Treasury Internal Revenue Service Information Document Request	Request Number

To: (Name of Taxpayer and Company, Division or Branch)	Subject:
	Submitted to:
	Dates of Previous Requests:

Description of Documents Requested:

- Power of Attorney, if you wish to have a representative work with me during the examination.
- All accounting books and records for the period December 1, 19X1 through January 31, 19X3. Records should include, but not be limited to check registers, disbursements journals, receipts journals, general ledger, and other workpapers used in the preparation of the tax return(s) or financial statement(s).
- All other books and records relating to your income, expenses, and deductions used in the preparation of your return.
- All sales invoices, sales contracts, cash register tapes, etc. which document gross receipts for the tax year(s).
- Your copy of any auditor's reports; internal or external.
- Bank Statements with cancelled checks, debit/credit memos and deposit slips for the period December 1, 19X1 to January 31, 19X3 for all checking, savings, and money market accounts (both business and personal).
- Contracts, purchase receipts, etc. for assets purchased in the tax year(s).
- Information on other invested funds.
- Records of all loans and repayments for the year(s) 19__ and 19__.
- Information on any nontaxable income for the tax year(s).
- Copies of prior and subsequent year income tax returns.
- Copy of K-1(s) for flow through income.

Information Due By _____ **At Next Appointment** ☐ **Mail In** ☐

	Name and Title of Requestor	Date:
	Internal Revenue Agent	
FROM	Office Location:	
	Phone: Voice (xxx) 123-4567 ext. 205 FAX (xxx) 123-4568	Page 1

Form 4564

Exhibit 3-1, Continued

Form 4564	Department of the Treasury Internal Revenue Service Information Document Request	Request Number

To: (Name of Taxpayer and Company, Division or Branch)	Subject:
	Submitted to:
	Dates of Previous Requests:

Description of Documents Requested:

- Inventory of assets transferred to any and all promotion entities.
- Bill of sale for any item(s) sold to any and all promotion entities.
- Copies of returns for spouse, children or related entities (Forms 1040, 1120, 1120S, 1065, 1041, 940, 941).
- All documents evidencing transfers of assets or property to any and all promotion entities including, but not limited to, trust deeds, savings account passbooks, and stock transfer records.
- All contracts between you and any entity, including rental arrangements and agreements, concerning any management or professional fees to be paid by you.
- All contracts between you and any entity, including rental arrangements and agreements, concerning any management or professional fees to be received by you.
- A listing of all entities you were involved in as an investor, consultant, officer or employee that currently hold assets that once belonged to you. Provide the employer identification number (EIN) for each entity and in what capacity you are involved with the entity. Provide share of ownership, if applicable.
- A listing of all other business entities in which you are involved.

Information Due By _____ **At Next Appointment** ☐ **Mail In** ☐

	Name and Title of Requestor Internal Revenue Agent	Date:
FROM	Office Location: Phone: Voice (xxx) 123-4567 ext. 205 FAX (xxx) 123-4568	Page 2

Form 4564

Exhibit 3-2

Interview Questions for Investor/Participant

Taxpayer Name:
Years:
Type of Return:

Date & Time of Interview:

Place of interview:

Persons Present: 1. Revenue Agent
2.
3.

Representative: 1.
2.

ENTITIES CREATED

1. What are the names and addresses of all entities in which you and/or your spouse had an interest in or are associated with (ie., trusts, partnerships, corporations, LLC's, or sole-proprietorships) both domestic and foreign?

2. What are the names and addresses of all entities for which you and/or your spouse exchanged property for shares of ownership, certificates of beneficial interest, stock, bonds, or promissory notes?

3. What are the names and addresses of all entities that hold property that formerly belonged to you personally, to a family member, or to any related business entity?

4. When were each of these entities created?

5. For what purpose were each of these entities created?

6. What property did you and/or your spouse transfer to each of these entities initially?

7. Have you transferred any additional property in subsequent years? If so, what was transferred?

Exhibit 3-2, Continued

8. Who were the original incorporators, shareholders, partners, grantors, trustees and/or beneficiaries of each of these entities?

9. What is your relationship to each or the persons involved with these entities?

10. Do you and/or your spouse have any control over any of these entities or their principals?

11. Who has authority to appoint new trustees?

12. Have any of the persons resigned or been replaced? If so, how and when?

13. Who maintains the legal and accounting records for each of these entities?

BUSINESS ACTIVITY

14. Describe the business activity of each entity.

(a) How is it operated?

(b) Who manages the business?

(c) Who controls the business assets?

(d) Who makes the day-to-day decisions?

(e) Where does the entity do its banking? What is the account number?

(f) Who has signature authority over the entity bank accounts? Who opened the bank accounts?

(g) How are bills approved for payment?

(h) How are the checks actually signed (i.e. rubber stamped, in advance, by whom, etc.)?

Exhibit 3-2, Continued

15. Do you hold any position with respect to each of these entities (general manager, agent, employee)?

16. Are you compensated by these entities in any way? If so, did you receive any Forms W-2 or 1099?

17. Did you receive any distributions of property from any of these entities for any reason?

18. Do you have possession or use of the assets of any of these entities?

19. Do any of these entities pay rent for any property? If so, what is rented and for what amounts?

20. Do any of these entities make payments for services or products to any of the other entity?

21. Were any loans paid out of any of these entities? If so to whom, when, and for what amount?

22. Have the loans been repaid with interest?

23. Have you and/or your spouse ever loaned any funds to any of these entities? If so, explain the details of the loan.

24. Have any loan repayments been made?

25. Do any of these entities provide for or pay for any personal living expenses of your family?

26. What kind of business were you engaged in prior to the formation of these entities?

27. Did you operate your business as a corporation, partnership or as a sole-proprietorship?

Exhibit 3-2, Continued

28. Did you change the type of entity you were operating to a different type of entity?

29. What is your and your spouse's educational background? Other professional training?

30. Do you and/or your spouse hold any professional or business licenses? If so, are you still operating your business using this license?

PROMOTION

31. How did you find out about this promotion?

32. Who personally assisted you in the formation of these entities? Get names of everyone involved in the promotion.

33. Where does the promoter maintain his office?

34. Why were you first interested in the promotion?

35. What made you decide to purchase the promotion?

36. How does the promotion work? What are the benefits of the promotion?

37. Do you have copies of all the legal documents that were prepared as part of the promotion (trust documents, incorporation papers, property deed transfers, etc.)? May I review them? May I copy them?

38. How does the promoter solicit customers?

39. What written materials were you given regarding the promotion?

40. Who gave you the written materials regarding the promotion?

Exhibit 3-2, Continued

41. Do you know who wrote the promotional documents?

42. Can I review the written materials you received and make copies of them?

43. Did you view any video tapes regarding the tax shelter? If so, can I borrow the video?

44. Did you attend any seminars or training sessions? If so, where and when?

45. Who spoke at the seminars or training sessions?

46. Did you completely follow the advice given to you by the promoter or the promotional materials?

47. To your knowledge is the promoter still marketing the shelter in the same manner?

48. Does the promoter market any other tax shelter or investment products?

49. Did you have any concerns about any of the information contained in the promotional brochures and/or discussed at the seminars (giving up control of the assets)?

50. Were any tax benefits explained to you? If yes, what were the tax benefits as explained to you?

51. What made you think the information was accurate?

52. Does the promoter hold any professional licenses? If so, what licenses?

53. Did the promoter indicate that he had expertise in accounting or tax law?

54. Did you consult with an attorney or CPA about the promotion? If so, whom? If not, why?

55. What advice did the attorney or CPA give you?

56. What was the cost of the promotion?

57. Did you receive a receipt or invoice for the cost of the promotion?

58. Who did you make payment to?

59. Did you pay for the services by check? If so, can I inspect the check?

60. What entity claimed the deduction for the cost of the promotion?

RETURN PREPARATION

61. Did the promoter arrange for all your personal and entity tax returns prepared by a particular accounting or tax preparation firm?

62. Did the promoter refer you to a particular tax return preparer?

63. How much were you charged for preparation of the tax returns?

64. Did you receive any promotional materials or instruction manuals? If yes, describe?

65. Were federal gift tax returns filed to report the transfer of assets to any of these entities? If not, why?

Exhibit 3-3

Affidavit

United States of America _____)
_____, District of _____)

1. I _____, state that:

2. I reside at _____,

3 _____

4 _____

5 _____

6 _____

7 _____

8 _____

9 _____

10 _____

11 _____

12 _____

13 _____

14 _____

15 _____

16 _____

17 _____

18 _____

19 _____

20 _____

21 _____

22 _____

Exhibit 3-3, Continued

23 _____

24 _____

25 _____

26 _____

27 _____

28 _____

29 _____

30 _____

31 _____

32 _____

33 _____

34 _____

35 _____

36 _____

I have read the foregoing statement consisting of __ pages, each of which I have signed, I fully understand this statement and it is true, accurate and complete to the best of my knowledge and belief. I made the corrections shown and placed my initials opposite each.

I made this statement freely and voluntarily without any threats or rewards, or promises of reward having been made to me in return for it.

_____
(Signature of affiant)

Subscribed and sworn to before me
this _____, 19____,
at _____.

_____
(Signature)

_____
(Title)
Internal Revenue Service

_____
(Signature of witness, if any)

Exhibit 3-4

Constitutional Arguments

1. **First Amendment** (freedom of religion and association). The party asserting this privilege has the burden of showing that disclosure of the information sought will be prejudicial to them, such as exposure to public hostility or deterrence of free association. *Bronner v. Commissioner*, 72 T.C. 368 (1979); *United States v. Freedom Church*, 613 F.2d 316 (1st Cir. 1979). It is not enough that a "generalized dread of an IRS investigation is expressed...." *United States v. Norcutt*, 680 F.2d 54 (8th Cir. 1982).

2. **Fourth Amendment** (unreasonable search and seizure). A summons is not a violation of the Fourth Amendment. *Oklahoma Press Publishing Co. v. Walling*, 327 U.S. 186 (1946). The information sought must meet the four tests found in *United States v. Powell*, 64-2 USTC, 9858, 379 U.S. 48 (1964). The government must show that (1) the investigation was conducted pursuant to a legitimate purpose, (2) the materials sought may be relevant to that purpose, (3) the information sought is not already in the possession of the IRS, and (4) the administrative steps required by the code have been followed. Protection against unreasonable search and seizure is a personal privilege and cannot be claimed by a third party for another person.

3. **Fifth Amendment** (privilege against self-incrimination). This amendment protects individuals from being a witness against themselves in a criminal case. The privilege applies only in situations where one is faced with "substantial hazards of self-incrimination," *California v. Byers*, 402 U.S. 424 (1971), or where the claimant can demonstrate "real dangers of incrimination, as opposed to dangers which are remote and speculative," *Zicarelli v. New Jersey State Commission of Investigation*, 406 U.S. 472 (1972). The defense pertains to both documentary requests and oral testimony.

   This is also a personal privilege. It cannot be used in a representative capacity (e.g., as trustee of a trust or entity official) with respect to entity records, even if the act of producing them might incriminate the recordkeeper personally. *United States v. Blackman*, 72 F.3d 1418 (9th Cir. 1995); *Braswell v. United States*, 487 U.S. 99 (1988). The custodian's acts are considered representative rather than personal, and so are deemed to be acts of the entity and not of the individual. Mere identification of the records by a custodian is <u>not</u> a violation of the Fifth Amendment.

   This is not a blanket privilege. The party responding to a summons must object on a question-by-question and document-by-document basis. *United States v. Bell*, 448 F.2d 40, 42 (9th Cir. 1971). This ensures that the court can decide on each element of the privilege at the enforcement stage, rather than in a contempt proceeding.

Continued on next page

Exhibit 3-4, Continued

4. **Attorney-client privilege** (protects confidential communications between a person and their professional legal advisor). The purpose of this privilege is to encourage free and open communications between attorneys and their clients. However, since it is an obstacle to the search for the truth, the privilege is construed as narrowly as is consistent with its purpose. The protection of the privilege extends only to Confidential communications and not to underlying facts. *Upjohn Co, v. United States*, 449 U.S. 383 (1981).

5. **Attorney work-product doctrine** (protects certain materials prepared by an attorney for a client). This doctrine is limited to protecting "materials prepared by an attorney acting for his client in anticipation of litigation." *United States v. Nobles*, 422 U.S. 225 (1975). This does not envelop all materials prepared by an attorney. Rather, the purpose of the doctrine is to prevent the forced disclosure of the attorney's litigation strategy and the materials he develops to further that strategy.

6. **Accountant-client privilege** (protects communications between taxpayers and "any federally authorized tax practitioner" concerning "tax advice"). This privilege was added by RRA 98, and is found in IRC 7525. This provision does not modify the attorney-client privilege, but extends it to other authorized practitioners.

   This privilege may be asserted in any non-criminal proceeding before the Service or in any non-criminal tax proceeding in federal court "to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney," except for written communications made "in connection with the direct or indirect participation" by a corporation in a "tax shelter." For example, information disclosed to an attorney for the purpose of preparing a tax return is not privileged. Such information would not be protected under the new privilege whether it was disclosed to an attorney, CPA, enrolled agent, or enrolled actuary. *See RRA 3411.*

Exhibit 3-5

Authority/Responsibility Arguments

ISSUE	*CITE REF.*	*EXPLANATION*
Authority	Del. Order 4 C.B. 1990-1, 294	The authorities granted to the Commissioner of Internal Revenue by 26 CFR 301.7602-1(b), 301.7603-7, 301.7604-1 and 301.7605-1(a) and the authorities contained in Section 7609 of the Internal Revenue Code of 1954 and vested in the Commissioner of the Internal Revenue Service by Treasury Order No. 150-10 are delegated to the officers and employees of the Internal Revenue Service specified in paragraphs 1(b), 1(c) and 1(d) of this order and subject to the limitations stated in paragraphs 1(b), 1(c), 1(d), 5 and 6 of this order.
Authority	Treasury Department Order 150-10	Never published but held by the courts to be valid as there is no requirement for them to be published.
Authority	IRC Regs. 301.7805-1	(a) The Commissioner, with the approval of the Secretary, shall prescribe all needful rules and regulations for the enforcement of the Code. (b) Retroactively, The Commissioner, with the approval of the Secretary, may prescribe the extent, if any, to which the regulation or Treasury Decision relating to the Internal Revenue Code shall be applied.
Authority	IRC Regs. 301.7701-9	The term "Secretary or his delegate" means the Secretary of the Treasury, or any officer, employee, or agency of the Treasury Department duly authorized by the Secretary (directly, or indirectly by one or more redelegations of authority) to perform the function mentioned or described in context, and the term "or his delegate" when used with any other official of the United States shall be similarly construed.

Authority	IRC Regs. 301.6212-1	Director is authorized to issue notice of deficiency.
Authority	IRC Section 7602	(a) Authority to summons, etc. For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, the Secretary is authorized.
Authority lack of OMB #	U.S. v. Barker (1990, DC CA) 71A AFTR 2d 93-4596, 90-2 USTC para.50490.	Taxpayer was ordered to comply with IRS summons for production of records in order to determine his tax liabilities. IRS's delegated authority to issue summons, and validity of summons wasn't affected by lack of OMB control numbers in forms used.
Authority to request info. Without official summons	Bill H. Rowley (1977) TC Memo 1977-357, PH TCM Para.77,357, aff'd by unpublished order (CA9, 6-9-80)	IRC Sec. 7602 doesn't require IRS to issue summons for material substantiating deductions before it issues valid statutory notice of deficiency.
Authority	Rev. Proc. 64-22, 1964-1 C.B. 689	The function of the Internal Revenue Service is to administer the Internal Revenue Code. Tax Policy for raising revenue is determined by Congress.
Tax Imposed	IRC Sec. 1	Stipulates the filing status and the rate at which tax is assessed on taxable income for; (a) married individuals (b) Heads of household (c) Unmarried individuals (d) Married individuals filing separately (e) Estates and trusts (f) Adjustments for inflation (g) Certain unearned income of minors

Requirement to produce records	IRC Sec. 6001	(7)	Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe.
Requirement to provide complete returns	IRC Sec. 6011	(8)	When required by the regulations prescribed by the Secretary any person made liable for any tax imposed by this title, or with respect to the collection thereof, shall make a retrun or statement according to the forms and regulations prescribed by the Secretary. Every person required to make a return o0r statement shall include therein the information required by such forms or regulations.
Persons required to make returns	IRC Sec. 6012	(9)	General Rule Returns with respect to income taxes under Subtitle A shal be made by the following; (a) Every individual for the taxable year gross income which equals or exceeds the exemption amount.
Authority to make returns	Del. Order 182	(10)	The authority granted to the Commissioner of Internal Revenue, by 26 CFR 301.6020-1(b) and 26 CFR 301.7701-9 to execute returns required by any internal revenue law is delegated to: (1) Revenue Agents, (2) Tax Auditors, (3) Revenue Officers, etc.

Authority to Issue Formal Document Requests	Del. Order 213	(11)	The authorities granted to the Commissioner of Internal Revenue by 26 CFR 301-7602-1 and Section 982 of the Internal Revenue Code to issue Formal Document Requests and top perform the other functions related thereto are delegated to all District Directors, Service Center Directors, and the following officers and employees; (1) District Examination; Chiefs of Division; Chiefs of Examination Sections; Chiefs of Examination Branches; Case Managers; Group Managers; Internal Revenue Agents; Tax Auditors; Attorneys, Estate Tax; and Estate Tax Examiners.
No criminal statutes in attempting to audit his return.	John Earl Tomlinson v. Allen Nailor; 78 A.F.T.R.2d (RIA) 7433	(12)	District Courts dismissal of his action alleging that the defendants violated his constitutional rights and various criminal statutes by attempting to audit his federal income tax return. Because the taxpayers contentions were found wholly without merit, we impose sanctions of $ 500.00 for bringing the appeal.
Assignment of income	Lucas v Earl, 281 U.S. 111, 74 L. Ed. 731, 50 S. Ct. 241	(13)	Prevents attempts to assign income away from its earner.
Assignment of income, Deductions of the trust.	Schulze et al v Commissioner 686 F.2d 490; 1982	(14)	Discussions on the handling of various cases settled. Dealt with the disallowance of expenses on the trusts, disallowance of the assignment of the income, etc.
	Holman v USA 728 F.2d 462; 1984 U.S. App	(15)	
	Sampson v Commissioner 829 F.2d 39; 1987	(16)	
	Pfluger v. Commissioner 840 F.2d 1379; 1988	(17)	Court found contentions were meritless.

Settlement agreements	Smith v. US 86-2 USTC P9536	(18)	Taxpayer wrote a check "Deposit shall settle all claims the United States may have.." does not -- as a matter of law -- preclude the gov't from making additional assessments.
Promoter - Trust schemes	U.S. v. Buttorff 761 F.2d 1056; 1985	(19)	Enjoined from selling and / or promoting trust schemes.
Cited by Representative	Federal Crop Insurance v. Merrill 332 U.S. 380; 68 S. Ct. 1	(20)	Case is not a tax case. Case held Employee of federal Crop Insurance held responsible for advising farmer to plant winter wheat that would be covered when in fact there was an exclusion in the policy for winter wheat coverage.

Lesson 4

THE 6700 PENALTY COMMITTEE

Introduction

Background

Rev. Procs. 83-78 and 84-84 describe the 6700 Committee (Committee) which is established in each district. The 6700 Committee reviews information submitted by the Abusive Tax Shelter Coordinator (Coordinator) and selects those promotions in which promoter penalties, pre-filing notification, and/or injunction action may be applicable.

Objectives

At the end of this lesson you will be able to:

1. Describe the purpose of the 6700 Committee.
2. Identify the participants in a 6700 Committee and their functions.

Contents

Overview

In general

Before initiating a 6700/6701 penalty and/or 7408 injunction, a referral must be made to the Committee. The Committee will then decide whether the referral warrants a more detailed examination or whether some other action should be taken. IRM 42(17)(11).5 (see Appendix) explains case selection procedures.

Continued on next page

Overview, Continued

Abusive Tax Shelter Coordinator

Most Districts have an Abusive Tax Shelter (or 6700) Coordinator (usually located in PSP) who is responsible for gathering, reviewing, and maintaining information concerning promoter schemes. Upon obtaining a prospectus and/or other promotional material indicating a potential abusive tax promotion, the Abusive Tax Shelter Coordinator (Coordinator) will periodically present such information in a written or oral format to the Committee.

Prior to submission of a potential case to the Committee, the Coordinator should copy relevant portions of the prospectus and other promotional material for submission to the Committee for their review. The Coordinator is not a member of the Committee.

Committee Members

Required members

Rev. Procs. 83-78 and 84-84 describe who is on the Committee and the respective roles and responsibilities of each member. At a minimum, the Committee must have designated representatives from:

- District Counsel,
- Criminal Investigation, and
- Examination.

Recommended members

The Committee should also include:

- a Criminal Investigation manager,
- an Examination manager, and
- a senior trial attorney from District Counsel.

Additional non-voting or informal participants may also prove helpful:

- In promoter schemes involving private foundations, churches, etc., a representative from the Exempt Organizations should be present.
- Collection should be involved when considering past and present collection issues.
- Communication's role is vital if a 7408 injunction is ultimately pursued for publication/media purposes.

Continued on next page

Committee Members, Continued

Examination's role

The role of the Examination Division representative is to review the promoter material(s) to be presented to the Committee with the main purpose of showing a "likely basis" for a possible IRC 6700 or 6701 examination. The source of this promotional material was discussed in Lesson 2. The Committee as a whole will determine if there is sufficient potential to open a 6700 case.

District Counsel's role

District Counsel's role is that of legal adviser to the Committee. In those instances when more than one District Counsel office covers an IRS district, the District Counsel office having jurisdiction over the promoter/salesman will be the office to be represented on the committee for that promotion. Multi-district promotions must be coordinated with other affected District Counsel offices.

Criminal Investigation's role

CI's role is limited to:

- participating in the decision as to whether or not a shelter promotion should be pursued as a potential 6700/7408 examination;
- providing to the committee any information from CI files concerning the promotion; and
- recommending immediate referral to CI, if appropriate.

CI cannot advise or direct that certain actions be taken in order for the promotion to be accepted by the Committee or referred to CI.

Prior to the time the Committee meets to review information presented by the Abusive Tax Shelter Coordinator, the CI member should query TECS-INTEL to determine whether any 6700/7408 activity is pending against the promoter/salesperson. Where action is pending, the proposed 6700 examination should be coordinated.

Per Section 5.02 of Manual Supplement 9G-147 (CR42G-415), dated September 10, 1984, the Exam member of the IRC 6700 committee will provide information regarding the status of any injunctive action to the CI representative of the committee. The CI representative is responsible for reviewing this information and assuring that it is input on TECS-INTEL.

Committee Responsibilities

The basics

The responsibility of the Committee is to review the information submitted by the Coordinator and to select promotions for which promoter penalties, pre-filing notification, and/or injunction action may be warranted.

It is not the role of the Committee to set forth an examination plan or to direct the examination of the case. Likewise, it is not necessary to have a completed examination prior to submission of a promotion to the Committee. The Committee is to decide if an investigation is to be started.

Continued on next page

Committee Responsibilities, Continued

Factors to consider

These factors should be considered in evaluating promoters/schemes for further investigation:

- Prospectus and/or promotional material. The type of scheme being promoted (e.g., sale or lease of assets with inflated value, phony charitable contribution, research and development, family trust, or plan to unlawfully evade federal taxes) ordinarily indicates the degree of difficulty and time involved in conducting an examination.

- Past activity of promoter. The prior promotion of abusive shelters raises the possibility that the current offering may be abusive. Prior activity, particularly if examined by the Service with adverse results, also indicates knowledge and intent.

- Size of the promotion. The potential number of investors and potential revenue loss must justify the resources required to develop the case.

- Income exclusions, tax deductions, or credits claimed. Generally, the promotional materials will make statements clearly contrary to the tax law. These will typically relate to the splitting or exclusion of taxable income; the deductibility of "personal" expenses or the ability to claim a deduction or credit for a sham transaction.

- Possible tax law violations. Asset overvaluation (IRC 6700(b)) or false or fraudulent statements of a material nature (IRC 6700(a)(2)(A)) are indicators of a potential 6700 case. The potential for one of these issues must be identified prior to forwarding the case to the committee.

- Other relevant factors. To the extent possible, resources should be concentrated on schemes/promoters that will have a favorable public impact as well as a favorable compliance impact. Examples would include promotions directed at the elderly and promotions with a strong consumer fraud element.

Level of proof

The Committee does not need to determine at this point whether there is "proof" of a violation under 6700 or 6701, only whether there is a reasonable probability that the promoter's conduct violates the tax laws and that an investigation is warranted. In other words, at this point in the 6700 process, there must only be "probable cause" that a violation exists, not proof of such violation.

Continued on next page

Committee Responsibilities, Continued

Conducting Committee meetings

The Committee is to meet in person and as often as needed in order to expeditiously review and arrive at a decision. The Coordinator should expeditiously review all prospectuses and offering memoranda, and then present those that have potential to the Committee.

At a minimum, Committee meetings should be held within two weeks after the Coordinator has determined that a promotion is potentially abusive. Each Committee member should formally document approval of the promotion for possible promoter penalties and/or injunction and/or pre-filing notification action. Exhibit 4-1 is recommended for this purpose.

If disagreements arise among the committee members as to the outcome of the case, the District Director will resolve it after consultation with District Counsel.

Coordination

When a salesperson of a potential 6700 activity is identified, a 6700 examination of that salesperson should not be commenced independently of the key district. Rather, the examination should be coordinated with the district where the promoter resides. If the key district has not initiated an examination, formal correspondence and appropriate follow-up should be initiated to coordinate the examination.

Closing Cases Out of the Committee

Selected cases

If the Committee selects the promoter/scheme for examination, a revenue agent will be assigned per IRM 42(17)(11).61.

Rejected cases

If the Committee rejects the promoter/scheme for examination, the file will be documented. Rejected cases should be retained by the Coordinator in case new information is discovered later. The case could then be resubmitted to the Committee.

Continued on next page

Closing Cases Out of the Committee, Continued

Exercise 1

The District Director receives a letter from a local CPA explaining one of his clients was approached about setting up a trust for his business. Included with the letter is a packet of information about setting up a business trust. The District Director sends this information to the Coordinator. What should the Coordinator do with this information?

Summary

The 6700 Committee must have representatives from Examination, Criminal Investigation, and District Counsel.
Participation by Communication, Exempt Organizations, and Collection is recommended where appropriate.
The Committee's goal is to select promotions for investigation of potential 6700/6701 penalties and/or 7408 injunctions.

Answers To Exercises

Exercise 1

The Coordinator should review the material to see if it contains information raising a reasonable inference that penalties under IRC 6700 or 6701 would apply. IDRS should be checked for information concerning the name of the person (promoter), if identified in the CPA's letter.

The Coordinator could contact the CPA. The CPA might provide additional information.

If it is determined that potential 6700/6701 penalties may apply, the information should be presented to the 6700 Committee, who will then decide whether a full investigation is warranted.

Exhibit 4-1

RECOMMENDATION TO COMMENCE 6700/7408 INVESTIGATION

Subject of Inquiry: _____ (Name) _____ (SSN/EIN)

Referred by: _____ (Examiner/Group) _____ (Date)

Approved by: _____ (Manager) _____ (Date)

BACKGROUND AND DOCUMENTATION ATTACHED	YES	NO
Complete copy of Prospectus		
Information on the past history of the promoter		
Discussion of the type of program being promoted		
Information regarding the number of investors, revenue loss, etc.		
Discussion of the technical issues involved		
Information regarding the impact and scope of the promotion.		

RECOMMENDATION	YES	NO
Based on my review of the above documentation, I do/do not recommend approval.		

_____
Abusive Trust Coordinator Name/Signature/Date

CONCURRENCES	YES	NO

_____
Examination Representative Name/Signature/Date

_____
District Counsel Representative Name/Signature/Date

_____
Criminal Investigation Representative Name/Signature/Date

DECISION (only required when committee does not agree)

I have reviewed the material presented by the functional representatives and determined that the investigation should/should not proceed.

_____
District Director Name/Signature/Date

- All noncurrences must be documented in the file and shared with the originator.

Lesson 5

POSSIBLE OUTCOMES 6700 PENALTY COMMITTEE MEETING

Introduction

Background

Depending on the available information, the Committee's review may result in various outcomes. It is not necessary to have a completed examination prior to submitting the promotional material to the Committee. It is also not the role of the Committee to plan or direct the 6700 investigation.

Objectives

At the end of this lesson you will be able to:

1. Describe the outcomes of the 6700/7408 Committee.
2. Start a 6700 investigation.

Contents

Possible Outcomes

Five outcomes

Depending on the facts and circumstances documented in the material presented to the Committee, five outcomes are possible:

1. Criminal Investigation takes the case.
2. Criminal investigation and Examination each work part(s) of the case.
3. The case is rejected.
4. The Committee members disagree.
5. The case is approved.

Continued on next page

Possible Outcomes, Continued

Criminal Investigation takes the case	If CI takes the case, the Committee should annotate the case and forward it through Examination to CI under general fraud procedures. The investigation will then proceed as a joint CI/Exam investigation.
Criminal Investigation and Examination both work part(s) of the case	CI may have an ongoing investigation with the promoter and/or participants or may open one after Exam's referral. Even if CI accepts part(s) or all of the case, Exam should stay involved in the case. For example, if CI accepts the promoter, Exam may continue to investigate the participants. Thus, civil enforcement actions may continue unless there is agreement between the functions that civil action will cease during the criminal investigation. If CI ultimately drops the case, the 6700/7408 investigation may continue without additional review by the Committee. **NOTE:** Policy Statement P-4-84 allows for civil enforcement action with respect to tax periods of the same or other types of tax not included in the criminal investigation. Communication between both functions is vital. CI is to inform Exam if referral is accepted. It is usual for CI to accept the promoter case and for exam to conduct income tax examinations of the participants. During this stage, examination continues to gather information concerning the promoter from these audits. If at any time a grand jury is impaneled, the functions should decide how to proceed.
The case is rejected	For various reasons, the Committee can decline the case. The Committee can recommend that additional information be gathered by examination. The case should be noted and sent back to the Coordinator. The case may always be referred back to the Committee.
The Committee members disagree	It is unusual, but if committee members can not agree on whether a specific promoter scheme should be selected for 6700 and/or 7408 investigation and/or pre-filing notification activity, the District Director will decide after consulting with District Counsel.

Continued on next page

Possible Outcomes, Continued

The case is approved

Once the committee approves the promoter/scheme case, a revenue agent will be assigned. District Counsel will assign an attorney to provide legal assistance. This attorney will work with the revenue agent throughout the investigation.

After assignment of the case, a revenue agent will:

- Determine if IRC 6700 promoter penalty is applicable.
- Obtain the necessary documentation.
- Determine when and if pre-filing notification letters are to be issued.
- Determine if injunctive relief under IRC 7408 should be sought.
- Work with the District Counsel attorney.

Starting the Investigation

Letter 1844

The Revenue Agent (in consultation with District Counsel attorney) will send a letter to the promoter stating that IRS is considering possible penalties and/or injunctive action under IRC 6700 and 7408. It will also state that IRS is considering the issuance of pre-filing notification letters to the participants in the promotion. Letter 1844, Notice of Commencement of IRC 6700 Examination, is to be used. This letter (Exhibit 5-1) should be signed by the District Director.

Information Document Request

Included with Letter 1844 is an Information Document Request (IDR) requesting books and records and a list of participants (investors). The District Counsel attorney will provide assistance on the format as well as what information to request. It should be in a format that could be included in a summons, if necessary. Exhibit 5-2 is a sample IDR.

Third party contacts

In accordance with IRC 6671, the 6700 penalty is considered a tax. When third party contacts are made to determine a promoter penalty, the rules of IRC 7602(c) apply. The revenue agent will work with District Counsel to draft the third party contact letter.

Continued on next page

10-day deadline

According to Rev. Proc. 83-78, Sec. 4.02, the promoter must make the requested documents available for examination within 10 days. If the promoter furnishes the service with a power of attorney, it will be retained in the administrative case file. A copy should be faxed to the service center.

More on Letter 1844

Letter 1844 will also advise the promoter that if the Service concludes (after the examination) that the penalty, injunction, or pre-filing notification action is appropriate, the promoter will be granted a meeting to present any facts or legal arguments for not pursuing these actions. A summons may be necessary if the requested information is not provided.

Documentation

It is vital to timely and completely document all activities in the case. A case history worksheet may be used for this purpose. All conversations and meetings need to be documented. It should be assumed that the case will eventually be tried in federal court. Detailed workpapers covering all activities are essential, including identification of all document sources.

Income tax audit

The 6700 investigation can be conducted simultaneously with the income tax examination of the promoter and/or participant. It is recommended that the same revenue agent perform both.

Promoter responses

Possible responses to the letter are:

1. Ask for an extension of time
2. Receipt of letter containing Frivolous Filer/Non-filer rhetoric
3. No show
4. Meet with the promoter/preparer

Extension of time

The promoter was given 10 days to have the requested books, records, and other information requested. *See Rev. Proc.83-78, Sec. 4.02.* If there are extenuating circumstances, an extension may be granted.

Continued on next page

Starting the Investigation, Continued

Frivolous filer/non-filer rhetoric	If you receive correspondence citing various rhetorical information (e.g., Constitutional arguments), work with District Counsel as to how to proceed. The revenue agent will either issue a summons or request commencement of 6700 penalty, 7408 injunction, and/or pre-filing notification letters.
No show	If the promoter does not show, again work with District Counsel as to the next step. The agent will either issue a summons or request commencement of 6700 penalty, 7408 injunction, and/or pre-filing notification letters.
Meet with the promoter/ preparer	This meeting is discussed in detail in Lesson 7. It is important for the revenue agent to work closely with the District Counsel Attorney who will provide assistance. This case is top priority and should be worked as expeditiously as possible.

Summary

Once the Committee has selected a case, it will be assigned to a revenue agent.
An attorney from District Counsel will also be assigned to the case.
The revenue agent has full responsibility for the investigation.

Exercises

Exercise 1 List four of the five possible Committee outcomes:

Exercise 2 List three of the four possible responses to Letter 1844:

Answers to Exercises

Exercise 1

Depending on the facts and circumstances documented in the material presented to the Committee, five outcomes are possible:

1. Criminal Investigation takes the case.
2. Criminal investigation and Examination each work part(s) of the case.
3. The case is rejected.
4. The Committee members disagree.
5. The case is approved.

Exercise 2

Possible responses to the letter are:

1. Ask for an extension of time
2. Receipt of letter containing Frivolous Filer/Non-filer rhetoric
3. No show
4. Meet with the promoter/preparer

Exhibit 5-1

Internal Revenue Service

District Director

Date:

Examiner:
Employee ID. Number:
Telephone Number:
Date and Time of Examination:

Dear

We have reviewed certain materials with respect to your tax shelter promotion. We are considering possible action under Section 6700 and 7408 of the Internal Revenue Code relating to penalties and an injunction action for promoting abusive tax shelters. In addition, we plan to consider issuing "pre-filing notification" letters to the investors who have invested in this promotion.

You are requested to meet with the examiner at the above date and time at your office. Enclosed is a list of documents, books and records that you should have available and questions you should be prepared to reply to at that time.

If we conclude that penalties, injunction, and/or "pre-filing notification" action is appropriate, you will be afforded an opportunity to present any facts or legal arguments which you feel indicate that such action should not be taken.

Sincerely yours,

District Director

Enclosure

Letter 1844

Exhibit 5-2

PROVIDE THE FOLLOWING INFORMATION FOR THE PERIOD JANUARY 1, 1996 TO THE PRESENT:

The following request for information applies to the Promoter and/or the Tax Shelter Company or any other company of which the Promoter is an officer, trustee, and/or partner. It also includes any employees, agents or staff of any of the above.

All manuals, operations handbooks, prospectuses, offering documents, or other documents which describe the plan, operations or structuring of any tax shelter plan or arrangement offered to investors or purchasers.

All documents describing the marketing activities and strategies of any tax shelter plan or arrangement promoted or offered. This includes (1) any training manuals provided to salespeople, (2) any media, including but not limited to, videotapes, audiotapes, or compact discs, used to train salespeople, and (3) any media, including but not limited to, videotapes, audiotapes, or compact discs, used in marketing any tax shelter plans or arrangements.

Documents which identify names and addresses of all persons involved in the organization (or assisting in the organization) or sale of any tax shelter plan or arrangement promoted or offered by the Promoter or any of the above listed organizations. These persons include, but are not limited to, (1) attorneys, (2) Certified Public Accountants, (3) salespersons, and (4) other persons to whom commissions or finders fees were paid.

All books and publications used in promoting the tax shelter plan or arrangement offered by the Promoter or any of the above listed organizations. These include, but are not limited to, the following:

All legal, accounting, or other opinions used in drafting all books and publications used in promoting tax shelter plan or arrangement offered by the Promoter or any of the above listed organizations. These include, but are not limited to, the following :

Continued on next page

Exhibit 5-2, Continued

All legal, accounting or other opinions utilized in the promotion of any tax shelter plan or arrangement promoted or offered by the Promoter or any of the above listed organizations.

All documents which identify names and addresses of any purchasers of any tax shelter plan or arrangement promoted or offered by the Promoter or any of the above listed organizations.

All applications, contracts and invoices with respect to purchasers.

All receipts for payment with respect to purchasers.

All documents which suggest or propose entries on any tax form, including Forms 1040, Forms 1041, Forms 1065, Forms 1120, Schedule C or Schedule F, with respect to any tax shelter plan or arrangement promoted or offered by the Promoter or any of the above listed organizations.

All records, including, but not limited to, documents, brochures, videotapes, audiotapes, or compacts discs, of any statements made by any individuals with respect to the allowability of credits or deductions or other tax benefits obtainable through participation in tax shelter plan or arrangement promoted or offered by the Promoter or any of the above listed organizations.

All forms, including, but not limited to, company formation documents, provided to investors or purchasers by the Promoter or any of the above listed organizations.

All agreements between the Promoter and tax shelter plan or arrangement purchasers, or between any of the above listed organizations and the tax shelter plan or arrangement purchasers, including, but not limited to, purchase agreements, payment agreements, partnership agreements, notes, security agreements, or lease agreements.

All records of payments received from purchasers of tax shelter plan or arrangement by the Promoter or any of the above listed organizations, or their agents, including, but not limited to, general ledgers and cash receipts journals.

Lesson 6

NATIONAL COORDINATION AND CASE CONTROL

Introduction

Background

As soon as you begin to develop leads and gather information on a promoter, you will need to account for your time. You will also need to ensure that your promoter and investor cases are controlled according to the national guidelines. In this lesson some of the steps which take place during the promoter investigation are mentioned briefly and only as they pertain to the coordination and control of cases. They will be discussed in detail in other chapters.

Objectives

At the end of this lesson you will be able to:

1. Determine when to begin to control a promoter investigation on ERCS.
2. Describe the steps required to control the investigation on ERCS.
3. Describe how to control and link the investor cases to the promoter case.
4. Identify four different Tracking Code reports that are available.

Contents

National Program Coordination Requirements

When do I contact the National Tax Shelter Issue Specialist?

You should contact the National Tax Shelter Issue Specialist as soon as you think you have a promoter lead that you would like to pursue. Another agent or Area may already be pursuing that promoter. If so, then a promoter Tracking Code will already be assigned.

The Tracking Code is used to number the promoter investigation and track its progress. More than one Area can use the same tracking code if they are investigating parts of the same promoter operation. The National Tax Shelter Issue Specialist will provide you with all of this information. Therefore, it is important to make contact right away.

How do I contact the National Tax Shelter Issue Specialist?

You can call or email the National Tax Shelter Issue Specialist. Names, telephone numbers, email and fax information can be found on the Tax Shelter Website, http://abusiveshelter.web.irs.gov.

What is the role of the National Tax Shelter Issue Specialist?

The National Tax Shelter Issue Specialist(s) provides case control information, gather and analyze data from the promoter investigations, and answer any questions you may have. They are also available to answer your questions and provide assistance with your investigation. If necessary, they can make an assistance trip to your Area.

How to Control a Promoter Case

How do I charge my time?

Your time should be charged to Activity Code 593 (Promoter Penalty) or Activity Code 594 (Aiding and Abetting Penalty) as soon as you begin to spend time developing a lead. There are two stages when charging your time to these codes:

- pre-6700 Committee review of lead, and
- post-6700 Committee review of lead.

Continued on next page

Pre-6700 Committee review

During this stage of your investigation, when you are gathering preliminary information but have not yet referred your promoter to the 6700 Committee, all you will input to your ERCS Agent Input Sheet is Activity Code 593/594, date, and hours. ERCS does not need second segment information for this activity code.

Post-6700 Committee review

After the promoter lead has been referred to the 6700 Committee and approved for further investigation, you must contact the National Tax Shelter Issue Specialist again to obtain a Tracking Code for your investigation. From this point on your promoter and all related entities including investors and related sub-sellers, preparers, etc., should contain this Tracking Code in their ERCS record. This will link all the related entities together.

What to do with the Tracking Code

Once you receive your Tracking Code, you should then have your local Tax Shelter Coordinator add it to ERCS. The Coordinator must have PSP menu permissions to do this. The Coordinator is also responsible for adding other Area's Tracking Codes to your local ERCS database. Periodically, an updated list of approved promoter investigations and Tracking Codes will be provided to each Coordinator by the National Tax Shelter Issue Specialist.

The Tax Shelter Coordinators will be responsible for monitoring the cases related to promoter investigations both within their Area and outside their Area, to ensure that the Tracking Code has been added to all related cases. Reports designed to help with this task will be discussed at the end of the chapter.

Case accepted as criminal referral

After the case is screened by the 6700 Committee, another possible outcome is a criminal referral. If so, you still need to notify the National Tax Shelter Issue Specialist. A Tracking Code will be assigned to that case. While Criminal Investigation pursues the investigation, you should continue to monitor the case and charge your time to Activity Code 593/594 and the appropriate Tracking Code.

Continued on next page

Entering the promoter case into ERCS

Once you have an approved promoter investigation as well as the promoter TIN, your group secretary should input the case to ERCS. Since this is not an income tax audit, the case will **not** be controlled on AIMS, **only on ERCS**. Exhibits 6-1 through 6-7 demonstrate the menu selections and data that should be input to ERCS.

Your group secretary will:
1. Request tax return (Exhibit 6-1).
2. Control penalty investigation (Exhibit 6-2).
3. Identify examiner requesting return (Exhibit 6-3).
4. Input penalty case data (Exhibits 6-4 and 6-5).

Exhibits 6-6 and 6-7 provide an example of a full display ERCS record after all data is entered.

Entering your time into ERCS

Exhibit 6-8 illustrates how your group secretary will input your time for Activity Code 593/594, during either stage of the investigation (pre- or post-6700 Committee review).

On your Examiner's Time Input ERCS Document which you provide to your secretary, you will enter activity code, day, and hours if you are still in the pre-6700 Committee review stage. If you are in the post-6700 Committee review stage, you will enter the promoter name, TIN, MFT, and tax year in addition to the day and time charged.

Exhibit 6-9 is an example of your completed 4502 after time is input to Activity Code 593/594 during both stages of a promoter investigation.

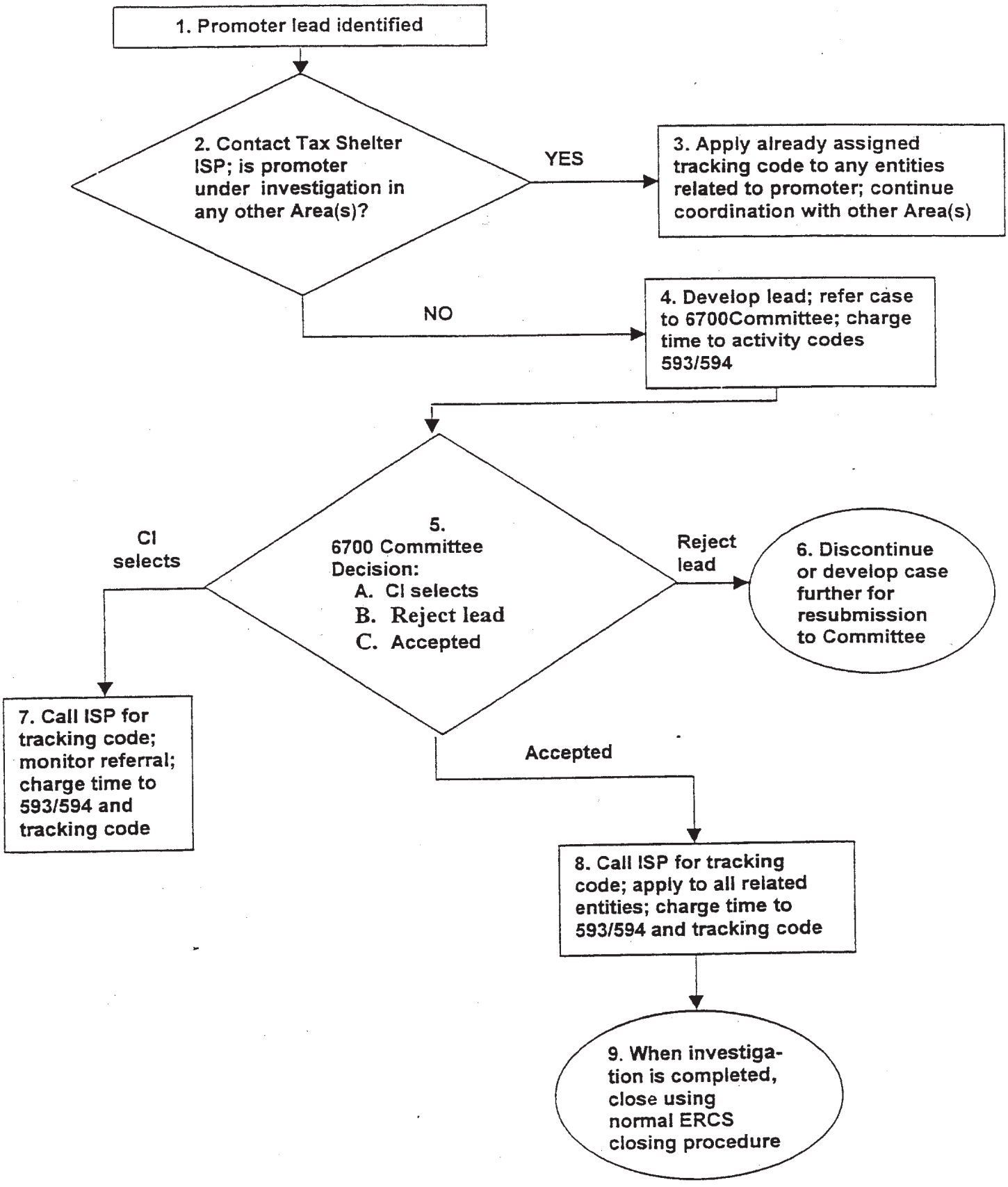
Tracking codes

Tracking Codes can be entered on ERCS at the group level. However, only PSP can change or remove a tracking code.

When your promoter investigation is approved, you may already have investor cases related to the investor which are in process. The promoter Tracking Code should be added to those cases. However, if one of those cases already has a Tracking Code, you will need to ask your district ERCS Coordinator in PSP to change it to your new promoter Tracking Code.

In most, if not all cases, the promoter Tracking Code will override any other Tracking Code.

Case Control Process Flowchart



How to Control an Investor Case

Use AIMS

As mentioned above, you may begin audits of investor cases before or after the promoter investigation begins.

If an investor case is already in process when the promoter investigation is approved, it will already be established on AIMS. Just be sure to add the tracking code once it is known.

If you begin an investor case after the promoter investigation is approved, you will establish it on AIMS as usual and include the tracking code information.

Tracking Code Reports

How many ERCS Tracking Code Reports are there?	We plan to provide four ERCS Tracking Code Reports. Currently, two have been completed and two are in the process of being designed. They will be placed on each of the 33 ERCS databases by the ERCS System Administrators.
What will the reports be used for?	Two of the reports will apply to the promoter investigation cases and their related entities. Any case that has a promoter Tracking Code will be listed on the Tax Shelter IVL Tracking Code Report. The Tax Shelter Database Report will take that information and put it into a database that can be merged with all of the 33 ERCS databases. The Area Tax Shelter Coordinator can use that report to monitor related promoter investigation entities in other Areas and ensure the Tracking Code has been properly applied. The other two reports will capture the time applied to Activity Code 593 and 594 in each Area.
Who will use the reports?	The Tax Shelter Coordinator and the ERCS Coordinator will be able to access the reports from the ERCS main menu. The Tax Shelter Coordinator will have primary responsibility for accessing the reports when needed and will use the reports to monitor the Area program. Additionally, each Area Tax Shelter Coordinator will produce the reports on a monthly basis and forward them electronically to the National Tax Shelter Issue Specialist. Then all Area reports will be merged into one database.

Summary

The National Tax Shelter Issue Specialist should be contacted as soon as you begin gathering information on a promoter lead.
Examiners' time on promoter cases is charged to Activity Code 593/594, above the line DET code.
Promoter cases are controlled on ERCS through the use of Tracking Codes.
Investor cases and all other entities related to the promoter investigation should be linked by use of the same Tracking Code.
The Tax Shelter Coordinator must add each new Tracking Code to the ERCS database, and can use the four ERCS Tracking Code reports to monitor promoter investigation inventory.

Exhibit 6-1

CLT EXAMINATION MAIN MENU Jan 2000 GROUP Version 7.7

1. Request Tax Return
2. Correct or Display Records
3. Input Time and Leave
4. Tax Auditor Menu
5. Manager's Reports
7. Employee Records
8. Check AIMS Results
9. Suggestion and Error Reporting
10. Print User Documentation
11. Select User Group

5. Transfer, Close, Establish Control

0. Quit

Input Selection Number and Press <Enter>:
There are ERCS-AIMS Uploading results to check. Use the "Check AIMS Results" selection to View/Print or Delete results file(s).

Exhibit 6-2

CLT REQUEST TAX RETURN Jan 2000 GROUP Version 7.7

1. Request Return
2. Control Penalty Investigation
3. Control Non-AIMS DET Item
4. Control Collateral Examination
5. Resubmit Request
0. Return To Main Menu

Selection Number:

Exhibit 6-3

Identify examiner requesting return:

Org Code: 1203

Employee ID: 9999

Employee Name: CLARK, WILL

MATCH FOUND ON EXAM EMPLOYEE FILE

Is this the correct examiner? (Y/N)

Exhibit 6-4

```
Org Code: 1203                PENALTY CASE              Employee ID: 9999

TIN: 99-9999999     MFT: P6     Tax Period:  200012

Activity Code: 593
Source Code:   17
Status Code:   12

Statute Info:
Tracking Code: 9542


          Is the above information for this return correct? (Y/N)
```

Exhibit 6-5

```
    Tax Period   Activity   Source   Status   Statute      Tracking
01.   200012       593        17       12                   9542

-------------------------------------------------------------------------
  Org Code: 1203              PENALTY CASE       Employee ID: 9999

  TIN: 99-9999999      MFT:         Tax Period:  N

  Activity Code:
  Source Code:
  Status Code:

  Statute Info:
  Tracking Code:

                                                 Related Return Ind:  00

  Name:      STONE SCOTT
  Street:    123 POLK ST                         District Office:     36
  City:      MITCHELL
  State:     IL    Zip Code: 99999-9999

                          Is this data correct? (Y/N)
```

Exhibit 6-6

```
Today's Date: 06/01/2000      Screen 1     TIN          99-9999999
TP Name   STONE, SCOTT                     MFT          P6
Address   123 POLK ST                      Tax Period   200012
          MITCHELL     IL 99999-9999       Name Ctrl    STON

Organization Code    1203  AIMS BOD         NOT SET   DO Code   36
Employee ID          9999  Primary Bus      000       POD       07
Source Code          17    Secondary Bus    00000     MF BOD
Activity Code        593   Employee Group   0000      Client Code
Second Segment Code  000   Amount Claimed   $0
Status Code          12    Prior Status     00  Dates
Project Code         000   Freeze Code           Statute
Tracking Code        9542                        Requested     04262000
Message Code         000   Office Audit          AIMS Creation
Aging Reason         00      Action Code 00      ERCS Start
                             Purge Date          AIMS Start
Hours Charged                Appt Time   00:00   Status        04262000
  Claim Hours      0                            Notification
  Non-Claim        0                            895 Issued
  Audit Aide       0                            895 Returned
  Co-Op Hours      0    Record Type    PENALTY
  Transfer-In      0                                Record   1 of   1
          P - Indicates Managerial Approval Pending
Selection:       Screen 2  First  Last  Next  Back  Print_page  Quit
```

Exhibit 6-7

```
Today's Date: 06/01/2000      Screen 2     TIN          99-9999999
TP Name  STONE, SCOTT                      MFT          P6
                                           Tax Period   200012
                                           Name Ctrl    STON
Secondary SSN
Type Suspense     000
Action Date
Related Return    00          Group Closing Information
POA Number                    -------------------------
                              Disposal Code  00
                              Grp Disp Date
Indicators:                   Installment    NO
 Return Requested    N        Adv Pay Date
 Send Label          N        Collection     NO
 Return Received     N        Agreement Date
 Bad Address         N
 Joint Committee     N
 TEFRA Case          N
 PICF                0  Review Information:        ESP Information
 PDT                 N    Date In Review             Date In ESP
 CEP                 N    Review Empl ID   000       ESP Empl ID   0000
 ARDI                0    Type Review      00        Program Num   0
 Foreign Corp        N
 NAICS/PIA Code 00000     Reject reason    000       Case Code     0

Selection:          Quit     Screen 1      Print_page
```

Exhibit 6-8

```
Employee: CLARK, WILL     Enter   R: for TIN or MFT to repeat
                          N: when finished   X: to clear line
Date:   JUN. 01, 2000     Return: to go to the act code or back to TIN
WORKDAY
                          Tax   Act   Sec          P of   Lv
    TIN          MFT      Period CD    Seg    Hrs   RB     Cd
----------       ---      ------ --    ---    ---   ----   --
                                 593   000    4      N

99-9999999       P6       200012 593   000    4      N

N
```

Is this data correct? (Y/N)

Exhibit 6-9

EXAMINATION TECHNICAL TIME REPORT
AGENT ANALYSIS
05/19/2000 - 06/01/2000

ALLEN ADAMS
DATE PRINTED 06/01/2000
TIME PRINTED 01:39PM

1. Name (Last, First)	2. Dist-Code Ctrl Num	3. Cycle	4. Grade	5. Org Code	6. Position Code	7. Empl Status	8. POD
CLARK, WILL	36-9999	200005	13	1203	110	14	07

PART Ia - DIRECT EXAMINATION TIME

DAY OF MONTH

RL RT	TAXPAYER NAME	TAX PERIOD	BEG HRS	2 4	5	6	7	8	0 1	2	3	4	5	8	9	1 0	1	2	5	6	7	8	9	EMPL HRS	ACT CODE	END HRS	OTHER HRS	TOTAL HRS	END DAYS
00	STONE SCOTT	200012	0	4																				4N	593000	4	0	4	25
	TEFRA - Promoter Penalty		-	4																				4N	593000	4	-	4C	-
	Part Ia Total		2088	8																				8	901	2096	1098	3194	

Continued on next page

Exhibit 6-9, Continued

EXAMINATION TECHNICAL TIME REPORT
AGENT ANALYSIS
05/19/2000 - 06/01/2000

ALLEN ADAMS
DATE PRINTED 06/01/2000
TIME PRINTED 01:39PM

2. Name (Last, First)	2. Dist-Code Ctrl Num	3. Cycle	4. Grade	5. Org Code	6. Position Code	7. Empl Status	8. POD
CLARK, WILL	36-9999	200005	13	1203	110	14	07

PART II - NON EXAMINATION TIME

DAY OF MONTH

	2 4	5	6	7	8	0 1	2	3	4	5	8	9	1 0	1	2	5	6	7	8	9	TOTAL HRS	ACT CODE
Total Time	8																				8	903
Less: Details nto Exam																					0	840
AWS Hours Worked																					0	860
AWS Hours Taken																					0	860
Total Time Accounted For	8																				8	905

PART III - RECONCILIATION

Beginning Inventory Hours	2088	Remarks
Plus: Direct Examination Hours This Cycle	8	
Subtotal	2096	
Less: Hours Closed This Cycle	4	
Ending inventory Hours	2092	

Originator (Signature)	Date	Reviewer (Signature)	Date

Lesson 7

INITIAL MEETING WITH PROMOTER/PREPARER

Introduction

Background

One of the most important parts of the investigation of a promoter/preparer is the initial appointment. Most of the detailed information and documentation that you need for your investigation report can be obtained at this meeting. Therefore, considerable effort should be devoted to preparing for the meeting and anticipating the possible reactions of the promoter/preparer.

Objectives

At the end of this lesson you will be able to:

1. Identify the three goals of the initial meeting with the promoter/preparer.
2. List the five possible responses of the promoter/preparer.
3. Identify the major topics to be covered during the initial interview.
4. Identify the possible uses of the client list.
5. List the six questions that should be asked regarding the promotional material received.

Contents

Preparing for the Meeting

Goals of the meeting

Three primary goals of initial meeting are:

1. Conduct a detailed interview with the promoter/preparer.
2. Secure current promotional materials.
3. Secure a complete client list.

Every effort should be made to secure as much information as possible at the initial meeting. The promoter/preparer may cease to cooperate at any point in the investigation, making it difficult to obtain further information.

Possible responses

Promoter/ Preparer Response	Revenue Agent Action
Cooperates Fully	1) Complete interview and secure documents. 2) Encourage promoter to file amended returns for self and/or investor/participants. 3) Discuss the outcome of the meeting with District Counsel. 4) District Counsel should consider working with Department of Justice on consent decree.
Partially Complies	1) Complete interview and document all answers and non-answers. 2) Secure all documents provided. 3) At your discretion, consider issuing second IDR for any missing items and set another appointment date. 4) If information still not provided, issue a summons.
No Show	1) Issue summons and seek summons enforcement. 2) Continue investigation by contacting clients and other third parties. 3) Issue bank summonses to identify clients.
Disappears	1) Continue to pursue penalty/injunction investigation. 2) Possibly transfer case to district where the promoter/preparer flees.
Refuses to Comply	1) Issue summons and seek summons enforcement. 2) Continue investigation by contacting clients and other third parties. 3) Issue bank summonses to identify clients.

Continued on next page

Preparing for the Meeting, Continued

Time and place	The initial appointment letter (Exhibit 7-1) states that you would like to meet at the promoter/preparer's office at a specific date and time. The promoter/preparer may request that the meeting be held at his attorney's office or at the IRS office. The location of the meeting is not important. However, it is important to remind the promoter/preparer that you need to secure all of the records and documents listed on the information document request at the first meeting.
Power of attorney	The promoter/preparer may wish to have an attorney, CPA, Enrolled Agent, or other person represent him/her during the investigation. If so, a Form 2848, *Power of Attorney* should be secured. The form should be completed indicating the type of tax to be "Income Tax." The tax form number should be identified as "IRC 6700 and IRC 7408" or "IRC 6701 and IRC 7408." The IRC cites are used because no return has been opened on the promoter/preparer. The year block should be completed showing the years under investigation.
Taping the meeting	The promoter/preparer may come to the meeting with an audio or video recorder. The IRM states that cameras and video-taping of an examiner should not be allowed. However, tape recordings and verbatim transcriptions are generally allowable provided the taxpayer provides you with advance notice of their intent to tape the meeting. If the taxpayer tapes the meeting, the examiner must also do so. Since time is of the essence in these cases, it may be wise to bring a tape recorder to the initial meeting so that the meeting can proceed without delay.

Initial Interview

Interview questions

In advance of the initial meeting, you should prepare a list of interview questions. The in-depth interview questions should cover the following topics:

1. Personal history.
2. Occupational, business, and professional history.
3. Structure of organization and role of various parties within the organization.
4. Size of promotion.
5. Description of tax attributes of promotion.

It is advisable to have District Counsel review the interview questions and provide assistance and suggestions. Exhibit 7-1 is a list of sample questions.

Personal history

The personal history portion of the interview should include questions dealing with the following items:

1. Age
2. Current home address
3. Current marital status
4. Educational background
5. Health
6. Reputation in the community
    a) Civil leadership
    b) Charitable Involvement
    c) Bankruptcies
    d) Civil lawsuits
    e) Criminal charges and convictions

Continued on next page

Business and professional history

Understanding the promoter/preparer's business background can be critical in establishing his or her knowledge that the tax attributes claimed by the promotion are false and determining the likelihood that the promoter/preparer's conduct will continue if an injunction is not obtained.

A complete history of the jobs, occupations, and businesses the promoter/preparer has been engaged can be very useful information. Any professional licenses ever held by the taxpayer should be noted. If the taxpayer no longer holds that license, questions should be asked as to the circumstances why the license was allowed to expire or if the licensing agency removed the license based upon any conduct violations.

The promoter/preparer should be asked what tax law training he or she has received. If the issue involves asset valuation, questions should be included that determine the appraiser's training and experience. Frequently the promoter/preparer has indicated in promotional literature and at sales seminars that they have expertise in certain areas of tax law or in a particular field involved in the tax shelter. You may want to ask them if they consider themselves experts in this field and how they acquired this expertise.

The interview should explore any prior involvement of the promoter/preparer with other tax shelters. Has the promoter/preparer been involved in any other past or present IRS investigations?

Structure of the organization

The organizational structure of the tax shelter marketing company needs to be fully established. If you are dealing with a corporation, partnership, and/or trust entities, the names, addresses, and phone numbers should be secured for all the corporate officers, partners, and trustees. If multiple entities are involved in the tax shelter arrangement, the function of each entity should be determined during the interview. A flowchart may be helpful in showing how the transaction is completed.

The identification of key employees, associates, and agents of the tax shelter promotion should be thoroughly discussed. If the tax shelter arrangement involves seminars or presentations to clients or prospective clients, determine what topics are covered and who are the speakers at these events. These other individuals and entities may later be developed as additional targets of the IRC 6700, 6701, and 7408 investigation.

Continued on next page

Size of the promotion

The promoter/preparer should be questioned about the number of tax shelter packages sold or the number of tax returns prepared during the period under investigation. The fees charged by the promoter/preparer are also important to establish. The promoter/preparer's statements may be useful in determining the amount of penalties that may be assessed under IRC 6700 or 6701.

Tax attributes of the promotion

A series of questions should be developed to determine the promoter/preparer's position with respect to the promotional materials secured prior to the initial interview. The promoter/preparer should be questioned as to whether or not they agree with each specific false tax attribute identified in the promotional material and why. The questions should probe for any defenses that the promoter/preparer may use against the assertion of penalties and/or an injunction.

Frequently, promoters/preparers will try to minimize their tax knowledge during the interview. They will state that they relied on lawyers, accountants, and other parties as to the validity of the tax issues. If so, an attempt should be made to secure all the specific names, addresses, phone numbers of these other parties. You will probably need to locate and interview some of these parties during your investigation.

Securing Information From Promoter/Preparer

Promotional documents

From the outset of the investigation, it should be assumed that the case will eventually be tried in federal court. It is important that you secure original documents. If for any reason, the promoter/preparer will not provide an original copy of any item listed on the IDR, an attempt should be made to secure a photocopy. As a precaution, a portable copy machine or microfilm copier could be brought to the initial meeting. Document how, when, and from whom all promotional materials were received. Do not highlight or otherwise write on the original documents.

When securing the promotional brochures, operation manuals, and other materials, you need to establish:

1. Who wrote the material?
2. When was it written?
3. Is this the most current version?
4. If there were early versions, what changes were made and why?
5. Is this document still being used?
6. Are there any other brochures or manuals used in the promotion?

Continued on next page

Client list

One of the most difficult documents to secure from the promoter is the investor list. Because investor interviews result in extremely credible evidence, it is important to identify and interview enough clients to support the penalty/injunction recommendation. During the promoter's investigation, discussed in a previous lesson, it may be possible to identify clients when analyzing gross receipts.

The promoter/preparer's client list is a critical item for the investigation. For purposes of computing the amount of penalty under IRC 6700 and/or IRC 6701, an accurate client list is very important because:

- It may be useful in determining the amount of harm done to the government by the promotion.
- Some of the clients may be contacted as potential witnesses in the case.
- At the completion of the investigation, Pre-filing Notification Letters may be authorized and distributed to these clients.
- It may be used to initiate an examination project on the investor/participants of the tax scheme.

The promoter/preparer generally is going to resist providing the client list to you for all the above reasons.

Tax return preparers are required by IRC 6107(b) to provide their client list upon request by the IRS. Failure to provide the client list or copies of the tax returns upon request can result in a penalty of $50 per return in accordance with IRC 6695(d). This penalty may be assessed in addition to any penalty asserted under IRC 6701.

Organizers and sellers of potentially abusive tax shelters are required by IRC 6112 to keep a list that identifies each purchase of the shelter. This list is to be made available upon request for inspection. IRC 6707 and 6708 impose penalties for failure to furnish information regarding tax shelters or failure to maintain a list of investors.

The promoter/preparer is to make the requested information available within 10 days. *See Rev. Proc. 83-78, Section 4.02.* If the promoter/preparer does not comply, you should issue a summons.

The Return Preparer Program Coordinator may be helpful in securing a client list. The coordinators may be able to pull a listing of tax returns filed using the return preparer's EIN and/or SSN.

Summary

The first meeting with the promoter/preparer is crucial to the development of the case.
The promoter/preparer may fully cooperate, partially cooperate, fail to show, flee, or refuse to meet with you. Regardless, the investigation should continue.
Thorough interview questions should be drafted in advance of the initial meeting. The five major topics to be covered in the initial interview are: • personal history, • business/professional history, • structure of the organization, • size of the promotion, and • tax issues involved in the promotion.
• Every effort should be made to secure the promoter/preparers client list and original copies of all the tax shelter promotional and operational brochures and manuals.

Exercises

Exercise 1 What are the three primary goals for the initial meeting?

Exercise 2 List four of the five major topics the interview should address.

Answers to Exercises

Exercise 1

The are three primary goals for the initial meeting:

1. Conduct a detailed interview with the promoter/preparer.
2. Secure current promotional materials.
3. Secure a complete client list.

Exercise 2

The in-depth interview questions should cover the following topics:

1. Personal history.
2. Occupational, business, and professional history.
3. Structure of organization and role of various parties within the organization.
4. Size of promotion.
5. Discussion of tax attributes of promotion.

Exhibit 7-1

Interview Questions for Promoter/Preparer

Date and time of interview:

Place of interview:

Persons conducting interview:

Name of person interviewed:

Other persons present during interview:

Name	Position or Relationship

Do you solemnly affirm under penalties of perjury that the testimony you are about to give in this matter is true and correct to the best of you knowledge and belief?

Personal History

1) Full name of person being interviewed?

2) What is your Social Security Number?

3) What is your current home address?

4) What is your current business address?

5) Phone Numbers
   Home:
   Business:
   Fax:
   Email:

6) What is your current marital status? When were you married?

7) What is your date of birth?

8) Are you a citizen of the United States?

Continued on next page

Exhibit 7-1, Continued

9) Do you have any medical or health problems?

10) What is your educational background?
Any Degrees? What? Where? When?

11) Have you ever filed for bankruptcy? If so, when, where, and how was it resolved?

12) Have any civil lawsuits been filed against you or your company? If so, what was the nature of the allegations and how was the case settled?

13) Have you ever been charged criminally for any alleged illegal conduct? If yes, what was the nature of those charges?

Business & Professional History

14) Could you provide a brief summary of your employment history since college or high school?

15) Do you currently hold any professional or business licenses? If yes, what?

16) Have you ever had any professional licenses? If yes, what and when?

17) Have you ever had a professional license revoked or suspended? If yes, for what reason?

18) How and when did you first get involved in the business of marketing tax shelters?

19) What education or training do you have in this field?

20) What education or training do you have in the area of income taxation?

Structure of the Organization

21) What does the organization market?

22) What is your position and responsibilities with the company?

23) How are you compensated for your services?

24) Do you supervise anybody? If yes, who?

Continued on next page

Exhibit 7-1, Continued

25) Who are the officers of the company?

26) What are their duties and responsibilities?

27) How are these people compensated for their services (hourly, salary, commissions)?

28) How many people work for the company?
Employees:
Independent Contractors:
Salespeople or agents:
Leased employees:
Others:

29) Are all these people under your supervision? If not, who supervises them?

30) How are these people compensated for their services (i.e. hourly, salary, commission)?

31) What types of tax shelters does the company promote?

Size of Promotion

32) How many clients/participants are involved with tax shelters promoted by the company (estimate or actual)?

33) What percentage of your business income is from the marketing, management fees, accounting services and tax return preparation related to the tax shelters?

34) Do (or did) you conduct any training courses or marketing seminars dealing with these tax shelters?

35) If so, where and when have you conducted the seminars?

36) Are you compensated for these courses?

37) Who (if anyone) assists you in conducting these courses?

38) How many training classes or seminars have you conducted since 1996?

39) How many people have attended your training classes or seminars?

40) How do you advertise these seminars?

Continued on next page

Exhibit 7-1, Continued

41) What is the background of the people attending your classes?

42) Do you charge a fee for these courses? If yes, what is the cost?

43) What information do you provide in these training classes?

44) What do you tell people are your qualifications to market the tax shelter?

Tax Attributes of the Promotion

45) Did you prepare any income tax returns for clients or participants in this promotion? If yes, how many and were you compensated?

46) Do you sign all the tax returns you prepare?

47) When did you first begin preparing tax returns for other people?

48) Have you received any training in the preparation of tax returns? If yes, when and where?

49) Are you licensed with the State of California as a tax preparer?

50) What is your fee schedule for preparing tax returns?

51) Have you taken any tax law courses or attended any income tax seminars?

52) Did you discuss any income tax laws at any of the training classes or marketing seminars you conducted for the company?

53) Do you consider yourself very knowledgeable in federal income tax law?

54) Have you sought advice from a tax attorney, a CPA, and/or an Enrolled Agent, regarding tax issues of any of your products or clients? If so, with whom have you consulted?

55) Has anyone ever disagreed with you regarding the tax benefits you advocated can be achieved through the use of the tax shelter you promote? If yes, who? When? What was said?

56) How did you respond?

57) Did you do any additional tax research into the disputed issues?

Continued on next page

Promotional Documents

58) Who wrote the following brochures used to market the tax shelter?
(List the titles of all the brochures)

59) When were the brochures written?
(List the titles of all the brochures)

60) What was the purpose of writing each of these brochures (resale, training, promotional)?

61) Did you charge any fees for these brochures?

62) How many copies have been distributed (either sold or given away free of charge)?

63) Who are the primary recipients of these brochures (investors, accountants, or sale agents)?

64) Did you secure any legal opinions from tax attorneys or CPA's regarding the tax issues discussed in the brochures?

65) List specific questions regarding each of the questionable tax positions claimed by the promotion.

66) Has anyone ever challenged you as to the validity of the tax attributes of the promotion? If yes, who, when, and what did they say?

67) Have you ever been involved in the promotion of any other tax shelter or tax motivated activity?

Lesson 8

INVESTIGATIVE TECHNIQUES

Introduction

Background

Lesson 7 discussed the information that should be obtained during the initial interview to make a determinations on the:

- applicability of IRC 6700 or 6701 penalties
- pursuit an IRC 7408 injunction
- issuance of pre-filing notifications

Objectives

At the end of this lesson you will be able to:

1. Determine the evidence needed to persuade a court to uphold the 6700/6701/7408 actions.
2. Identify where and how to obtain this evidence.
3. List the procedures for third party contacts.
4. Implement summons procedures and how to proceed with summons enforcement.

Contents

Goal of the Investigation

Possible responses

Lesson 7 listed the following possible responses to an initial interview with the promoter. Only full cooperation will allow the examiner to proceed without any further investigation.

Promoter/ Preparer Response	Revenue Agent Reaction
Cooperates Fully	1) Complete interview & secure documents. 2) Encourage promoter to file amended returns for self and/or investor/participants. 3) Discuss with District Counsel. 4) District Counsel should consider working with Department of Justice on consent decree.
Partially Complies	1) Complete interview and document all answers and non-answers. 2) Secure all documents provided. 3) At your discretion, consider issuing second IDR for any missing items and set another appointment date. 4) If information still not provided, issue a summons.
No Show	1) Issue summons and seek summons enforcement. 2) Continue investigation by contacting clients and other third parties. 3) Issue bank summonses to identify clients.
Disappears	1) Continue to pursue penalty/injunction investigation. 2) Transfer case to district where the promoter/preparer flees.
Refuses to Comply	1) Issue summons and seek summons enforcement. 2) Continue investigation by contacting clients and other third parties. 3) Issue bank summonses to identify clients.

Next steps

If the promoter/preparer does not comply with the IDR request and/or interview, take the following steps:

- Continue the investigation through other means, such as interviewing the investors.
- Secure evidence with summons and summons enforcement. This may include preparation and issuance of the summons, requesting enforcement of the summons, serving court documents on the promoter, and requesting that contempt charges be brought.

Continued on next page

Burden of Proof

Gathering evidence

It is important to remember what result is desired. Ultimately you hope to persuade the court that the 6700/6701 penalty should be upheld or that the promoter should be enjoined from continuing to promote the tax shelter. The evidence gathered must be sufficient to persuade these parties:

- District Director
- District Counsel
- Department of Justice
- United States District Court

Definitions

The Government has the burden of proof regarding IRC 6700/6701/6702 penalties. *See IRC 6703 in the Appendix*. This burden of proof includes two different concepts:

The term **burden of production** means that the Government must "go forward with the evidence." In other words, if the taxpayer does not appear for a judicial hearing, the Government must nevertheless put on a "mini-trial" and demonstrate that it has some evidence that justifies the imposition of a penalty against the taxpayer. IRC 7491(c) provides that the IRS shall have the burden of production in any court proceeding with respect to the liability of any individual for any penalty, addition to tax, or additional amount, for court proceedings arising in connection with examinations commencing after July 22, 1998.

If the taxpayer appears at the hearing and disputes the correctness of the Government's determination, then the concept of **burden of persuasion** arises. This means that the Government must persuade the Court that a certain thing happened. There are different levels of persuasion for different cases. For example, in criminal cases the proof must be "beyond reasonable doubt;" in civil fraud cases the proof must be "clear and convincing" (which is a somewhat lower standard); for other civil penalties, including 6700 and 6701, the proof must be "by a preponderance of the evidence" (which is the basic level of proof required in most cases). The Court must be able, from the evidence placed before it, to reasonably conclude that the particular conduct occurred and resulted (or would result, in the case of an injunction) in the harm described by the Government.

Continued on next page

Burden of Proof, Continued

IRC 6700

This section imposes a penalty on any person who organizes, or assists in the organization of, a partnership or other entity, an investment plan or arrangement, or participates (directly or indirectly) in the sale of any interest in an entity, investment plan or arrangement; and who makes or furnishes, or causes others to make or furnish a statement regarding the allowability of any deduction or credit, the excludibility of 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; or a gross valuation overstatement as to any property or services if the value stated exceeds 200% of the correct value, and the value of the property or services is directly related to the amount of any deduction or credit allowable.

The key phrases are:

- assists or participates
- statement
- knows (or has reason to know)
- false or fraudulent
- gross valuation overstatement

The investigation should gather evidence showing that the promoter assisted or participated in the preparation or presentation of a statement regarding a tax benefit which he/she knows (or has reason to know) is false or fraudulent or contains a gross valuation overstatement. Given the nature of current abusive promotions, it is likely that 6700 penalties will be based on false or fraudulent statements as to tax benefits, rather than on gross valuation overstatements.

Continued on next page

Burden of Proof, Continued

IRC 6701

This section imposes a penalty on any person who aids or assists in, procures or advises with respect to, the preparation or presentation of any portion of a return, affidavit, claim, or other document; who knows (or has reason to know) that the portion will be used in connection with any material matter arising under the revenue laws; and who knows that such portion (if so used) would result in an understatement of the liability of another person. The key words are:

- document
- knows (or has reason to know)
- understatement

The investigation should gather evidence showing that the promoter is implicated in the preparation or presentation of a document, some portion of which he/she knows (or has reason to know) will be used in connection with a material matter arising under the tax laws and knows that such position (if so used) would result in an understatement of the tax liability.

IRC 7408

IRC 7408 injunctions may be issued to prevent current conduct which would be penalized under 6700 or 6701. In addition to the elements above, you must also show that the promoter is presently engaged in such conduct. Therefore, evidence must be gathered to show that the promotion is ongoing and involves a number of participants. The memorandum should demonstrate why the scheme violates federal tax law (a basis for a belief that it leads to the claiming of improper deductions) and that the promoter is currently doing business. The memo should include the current promotional materials, an estimate of the number of current participants, and an estimate of harm to the Government in terms of tax impact.

Continuing the Investigation

Securing evidence

After the initial meeting with the promoter, and assuming that the promoter does not provide all the information you requested, you should continue with the investigation. This will typically involve service (and enforcement) of a summons. While waiting for summons compliance or enforcement, you should continue the investigation. You should develop the facts and circumstances of the case per IRM 42(17)(11).62(5), contained in the Appendix.

1. Interview third parties who may have any knowledge of or insight into the promoter/preparer or the promotion itself:

   - participants
   - other salesmen involved in the promotion
   - attorneys and accountants in the community
   - individuals who were approached to buy the package but did not
   - prior employees
   - informants

2. Check other agencies such as the local county courthouse, state licensing boards, state taxing authorities, and the Securities and Exchange Commission for promotions involving stocks, bonds, or other securities.

3. Research local newspapers and Lexis to see if there are any articles about the promoter/ preparer.

4. Review the bankruptcy court filings and .

5. Contact other IRS personnel and divisions (i.e., collection, revenue agents and trust coordinators in other districts).

6. Initiate or continue income tax audits of the investors and/ot the promoter/preparer.

Continued on next page

Information Document Request (IDR)

Exhibit 8-1 contains an IDR that combines the information requested during an income tax examination with the information requested when the 6700 investigation appointment is scheduled (discussed in Lesson 6). If a 6700 investigation has already been approved or a referral is expected, Exhibit 8-1 may be used when starting the promoter examination.

The IDR must be prepared in a format that can easily be adapted for use in the summons. The language should precisely specify the documents requested and the period of time that the documents are to cover. You should work closely with District Counsel.

Following the IDR

Frequently the promoter will request an extension of time to provide the requested material. A moderate extension should be allowed (two weeks, for example), but long or repeated delays (over a month) should not be allowed. Ultimately the Service will explain the chronology of all actions to a court. Thus, it is important to "work with" the promoter and encourage voluntarily compliance. All contacts with the promoter, including requests for extensions of time, must be documented in your contact sheets.

If the promoter supplies the requested information, you may be able to identify clients/investors through analysis of gross receipts. The information shown on deposited checks may also identify participants in the promotion.

Promoters may anticipate investigative actions and set up defense strategies by making payments directly to trust accounts. Sometimes these accounts are maintained by the promoter's defense attorneys with dual signatory authority.

If the promoter does not cooperate and bank summons are necessary, deposited items made to the promoter's bank accounts can also reveal the clients' identity. When summoning bank accounts, request all accounts for which the promoter has signatory authority. Summons are discussed later in this lesson.

Third Party Contacts

Information from third parties

Information sought from third parties includes:

- The overall experience level and education of the promoter/preparer.
- The type of shelter sold.
- The tax benefits being claimed.
- Whether participants are non-compliant with the tax law by claiming tax benefits recommended in the promotion.
- How the shelter is marketed.
- Who is involved in selling the shelter.
- The degree of control the promoter/preparer has when organizing and selling the shelter.
- A detailed overview of the shelter and how it works.
- Details of the financial transactions and how tax liabilities would be reduced.
- The documents and information provided to participants.

The sample interview questionnaire provided in Lesson 3 may be modified for differing situations. Again, in deciding what to ask in the investigation, the agent should keep the goal in mind--you need information to prove to a court that the promoter is liable for each element of the 6700 or 6701 penalty and/or that the promoter is engaged in conduct which should be enjoined.

Refer to the Preparer/Promoter Penalties section of the Penalty Handbook, Chapter 6, 120.1.6.6.3.2 (in the Appendix) for factors to develop.

Continued on next page

Notice letter	IRC 7602(c)(1), contained in the Appendix, generally states that the Service may not contact any person other than the taxpayer, with respect to the collection or determination of a tax liability, without first providing reasonable notice to the taxpayer that contacts with persons other than the taxpayer may be made. The exceptions to this general rule are jeopardy or reprisal, CI involvement, or taxpayer permission for contacts (IRC 7602(c)(3)). Notification Letter 3164 is to be sent to the promoter and/or the participants. None of the 15 currently approved versions of Letter 3164 are appropriate for 6700/7408 investigations. You should work with the assigned District Counsel attorney in drafting a substitute.
Record of contacts	Pursuant to the requirements of IRC 7602(c)(2), you should keep a record of persons contacted. In most offices this requires submitting a record of each third party contact to a central point by completing a Form 12175, *Third Party Contact Report Form*. Any requests received from taxpayers for a list of third party contacts should also be forwarded to this unit.

Summonses

Issuing summons

Issue a summons when the promoter/preparer does not voluntarily comply with the IDR request and request for interview. The summons should be issued promptly. See the Summons Handbook in IRM 109.1 for detailed information.

The time and place for appearance should not be less than 11 full calendar days from the date the summons is served.

The summons on the promoter is to be delivered in person. Enforcement action cannot be taken on a summons that was served by mail (except for third-party recordkeeper summonses). *See IRC 7603(b) (contained in Appendix) and IRM 109.1, Chapter 3.*

Be certain to comply with all third-party contact and third-party summons rules when a summons is served on the promoter or others persons.

Continued on next page

Avoiding common problems

To avoid common problems District Counsel advises:

1. Name only one summoned person on each Form 2039. When summoning a husband and wife, use two summonses.

2. Use the full name and address of the taxpayer and the summoned person, and ensure that the address and the spelling are correct.

3. Identify specific time periods without abbreviation. For example, use "the fiscal year ended November 30, 1996," rather than "9611," or "calendar year 1995," rather than "9512."

4. If you think you need records for years other than those under investigation, seek District Counsel advice before issuing your summons. Be prepared to explain why the records are relevant; e.g., to use the net worth method of determining income. *See United States v. Goldman*, 637 F.2d 664 (9th Cir. 1980).

5. The description of records or other information should be specific enough to clearly identify what you are requesting. IRM 4022.64 and Exhibit 5-2 contain examples.

6. When summoning the taxpayer, set the date of appearance at least 11 calendar days after service.

7. When summoning a third party, set the date of appearance at least 23 calendar days after service; 26 days are recommended. Give notice to all noticees within 3 days of service; if you do this on the date of service, you will have less to keep track of. Both the taxpayer under investigation and any other person identified in the description of the records to be produced must be given notice.

8. Make proper service. Either hand the summons to the summoned person, or, if personal service is impossible, leave an attested copy at the "last and usual place of abode." Part A of Form 2039, which is the actual copy served, must contain a signed certification that it is a true and correct copy of the original. Make a copy of Part A before service and retain it for your case file. This will prevent any appearance of defect if the matter proceeds to enforcement.

9. Complete the certificate of service on the back of Form 2039 immediately after service. For a summons of a third party, also complete the certificate of notice.

Continued on next page

Reimbursement of summons costs

IRC 7610 provides for the payment of per diem and mileage costs incurred by witnesses, and for the costs of locating, reproducing, and transporting summoned records. Instructions are contained in IRM 109.1, Chapter 9. Standard Form 1157 is used for witness fees and mileage, while Form 6863 is used for costs related to producing records. Process these forms through your manager as soon as you are able to certify that the third party has complied with your summons.

If you receive records prior to the appearance date set on the summons, do not inspect them or certify the Form 6863 until after the appearance date. If a petition to quash is filed, the payment to the third party may be delayed until the court resolves the issue. Inform the third party of this possibility.

Summons enforcement

IRC 7604 and IRM 109.1, Chapter 10, provide for the enforcement of the summons if the person on whom it is served does not comply with the summons.

The four parties involved in every summons enforcement case are the:

- revenue agent who issues the summons
- taxpayer who refuses to comply
- local District Counsel office to which the agent refers the summons for enforcement
- local United States Attorney office, which will actually litigate the issue before the local United States District Court

If the summons is complicated or of a particular type, there may also be other parties involved--a summoned third party and/or the Tax Division of the Department of Justice.

After a summons is issued and the promoter fails or refuses to comply, the Service has two options--drop the matter or proceed with enforcement action.

Similarly, if a summons is issued to a third party and the promoter (or other noticee) directs the third party not to comply and files a petition to quash the summons with the local United States District Court, the Service has the same two options--drop the matter or proceed with enforcement action.

Continued on next page

Summons enforcement, continued

Both the 6700/6701 investigation and the investigation into the participants should proceed along other lines while awaiting enforcement of the summons. The District Counsel attorney assigned to the 6700/6701 investigation should have already reviewed the summons, prior to issuance, to ensure that it can be defended.

After failure of the promoter to respond to the summons:

1. You should prepare a memorandum within six workdays, providing the information requested in IRM 109.1 Chapter 10.4. This memorandum is sent to District Counsel. It will also transmit the original summons and an affidavit (called a "Declaration") prepared by the issuing agent detailing the facts of the matter.
2. District Counsel may send a "last chance letter" to the promoter briefly stating the law and warning the taxpayer of the penalties of noncompliance, and setting a new date for production of the records. If you and the attorney agree, this step may be omitted. District Counsel will then proceed with enforcement litigation.

Enforcement litigation

Actual enforcement litigation may involve:

District Counsel - in those locations where District Counsel attorneys are seconded to the local United States Attorneys offices as Special Assistant United States Attorneys and have been delegated the task of summons enforcement.

Tax Division of the Department of Justice - suits to enforce:

- Summonses issued to churches; 501(c)(3) organizations; ministers or persons claiming to be ministers.
- "John Doe" summonses.
- Summonses for "audit workpapers" or "tax accrual workpapers" as defined in IRM 4024.2(2) and (3).
- Summonses where a criminal case is being considered by District Counsel, but has not yet been forwarded to the Department of Justice.
- Designated summonses and related matters as defined in IRC 6503(k).
- Summonses where the Fifth Amendment has been raised as a defense, including witnesses who fail to comply with production immunity orders.
- Other significant, novel, or important issues.

Local United States Attorneys Office - All remaining summons enforcement work.

Continued on next page

Enforcement litigation, continued

Depending on local procedures and the type of enforcement proceeding, District Counsel will open a summons enforcement case file and the District Counsel attorney will prepare a letter requesting the United States Attorney to enforce the summons. This should be done within six workdays of receipt of the enforcement request in District Counsel. Typically, direct referral of the request for enforcement to the local United States Attorney is allowed without National Office review. *See CCDM (34)(12)33.*

The Assistant United States Attorney (the docket attorney actually handling the case) will then prepare and file with the United States District Court any legal papers necessary to place the case before the court (typically either the request for enforcement of the summons, an answer to a petition to quash, or a motion to dismiss a petition to quash).

Then the court will generally issue an Order To Show Cause why the summons should not be enforced and a hearing date will be set. The promoter (and/or third party, in the case of a petition to quash the summons) will have the opportunity at the hearing to present evidence on why the summons should not be enforced.

At the conclusion of the hearing, the court will generally issue an Order requiring the promoter/third party to produce the records at a given time and place. You may be asked by the attorney to serve papers for this (or other) hearings, and will almost certainly be required to testify as to the facts underlying the promoter, the promotion, and the summons.

If the promoter again refuses to produce the records, the Assistant United States Attorney will generally file a motion with the court to compel the promoter to comply with the court's Order requiring production of the documents. These sanctions may vary, but typically call for the promoter to be arrested and brought before the Judge and cited for contempt of a court order. A finding of contempt can result in the promoter being jailed until he/she decides to comply.

As mentioned above, the process of summons enforcement is long and complicated and generally will not toll the statute of limitations against participants in the tax shelter scheme. Therefore, the 6700/6701 investigation into the promoter's actions and the investigation into the participants should proceed along other lines, while awaiting enforcement of the summons.

Summary

The goal of the investigation is to gather sufficient evidence to persuade the court that the 6700/6701 penalties should be upheld and/or that the promoter should be enjoined from promoting the scheme.
Third parties are an important source of information.

Exhibit 8-1

Form 4564	of the Treasury Internal Revenue Service Department Information Document Request	Request Number

To: (Name of Taxpayer and Company, Division or Branch)	Subject:
	Submitted to:
	Dates of Previous Requests:

Description of Documents Requested:

- Complete copy of all documents related to all entities involved in the promotion. (If a trust is involved, Section 1.6012-3(a), Treasury Regulations, requires a trustee furnish these documents to the Internal Revenue Service upon request.)

- If one of the entities is a trust, a completed and signed Form 56 (copy enclosed) for the current trustee. (Note: Where more than one trustee is appointed under a trust instrument, the names of all trustees should appear on Form 56 and all should sign the consent. One trustee may sign if provided for in the trust instrument.)

- Power of attorney, if you wish to have a representative work with me during the examination. The authorization must be accompanied by evidence of the authority of the person(s) who appoints the representative.

- All minutes of any promotion entity from inception to the present, including records regarding the appointment and/or resignations/terminations of any entity official, records of all assets transferred into any entity, and all records regarding the ownership of all shares of beneficial interest in any entity.

- Identification of all former and current entity officials from inception of the promotion to the present. Identification to include name, address and telephone number, both business and personal.

- Listing of all owners of any promotion entity to include name, address, and Social Security Number or Employer Identification Number.

- Bank statements, deposit slips, debit/credit memos and cancelled checks for all promotion entity accounts, U.S. and foreign, checking and savings, for the period December 1, 19X1 through January 31, 19X3.

Information Due By _____ **At Next Appointment** ☐ **Mail In** ☐

	Name and Title of Requestor	Date:
	Internal Revenue Agent (ID#)	
FROM	Office Location:	
	Phone: Voice (xxx) 123-4567 ext. 205 FAX (xxx) 123-4568	Page 1

Form 4564

Exhibit 8-1, Continued

Form 4564	Department of the Treasury Internal Revenue Service Information Document Request	Request Number

To: (Name of Taxpayer and Company, Division or Branch)	Subject:
	Submitted to:
	Dates of Previous Requests:

Description of Documents Requested:

- All accounting books and records for each promotion entity from January 1, 19__ through December 31, 19__. Records to include, but not limited to check registers, disbursements journals, receipts journals, general ledger, and other workpapers used in the preparation of the tax return(s) and financial statement(s).
- Copies of all income tax returns for each entity involved in the promotion for the years 19__ through 19__.
- Copies of any related entities returns (Form 1120, 1120S, 1065, 1040, 940, 941, 945)
- Payroll tax returns (940 and all quarters 941) for the years 19__, 19__, and 19__. The documents should include Forms W-2 and current forms W-4.
- Payroll ledger and associated records for calendar year(s) 19__.
- Copies of all Forms 1099 issued by each entity for tax years 19__, 19__, and 19__.
- Copies of all Forms 1099 received by each entity for tax years 19__, 19__, and 19__.
- All lease agreements entered into or in effect between January 1, 19__ through December 31, 19__ for each entity.
- All loan documents, including but not limited to, loan agreements, promissory note, Deed of Trust, Security Agreement, payment record, and financial statements submitted to any lender, for loans entered into or that were in effect during the period January 1, 19__ through December 31, 19__ for each promotion entity.
- Documentation to establish basis of all assets held by each entity, including assets transferred by grantors and assets acquired by each entity from inception through December 31, 19__.

Information Due By _____ **At Next Appointment** ☐ **Mail In** ☐

	Name and Title of Requestor Internal Revenue Agent (ID#)	Date:
FROM	Office Location: Phone: Voice (xxx) 123-4567 ext. 205 FAX (xxx) 123-4568	Page 2

Form 4564

Exhibit 8-1, Continued

Form 4564	Department of the Treasury Internal Revenue Service Information Document Request	Request Number

To: (Name of Taxpayer and Company, Division or Branch)	Subject:
	Submitted to:
	Dates of Previous Requests:

Description of Documents Requested:

- Documents should include, but are not limited to, sales contracts, purchase agreements, and all documents showing the source of funds used to purchase the assets. Provide names and addresses of transferors of properties to each entity and the basis of these properties to the transferors immediately before the transfer(s).

- Documentation showing all sales and/or transfers of property from each entity from January 1, 19__ through December 31, 19__. Documents should include, but are not limited to, sales contracts, purchase agreements, and documents showing the disposition of funds received in the transfer of the assets.

- Provide a statement as to the purpose for operating your business as a trust or as any other type of entity. Provide information as to who controls the funds of this entity, who has the power to distribute entity's income, and who controls the entity's assets.

- Provide a statement showing the purpose for transferring salary, wages, or other compensation of the participant, or any other individual, by contractual assignment, or any other arrangement, to the entity.

Information Due By _____ **At Next Appointment** ☐ **Mail In** ☐

	Name and Title of Requestor Internal Revenue Agent (ID#)	Date:
FROM	Office Location: Phone: Voice (xxx) 123-4567 ext. 205 FAX (xxx) 123-4568	Page 3

Form 4564

Lesson 9

OPTIONS AFTER COMPLETING THE INVESTIGATION

Introduction

Background

Various options should be considered once the initial meeting with the promoter/preparer has occurred and the investigative work is complete. At that time, the revenue agent and the District Counsel attorney will decide which option to select. The factors that should be considered in reaching this decision are addressed in this lesson.

Objectives

At the end of this lesson you will be able to:

1. List the various options available during the 6700/6701/7408 process.
2. Use the proper procedures used to pursue each option.
3. List the various combinations of procedures available.

Contents

Options and Procedures

Options to be considered

Options	Action Required
1. Criminal referral	Prepare case for referral to CI
2. Injunction with no penalties	Propose IRC 7408 injunction with no IRC 6700/6701 penalties
3. Injunction with penalties	Propose IRC 7408 injunction **and** IRC 6700/6701 penalties
4. Penalties with no injunction	Propose IRC 6700/6701 penalties with no injunctive action
5. Close case as "no-change"	Close case, no potential exists
6. Drop part of case and/or some investors	Drop some issues and/or minor investors
7. Issue pre-filing notification letters	Issues these letters in investors in accord with Rev. Proc. 83-78 (in Appendix)

Procedures

A closing conference with the promoter/preparer must be offered. IRM 42(17)(11).64 and Rev. Proc. 83-78 (both in Appendix) provide procedures.

Prior to the conference the revenue agent and the District Counsel attorney must agree on the intended course of action with respect to penalties and/or injunctions. If they cannot agree, the matter must be referred to the Committee for decision.

The revenue agent and the District Counsel attorney will prepare and issue a closing conference appointment letter (Exhibit 9-1 is a sample). A copy of the appointment letter must be included in the file.

The District Counsel attorney should be present at the conference. Do not imply that any final decision has been made on what action will be pursued.

If the promoter declines the offer to meet or fails to keep the meeting, proceed based on the available information.

Continued on next page

Options and Proceduresand Procedures, Continued

Making a decision

After the closing conference, it is time to finalize the intended option. IRM 42(17)(11).64 directs the revenue agent and the District Counsel attorney to make this decision. However, it is strongly recommended that the 6700 Committee be reconvened at this point. All members of the Committee should discuss the case, consider all options, and reach a decision together.

Exercise 1

During the course of the injunction process, it is determined that some of the investors' returns are quite small and it would not be worthwhile to pursue them. Since these returns were included in the original package, must they be audited anyway?

Option 1: Criminal Referral

Background

This section covers the procedures and the factors that CI considers when analyzing a referral from Exam.

Referral procedures

When information is received from Exam detailing an abusive promotion, CI will make an initial decision on whether the promotion should be submitted for immediate criminal referral, accepted as it because it is related to a current criminal investigation, or returned to Exam for further development if appropriate.

This preliminary information from Exam will include the prospectus and/or other promotional materials. If the preliminary information warrants a criminal referral then CI will recommend to the committee to immediately refer the promotion. At this stage it is unlikely that the preliminary information will be sufficient to support a criminal referral.

If the promotion is referred to CI, all civil action should cease. In addition, CI will analyze the preliminary information and determine if there are related investigations within or outside district boundaries. The CI representative will query the Criminal Investigation Management Information System (CIMIS), Treasury Enforcement Communication System (TECS), and contact the National CI Trust Coordinator to determine if related investigations exist.

If related investigations exist, the CI representative will forward the information to the appropriate special agent. If there are related investigations no formal referral is necessary from Exam to CI.

If there are no related investigations the promotion should be given back to Exam for any action deemed suitable by the committee. These actions could include the preparation of a criminal referral, examinations, or injunction.

Continued on next page

Option 1: Criminal Referral, Continued

Factors to be considered by CI

Each abusive promotion should be evaluated on its individual facts. Consensus should be reached among Counsel, Exam, Collection, and CI on the course of action. There is no hard and fast rule on what factors or combination of factors warrant a criminal referral or alternative civil action. The existence of one of the elements does not necessarily warrant a criminal referral. The egregiousness of individual factors and the presence of multiple factors should be considered. The following factors are used as a guide in determining if a criminal referral is accepted:

1. Is there an offshore component to the promotion? If so:
   - Are funds transferred offshore?
   - Are entities, including but not limited to International Business Corporations, trusts, and bank accounts formed in offshore jurisdictions with tax secrecy laws?
   - Are debit/credit cards issued from foreign bank accounts as means to repatriate funds back to the US?
2. Are promotions advocating actions inconsistent with the law? If so:
   - Are promotions advising purchasers not file returns?
   - Are promotions advocating the evasion of tax?
   - Are promotions advising the deduction of "non-deductible" or bogus expenses?
3. Have false statements been made or false documents submitted to the IRS?
4. Are excessive fees charged for the promotion? Are these fees based on the amount of tax savings offered by the promotions?
5. Are there frequent replacement of trustees? If so, are the replacements justified?
6. Are grantors retaining complete control over trust assets even though trust paperwork may indicate otherwise?
7. Is there an unnecessarily complex web of inter-related or layered entities?
8. Is the promotion targeting wealthy clients?
9. What is the level of education of the promoter and participants?
10. Does the promoter have a "history" with the Service?
11. Are promoters and/or participants deviating from promotional instructions?

Continued on next page

Option 1: Criminal Referral, Continued

Additional factors

1. Publicity/deterrent factor - Which will cause the greatest deterrent effect: criminal prosecution or civil injunction?
2. Inventory of each division in the district - Are sufficient resources available in CI to investigate the promotion? Are sufficient resources available in Exam to work an additional injunction/penalty action?
3. The scope of the promotion - How many participants are involved in the scheme?
4. What is the tax loss to the government? Can the loss be recovered? What is the best means to recover the loss? Is time a factor in the recovery?
5. Complexity of the scheme - Will a criminal jury be able to understand the promotion or would the case be better understood by a judge in a civil injunction action? Is the complexity part of the overall fraud scheme?
6. Jury appeal - Will the promotion appeal to a criminal jury or are there factors such as health or age that may mitigate jury appeal?

Mutual issues for CI and Exam

1. Examination of clients after promoters have been referred to CI.
2. Prevention of improper criminal influence in civil examinations.
3. Prohibiting the presence of special agents at examinations of promoters' and return preparers' clients.
4. Preventing CI and AUSA's (Assistant United States Attorney)from having roles in determining what civil penalties Exam asserts against abusive promoters or their investors.
5. Sharing of client lists and other pertinent information between CI and Exam.

TC 910

IDRS Transaction Code 910 indicates clients who have been identified as being part of an abusive promotion but are not under criminal investigation.

Options 2-7

Option 2: injunction with no penalties

The decision may be made to pursue an injunction without any 6700/6701 penalties. In making this decision, the promoter/preparer's ability to pay should be taken into account:

- Are assets available for collection purposes?
- Have large outstanding liabilities already been assessed?
- Is the promoter/preparer already in bankruptcy?

Option 3: Injunction with penalties

If injunctive action is warranted, 6700/6701 penalties will generally also be warranted. However, the Department of Justice recommends the penalties not be assessed until after the injunction because the promoter/preparer will be entitled to appeal the penalties.

Part of the appeal process includes a jury trial, which can delay the injunction proceedings considerably. However, sction proceedings are heard by a judge without any jury, they can progress relatively quickly.

The penalties can be asserted successfully after the injunction is resolved. This is especially so if the injunction was upheld by the judge.

Option 4: Penalties with no injunction

If it is decided that no injunction is warranted, IRC 6700/6701 penalties may still be assessed. They may prove to be an effective deterrent.

Exercise 2

Are there times when it is preferable to pursue the issuance of an injunction without any related penalties? If so, why?

Continued on next page

Options 2-7, Continued

Option 5: No-change

There are times that the information available, either through the closing conference or through other means, indicates the case should be closed as a no-change. If it is determined that a no-change is warranted, the revenue agent prepares and issues a No-Change Letter 1866 (Exhibit 9-2).

Option 6: Drop part of case and/or some investors

Other promoters/preparers, sub-promoters, salesmen, and investors may be identified during the course of the examination process. If this occurs, it is sometimes necessary to limit the number of parties being examined as part of the package. The Department of Justice usually determines which parties are to be pursued.

If these individuals were not originally named and sent the initial pre-filing letter, ensure that there are no examination controls tying them to this package.

On the other hand, if these individuals were originally named and received the initial appointment letter (Letter 1844), it becomes necessary to issue No-Change Letter 1866.

Options 2-7

Option 7: Issue pre-filing notification letters

A pre-filing notification letter may be sent to investors in an abusive tax shelter promotion under consideration for IRC 7408 injunction procedures. This letter advises the investors before they file future returns that the claimed tax benefits of the promotion are not allowable and also advises the investors of any possible consequences if these benefits are claimed on their tax returns. With this pro-active approach, the Service provides guidance prior to the filing of the individual investor's return. Exhibit 9-5 is Pre-Filing Notification Letter 1843.

However, these letters may also be issued to investors after their tax returns are filed. The investors should be advised that if they claimed such tax benefits on their tax returns, they may file amended returns. Any applicable penalties, though, still may be asserted.

Option 7: Rev. Procs.

Rev. Proc. 83-78 and Rev. Proc. 84-84 contain the procedures for pre-filing notification letters. Rev. Proc. 84-84 made an important change in the requirements for a pre- notification letter. In order to send a pre-filing notification letter, either a gross valuation overstatement or a false or fraudulent statement with respect to the tax benefits available must be present. These letters will no longer be sent on any other grounds, including an aberrational use of technical positions. Complete copies of both Rev. Procs. are in the Appendix.

Continued on next page

Option 7: Procedures

After a basis has been established for pre-filing action, the case will be forwarded to the District Director for approval of the issuance of pre-filing notification letters. Upon this approval, the letters will be prepared and issued to the investors in the promotion.

Rev. Proc. 83-78, Sec. 7, states, "After the pre-filing notification letters are issued, the district will forward a list of the investors to the appropriate service centers. In addition to providing investor information, the district will also identify the name and type of abusive shelter and, if possible, the type and amount of tax benefits that an investor would be reporting. If the individual investors claim the tax benefits after issuance of the pre-filing notification, or fail to file amended returns, they will be notified that their tax returns are being examined. Normal audit and appeal procedures will be followed during the examination of the tax returns, and accuracy-related, civil or criminal fraud and/or any other penalties will be considered and, when appropriate, asserted."

Exercise 3

List some of the advantages of issuing pre-filing notification letters.

Exercise 4

What is the major difference between Rev. Proc 83-78 and Rev. Proc. 84-84 in the requirements for a pre-notification letter?

Summary

Various options have been described:
1. Criminal referral
2. Injunction with no penalties
3. Injunction with penalties
4. Penalties with no injunction
5. Close case as "no-change"
6. Drop part of case and/or some investors
7. Issue pre-filing notification letter

Answers to Exercises

Exercise 1

No, if it is determined that there are minor investors involved, these returns can be eliminated based upon a joint decision between the Revenue Agent and the District Counsel Attorney.

Exercise 2

Yes, the application of penalties can afford a jury trial for the promoter/preparer. The injunction proceedings are only heard by a judge.

Exercise 3

1. Issues a warning to investors that if they utilize the promotion, any refund may be held.
2. If the investors have already filed, they could file amended returns.
3. Can save time and money to the Service by not having to examine all of the investor returns.

Exercise 4

Without the promotion utilizing either a gross valuation overstatement or a false or fraudulent statement with respect to the tax benefits available, the letter will not be issued.

Exhibit 9-1

Internal Revenue Service
District Director

Department of the Treasury

Agent Name:

Address:

Date:

Dear

As you are aware, we have been conducting an examination with respect to your tax shelter promotion, to determine if the assessment of the IRC § 6700 penalty and whether an injunction to prohibit the continued selling of the shelter is warranted. We have discussed with you and/or your representative many areas of your promotion that we believe do not comply with the tax laws. The purpose of this letter is to schedule a meeting to give you an opportunity to present any facts or legal arguments which you feel would conclude that the penalties and/or the injunction is not appropriate.

We would like to schedule the meeting for _____ at 9:00 a.m. The location of this meeting will be at the IRS office at _____. Please call to confirm your attendance at this meeting.

Generally, no extension of time will be granted for this meeting; however, if you would like to reschedule, an earlier date will be considered. You will not be entitled to any additional meetings with the Service regarding the possible action(s) the Service may take. If you have any questions, please contact me at the address or the telephone number shown above.

Sincerely,

Revenue Agent Name
Revenue Agent ID#

Exhibit 9-2

Internal Revenue Service
District Director

Department of the Treasury

Tax Shelter Promotion:

Tax Year:

Person to Contact:

Employee ID#:

Contact Telephone Number:

Date:

Dear Mr.

We have reviewed certain materials with respect to your tax shelter promotion. Based on the information provided, we are discontinuing the review at this time with respect to possible actions under sections 6700 and 7408 of the Internal Revenue Code relating to penalties and an injunction action for promoting abusive tax shelters.

We may examine your returns for the correct determination of any income tax liability for the tax shelter promotion or any of its investors. This letter should not be construed to mean that the Service has approved the promotion; rather, it is a notice that our action under the above sections has been discontinued.

If you have any questions, please contact the person whose name and telephone number are shown above.

Thank you for your cooperation.

Sincerely,

District Director

L-1866

Exhibit 9-3

Internal Revenue Service
District Director

Department of the Treasury

Tax Shelter Promotion:

Tax Year:

Person to Contact:

Employee ID#:

Contact Telephone Number:

Date:

Dear

Our information indicates you were an investor in the above tax shelter promotion during the above tax year. Based on our review of that promotion, we believe the purported tax deductions and/or credits are not allowable.

We plan to review your return to determine whether you claimed these deductions and/or credits. If you did so, we will examine your return and reduce the portion of any refund due you that is attributable to the above tax shelter promotion. If our examination results in adjustments to your tax return, you will be given an opportunity to exercise your appeal rights. The Internal Revenue Code provides, in appropriate cases, for the application of the accuracy-related penalty under Internal Revenue Code § 6662 and other appropriate penalties. Our examination will determine whether these penalties are appropriate. See the back of this letter for an explanation of the penalties.

If you claimed deductions and/or credits on a return already filed, you may wish to file an amended tax return. If so, please file at the following address:

Internal Revenue Service Center
Attn: Pre-Filing Notification Coordinator

Sincerely,

District Director

L-1843

Lesson 10

REVENUE AGENTS' IRC 7408 REPORT

Introduction

Overview

At the conclusion of the investigation the examiner must prepare a memorandum to the District Director recommending any action to be taken against the promoter/preparer. The report must be prepared using a specific format that is substantially different than a regular Revenue Agents' Report. The IRC 7408 report is very similar to the format used in a Special Agents' Report. The report is very detailed and will take considerable time to prepare.

Exhibit 10-1 is a sample report.

Objectives

At the end of this lesson you will be able to:

1. Identify the five sections of an IRC 7408 referral report.
2. Identify the type of information that should be included in the narrative section of the report.
3. Organize the evidence as exhibits to the report.
4. Compile a witness list.

Background

IRM 4236(14) requires that a specific report format must be used in cases in which the examiner is recommending an injunction under IRC 7408. The report format should also be used in IRC 6700 penalty cases. This is particularly important if it appears the promoter/preparer may file an appeal of the penalty in District Court in accord with IRC 6703.

Report format

The IRC 7408 report is organized into the following five parts:

1. Case Summary
2. Facts and Findings
3. Appendix of Attached Exhibits
4. Investigative Agent Data
5. List of Witnesses

See IRM 4236(14)10.

Continued on next page

Introduction, Continued

Contents

Report Summary

Case summary

The first page of the report is a narrative summary of the agent's findings and recommended actions to be taken against the promoter/preparer. The case summary must include:

1. Name and address of person under investigation.
2. Years involved.
3. A statement whether the case is based upon false or fraudulent statements, gross valuation overstatement, or both.
4. Recommended action(s).

If several people were investigated, a separate paragraph should discuss the involvement of each person. The summary portion of the report, while specific, should not contain a detailed discussion. The report may be in narrative or outline format. *See IRM 4236(14)20.*

Body of Report

Facts and findings

The facts and findings part of the report is a comprehensive discussion of the case. It must contain eleven sections:

1. Personal history
2. Business background
3. CI involvement
4. Mechanics of promotion
5. IRC 6700 violations
6. IRC 6700 penalty calculation
7. IRC 7408 injunction
8. Venue
9. Pre-filing notification
10. Closing conference
11. Recommendations and conclusions

See IRM 4236(14)30.

Personal history

Separate sections for each person being investigated must address each person's:

- Age
- Marital status
- Educational background
- Health
- Reputation in the community

Business background

The promoter/preparer's occupation and business experience should be discussed completely. Any evidence gathered that could establish the promoter/preparer's tax knowledge should be highlighted. If the promoter/preparer has been involved in other questionable business transactions, fraudulent schemes, or prior tax shelter promotions, these facts should be established in the report. Any other prior or current IRS audits or investigations should be thoroughly explained.

Continued on next page

CI involvement

If CI participated in any way with the examination, this involvement should be detailed. If the case was referred to CI for possible criminal violations, the outcome of the referral should be noted. If the case was joint investigation, a written statement must be secured from the Chief, Criminal Investigation, that he/she has been advised of the examiner's recommendations and concur with those recommendations. CI concurrence should be documented in the report and the statement should be included as Exhibit 3-1. If CI places any restrictions or requests specific action or non-action on any parties involved in this case, such requests or restrictions should be fully detailed in Exhibit 3-2. If CI was not involved in the investigation, it is also important to state that in the report.

Mechanics of promotion

This section includes specific details about the operation of the promotion:

- How the promotion works.
- The abusive nature of the promotion.
- The size of the promotion.
- The estimated revenue loss from the promotion.
- The participation in the shelter of the person under investigation.

This section of the report requires a great deal of detail. Throughout the report, each statement of fact should be referenced to specific items of evidence included in the exhibits.

IRC 6700 violations

It is not mandatory that IRC 6700 penalties be asserted in order to proceed with an IRC 7408 injunction. However, it must proven that IRC 6700 or IRC 6701 violations exist. In this section the examiner must discuss the facts suggesting that the promoter/preparer violated each element of IRC 6700. All false statements or gross valuation overstatements made by the promoter/preparer should be identified. Any evidence supporting the position that the promoter knew (or had reason to know) that statements were false or valuation was overstated should be discussed. The specific participation of each person under investigation should be covered separately.

Continued on next page

IRC 6700 penalty

If an IRC 6700 penalty is being recommended, the amount of penalty to be assessed should be computed. The basis of the computation should be adequately explained in the report. The penalty must also be justified in the report.

IRC 7408 injunction

Any factors that were considered in evaluating the necessity for any injunction should be fully discussed. Evidence demonstrating that the promoter continued to engage in the bad conduct after initiation of the IRC 6700 investigation should be included. Is there any evidence to suggest that the promoter will continue to engage in the IRC 6700 conduct if an injunction is not secured?

Venue

In this section the examiner should recommend in which District Court the IRC 7408 injunction suit should be filed. An injunction suit can be sought in the District Court where the:

- person resides,
- person has his/her principal place of business, or
- IRC 6700 conduct occurred.

Consideration should be given to where the IRS can obtain the most deterrent effect. Consideration should be given to the place where the majority of the investor/participants reside, and to where the promoter earned the largest portion of his income from the abusive promotion.

Pre-filing notification letters

This section of the report (include it as Exhibit 9-1) deals with whether or not pre-filing letters should be issued to investor/participants. In evaluating this issue, examiner must determine if pre-filing letters will be effective in convincing investor/ participants not to utilize the tax abuses advocated by the promoter. Past audit results may be one method of determining the potential effectiveness of pre-filing letters.

If pre-filing notification letters have already been issued, the results of the letters should be discussed. Also, a list of the recipients and a copy of the letter should be included in the exhibits and referred to in the report.

Continued on next page

Body of Report, Continued

Closing conference

This section should include a summary of the closing conference held with the promoter. A memorandum summarizing the conference should be included as Exhibit 10-1. Any defense or rebuttal positions claimed by the promoter should be fully discussed in Exhibit 10-2. Any facts which would tend to rebut the promoter's defense should be included in this Exhibit 10-2.

Recommendations and conclusions

The final section contains the revenue agent's conclusions. The reasoning behind recommending certain actions and not others should be fully explained.

Supplemental Data

Appendix of exhibits

All the pertinent investigation documents and memoranda will be compiled as exhibits. Each fact discussed in the report should include a reference to the specific exhibit in parenthesis. The actual numbering system for the exhibits is not mandated in the IRM. However, evidence is frequently organized in this manner:

1. Witnesses
2. Type of information
3. Specific items or documents
4. Page number of documents

All evidence must be identified as to when, how, and from whom it was received. If possible secure original documents. Do not:

- write on any documents
- highlight anything on the documents
- write the exhibit numbers on the documents
- number the pages

Continued on next page

Supplemental Data, Continued

Investigative agent data

A list of all the IRS personnel involved in the case should be attached to the report. The names, addresses, phone numbers, e-mail addresses, and fax numbers should be listed for the revenue agents working on the case, the examination group manager, the district counsel attorney, and the attorney's supervisor.

Witness list

A list of all potential witnesses should be attached to the report. The witness list may be organized alphabetically or in order of probable appearance at trial. The witness information should include name, address, phone number, e-mail, fax number, and a reference to the exhibits pertaining to his or her testimony.

It is not required but it may be helpful to summarize what testimony the witness may be able to provide at trial. If the witness may be used to rebut a specific defense of the promoter, that should also be noted. Each item of evidence must be introduced by a witness at trial.

Witness testimony can be summarized in the following manner:

1. Will produce _____ (partnership agreement, sales data, budget, sales contracts, appraisal, etc.) which he or she prepared from _____ (information provided by X).
2. Will testify concerning preparation of _____. Will describe _____. Will testify regarding his knowledge of _____. _____.
3. If defense of _____ raised that _____ occurred, can testify in rebuttal that _____.

Summary

The examiner must prepare an IRC 7408 Investigation Report:

- The first part of the report is a brief narrative summary of the case and the recommended actions to be taken against the promoter/preparer.
- The second part of the report is a comprehensive discussion of the facts and findings of the investigation.
- An appendix of exhibits is attached.
- Contact information is compiled for all the IRS personnel involved.
- A witness list with expected testimony is attached.

Exercises

Exercise 1 List four of the five basic components of the IRC 7408 report:

Exercise 2 List eight of the eleven sections in the Facts and Findings component:

Answers to Exercises

Exercise 1

The IRC 7408 report is organized into the following five parts:

1. Case Summary
2. Facts and Findings
3. Appendix of Attached Exhibits
4. Investigative Agent Data
5. List of Witnesses

Exercise 2

The facts and findings part of the report is a comprehensive discussion of all the facts and issues developed during the investigation. The facts and findings part of the report should contain the following eleven sections:

1. Personal history
2. Business background
3. CI involvement
4. Mechanics of promotion
5. IRC 6700 violations
6. IRC 6700 penalty calculation
7. IRC 7408 injunction
8. Venue
9. Pre-filing notification
10. Closing conference
11. Recommendations and conclusions

Exhibit 10-1

CASE SUMMARY

1. Introduction

   a. Subject of investigation:

      Calvin Cooper 000-002-3333
      XXX Fisk Street
      Anywhere, Any State, XXXXX

      Conducting business through:

      Trust Abuse Inc. 10-XXXXXXX
      XXX Concord Ave.
      Anywhere, Any State, XXXXX

   b. Representative of subject: None at this time

   c. Type of case and years involved:

      Mr. Cooper is a significant promoter of abusive trust arrangements. On 3-1-96, Mr. Cooper formed Trust Abuse Inc. (Exhibit W10-1a). Trust Abuse Inc.'s only business activity is the marketing of trusts. The trust promotional materials suggest that a taxpayer can eliminate their income tax liability by utilizing a contractual trust arrangement. The trust promotion is very similar to the promotions warned against in the Internal Revenue Service Public Notice 97-24. Trust Abuse Inc. promotional materials created by Mr. Cooper contain false and fraudulent statements subject to civil penalties under Internal Revenue Code section 6700.

   d. Agent's recommendation:

      Mr. Cooper's promotional materials suggest that a taxpayer can eliminate their personal income tax liability through the use of contractual trusts. Mr. Cooper, although fully aware of Public Notice 97-24, continues to promote all of the improper tax positions the IRS cautioned the public against in the notice. The promotional materials used by Mr. Cooper contain false and fraudulent statements. In one of the publications "Trust Advantage A to Z"(Exhibit W3-1d), Mr. Cooper makes the following false or fraudulent statements with regards to tax advantages of business trusts:

      1) Exchanging assets into a trust for units of beneficial interest is a "tax-free exchange" in accordance with IRC 1031 (page 15);
      2) The property transferred into the trust should be depreciated using fair market value of the property as of the date the property was transferred to the trust (page 21 & 24);
      3) Business income distributed out of a trust is never subject to self-employment tax (page 5 & 19);
      4) The taxpayers residence can be placed into a trust and converted to rental property and the trust would claim as deductions all the expenses of maintaining the home and depreciation on the property, both real and personal (page 24 & 30);
      5) Assets placed in a business trust cannot be attached or seized by the Internal Revenue Service to pay the delinquent tax liabilities of the trustee, creator or beneficiary of the trust (page 10 & 12); and

6) The business trust can pay and deduct the health insurance, life insurance, disability insurance, medical expenses, auto expenses, and educational expenses of the taxpayer and his family can be deducted by the trust (page 31 & 32).

Based upon deposits to the bank accounts held by Trust Abuse Incorporated (Exhibit W13-1a), it was estimated that the company sold 40 trust packages in 1997, 70 trust packages in 1998 and 120 trust packages in 1999. According to Mr. Cooper (Exhibit W1-1c, page 6) the average cost of the trust package was approximately $8,000.

Mr. Cooper currently owes the government a large amount of unpaid taxes (Exhibit W12-1a) and has not filed income tax returns for the last two years. The corporation has not filed income tax returns since it was formed in 1996. It is doubtful that monetary penalties asserted under IRC 6700 would cause Mr. Cooper or his company to discontinue selling this abusive tax scheme. Since the number of actual trusts created or sold has not been determined, it is recommended that civil penalties under IRC 6700 not be asserted at this time. However, an injunction action under IRC 7408 should be initiated against Mr. Cooper and Trust Abuse Inc.

FACTS AND FINDINGS

1. Personal History of Mr. Cooper (Exhibit W1-1c):

   a. Birth date: 2-30-60 in Park, Any State

   b. Marital Status: Married to Winona Cooper (000-00-3334) in 1985.

   c. Educational Background:
      1) AA Degree from Small Town Community College located in Snead in 1980.
      2) BA Degree in Business from University of Southern Palomar in 1984.

   d. Health: Good Health.

   e. Reputation in Community:
      1) He is a convicted felon (embezzlement) and he has served 6 months in a California state prison in 1990 (Exhibit W10-1a).
      2) He filed for chapter 13 bankruptcy in 1987 (Exhibit W11-1a).

2. Business Background:

   a. Business Experience and Knowledge:

      Mr. Cooper operated his own bookkeeping and tax service in Reno from 1984 until 1997. In 1990, he was convicted of embezzling funds from a client' bank account (Exhibit W10-1a). He was sentenced to 6 months in Any State Prison. After he served his sentence, Mr. Cooper returned to his bookkeeping and tax business.

      On 3-1-96, Mr. Cooper formed Trust Abuse Incorporated (Exhibit W10-1a). Mr. and Mrs. Cooper are the sole-shareholders and officers of the company. The corporation's only business activity has been the marketing of trust packages and providing trustee services to clients.

b. Knowledge of Tax Matters and Involvement in Fraudulent Scheme:

Revenue Agent Emory Keene (Exhibit W1-1c) interviewed Mr. Cooper on 4-28-99. At that time Mr. Cooper stated that Trust Abuse Inc. creates multiple trusts arrangements for 5 or 10 clients each month. Besides Mr. Cooper, the company has 2 clerical employees. Finder fees of 15% were also paid to anyone who refers a client to the company.

Trust Abuse Inc. only sells "contractual trust" arrangements. Mr. Cooper holds seminars in hotels 2 or 3 times a month for business and professional people to promote the use of trusts. On average 15 to 20 people attend these meetings. Mr. Cooper tells people attending these meetings that he is a "nationally recognized trust expert with more than 10 years of experience creating and managing contractual trusts."

Mr. Cooper stated that he has attended numerous continuing professional education seminars put on by attorneys, certified public accountants and enrolled agents dealing with the formation and taxation of trusts. Most of the seminar lasted a few hours. In addition, Mr. Cooper took a "Fiduciary Taxation" course at the University of Southern Palomar in 1984.

In 1997, Trust Abuse Incorporation deposited approximately $320,000 from clients into an account at Bank of Northern Palomar (Exhibit W13-1a). In 1998, the deposits totaled $560,000. In 1999, the deposits totaled $960,000. All the deposits appear to be income from trust clients. The clients are located throughout the United States.

c. Prior Tax Shelter Involvement:

There is no record that Mr. Cooper has previously been involved with any other tax shelter. However, Mr. Cooper has not filed his personal income tax returns for the years of 1998 or 1999 (Exhibit W12-1a). Also, audits were conducted on Mr. and Mrs. Cooper's personal tax returns for the years of 1996 and 1997. Originally, Mr. and Mrs. Cooper reported no tax liability for these years. The audit resulted in the assessment of taxes, penalties, and interest in the amount of $80,000 in 1996 and $90,000 in 1997 (Exhibit 12-1a).

3. CID Involvement: At this time, CID has no involvement with this case.

4. Analysis of the Promotion:

a. In-depth Description of the Mechanics of the Promotion:

Mr. Cooper advocates the creation of multiple contractual trusts for purposes of 1) liability protection, 2) avoiding probate and 3) saving taxes (Exhibit W2-1b). Mr. Cooper promotes the trusts by sending mailings to professional people (Exhibit W6-1a) and inviting them to one of his information seminars discussing the benefits of trusts. Trust Abuse Inc. also advertises over the Internet (Exhibit W7-1a). As a consequence most of his clients reside in different states.

On their Internet site, Trust Abuse Inc. offers potential customers several brochures regarding the benefits of Contractual Trusts (Exhibit W7-1b). The books include;

- Understanding Trusts,
- The Trust Advantage A-Z,
- Reduce Your Tax Liability Legally, and
- What CPA's & the IRS Don't Want You to Know.

Mr. Cooper promotes the transfer of an individual's assets into multiple trusts, referred to as contractual trusts (Exhibit W3-1d). One trust would be created for the taxpayer's principal business activity. Business equipment and other assets would be transferred into a separate asset holding trusts. The business trust would then enter into a lease agreement to use the assets held by the equipment holding trust. The taxpayers would also create a "Family Trust" which would hold the shares of beneficial interest in the business and equipment trusts. All sorts of personal living expenses of the taxpayers would be deducted by these trusts including all of the costs for maintaining the taxpayer's personal residence.

Mr. Cooper charges his clients approximately $8,000 to create the standard 3 trust package, including the trust documents, and administration of the trusts (Exhibit W6-1a). Mr. Cooper prepares the tax returns for those trust clients, which hire Trust Abuse Inc. to be their independent trustee. Mr. Cooper indicated at the initial interview that Trust Abuse was trustee for about 30 trust clients (Exhibit W2-1c).

b. Description of Abusive Characteristics of Promotion:

Mr. Cooper suggests that the contractual trusts can protect your assets from liability, and eliminate the time delays and expenses associated with probate; however a very prominent purpose is tax avoidance.

Most of the unlawful tax avoidance issues promoted by Mr. Cooper and Trust Abuse Inc. are discussed in the brochure "The Trust Advantage From A-Z"(Exhibit W3-1d). The unlawful tax avoidance features are as follows:

1) Elimination of self-employment taxes by placing the taxpayer's business into a business trust (page 11);
2) The tax free exchange of assets for Units of Beneficial Interest in the trusts (page 15);
3) Claiming a new basis at fair market value for depreciable property (page 14 & 20);
4) Conversion of the taxpayer's residence into rental property and claiming utilities, repairs, maintenance and depreciation on the house and furnishings as deductions (page 12 & 45); and
5) Claiming deductions for life insurance, disability insurance, medical expenses, education expenses, pension plan, and other personal expenses of the grantor or beneficiary as employee benefits (page 9 & 27).

Federal tax statutes and/or case law do not support any of these tax avoidance features. In addition, the courts have consistently held that such trust arrangements are tax avoidance shams devoid of any economic substance and/or the trusts are grantor trusts within the meaning of Internal Revenue Code sections 671 to 679. As such, the trusts must be ignored for income tax purposes and all the income assigned to the trusts must be reported by the grantor/creator.

The courts have consistently supported this position as demonstrated in Schulz vs. Commissioner, 50 AFTR2d 82-5562; Holman vs. U.S., 5 AFTR2d 84-862; Schmidt vs. U.S., 68-AFTR2d 91-5005; Zmuda vs. Commissioner, 53-AFTR2d 84-1269; Wesenberg vs. Commissioner, 69 TC 1005; Keefover vs. Commissioner, TC Memo 1989-151; and Smith vs. Commissioner, TC Memo 1986-487. These are just a few of the many court cases that illustrate schemes where the trusts lacked economic substance and the grantors retained control and use of the trust assets. The courts have consistently ruled that such trusts should be ignored for federal tax purposes.

c. Size of Promotion and Tax Harm to the Treasury

It is clear from the deposits to Trust Abuse Inc.'s bank account (Exhibit W13-1a) that Mr. Cooper has set up a couple of hundred business trusts during the last couple of years. If the only false or fraudulent feature utilized by these trust clients was the elimination of self-employment tax, the average business person would be understating his tax liability by anywhere from $5,000 to $10,000 each year. Obviously, if a hundred clients utilized this only this one fraudulent feature, the harm to the Treasury would be $500,000 to $1,000,000 every year the trust scheme is utilized.

d. Each Person's Role in the Promotion:

During the initial investigation, Mr. Cooper indicated that he worked closely with Randall Ashland, a CPA. Mr. Cooper indicated that he referred many clients to Mr. Ashland to have their trust tax returns prepared. Mr. Ashland was interviewed on 6-2-98 (Exhibit W3-1a). During the interview, he indicated that he had attended 2 seminars put on by Mr. Cooper. He stated that he disagreed with Mr. Cooper on all the key tax avoidance issues. At the time he was preparing tax returns for about 10 Trust Abuse Inc. clients but he has treated the trusts as grantor trusts and reported all income on the taxpayer's personal 1040. Mr. Cooper is no longer referring clients to him.

A couple of years ago, an attorney by the name of Martin Mills was affiliated with Trust Abuse Inc. (Exhibit W4-1). Whatever the relationship Mr. Mills had with Trust Abuse Inc. or Mr. Cooper, it discontinued prior to the beginning of the 6700 investigation.

e. Evidence Related to IRC 6700 Violations:

Mr. Cooper has made false or fraudulent statements regarding the tax advantages during his sales seminars and they are discussed to various degrees in the marketing booklets used by Trust Abuse Inc. The following false or fraudulent tax positions were all clearly discussed in the marketing booklet "The Business Trust A-Z" (Exhibit W3-1d):

1) Elimination of self-employment taxes by placing the taxpayer's business into a business trust (page 11);
2) The tax free exchange of assets for Units of Beneficial Interest in the trusts (page 15);
3) Claiming a new basis at fair market value for depreciable property (pages 14 & 20);
4) Conversion of the taxpayer's residence into rental property and claiming utilities, repairs, maintenance and depreciation on the house and furnishings as deductions (pages 12 & 45);
5) Claiming deductions for life insurance, disability insurance, medical expenses, education expenses, pension plan, and other personal expenses of the grantor or beneficiary as employee benefits (page 9 & 27); and
6) Deductions can be claimed for contributions to the taxpayer's personal charitable foundation with benefits coming back to the taxpayer in the form of wages, per diem payments, and grants (pages 11 & 41).

Mr. Cooper indicated that most of the promotional booklets he plagiarized from other trust promotions and attorneys reviewed the information.

On 7-12-97, Dr. Carleton Glendale, a Chiropractor, attend one of Trust Abuse Inc. seminars held at the Endicott Suites in Ripon (Exhibit W4-1). There were about 25 people at the seminar. Mr. Cooper conducted the seminar and introduced Martin Mills as an attorney that had reviewed and approved the trust system being marketed. A couple of key points made during the meeting were:

1) the exchange of assets for units of beneficial interest was not a taxable event,
2) the transfer of assets would be at fair market value, and
3) the taxpayer could retain complete control to operate their business except for the purchase of assets which would have to be approved by the trustees.

The typical 3 trust package would cost between $5,000 to $10,000, depending on how many documents have to be prepared.

On 9-23-97, Dr. Morris Rockmont provided the Internal Revenue Service with promotional materials received while attending one of Trust Abuse Inc. seminars put on by Mr. Cooper (Exhibit W5-1). Included in the package were booklets entitled "The Trust Advantage A-Z, Reduce Your Tax Liability Legally, and What CPA's & IRS Don't Want You to Know." These promotional materials contained all of the false statements discussed above.

Mr. Cooper initially cooperated with the examiner, consented to be interviewed on 5-30-98, and he provided copies of some the publications that he used as reference materials which he used in compiling the Trust Abuse Inc. promotional materials (Exhibit W2-1a, 1b & 1c). Generally, the reference materials were publications of other trust promoters. Mr. Cooper did not provide all of the Trust Abuse Inc. promotional documents, a client list, and/or a list of sales agents as requested by IRS summons (Exhibit 1-1e) on 4-28-98. In a letter dated 6-24-98, Mr. Cooper stated that he would "exercise my Fifth Amendment right and refuse to participate in any further discussion with you, or any other employee of the IRS (Exhibit W1-1b). Since that time, Mr. Cooper has not cooperated in any way with the examiner.

5. IRC 6700

It is the Government's position that the following statements, made by Mr. Cooper and made in the Trust Abuse Inc. promotional materials are false and/or fraudulent within the meaning of section 6700 of the Internal Revenue Code:

1) Elimination of self-employment taxes by placing the taxpayer's business into a business trust (page 11);
2) The tax free exchange of assets for Units of Beneficial Interest in the trusts (page 15);
3) Claiming a new basis at fair market value for depreciable property (pages 14 & 20);
4) Conversion of the taxpayer's residence into rental property and claiming utilities, repairs, maintenance and depreciation on the house and furnishings as deductions (pages 12 & 45);
5) Claiming deductions for life insurance, disability insurance, medical expenses, education expenses, pension plan, and other personal expenses of the grantor or beneficiary as employee benefits (page 9 & 27); and
6) Deductions can be claimed for contributions to the taxpayer's personal charitable foundation with benefits coming back to the taxpayer in the form of wages, per diem payments, and grants (pages 11 & 41).

a. Materiality

The deposits into the Trust Abuse Inc. bank accounts (Exhibit W13-1) suggest that Mr. Cooper has been very successful in marketing the abusive trust arrangements. If the only false or fraudulent feature utilized by these trust clients was the elimination of self-employment tax, the average business person would be understating his tax liability by anywhere from $5,000 to $10,000 each year. If a hundred clients utilized this only this one fraudulent feature, the harm to the Treasury would be $500,000 to $1,000,000 every year the trust scheme is utilized.

b. Knowledge of the Misrepresentation

Mr. Cooper is fully aware that the IRS issued Public Notice 97-24 warning the public about the improper tax positions being advocated by trust promoters (Exhibit W1-1c). In response, Trust Abuse Inc. circulated a position paper (Exhibit W5-1f) explaining why their program was not an abusive trust arrangement as defined in the Notice. The position paper states that the trust arrangements they create are not within the scope of the public notice for the following reasons:

1) The grantors do not retain complete custody and control of the assets of the trusts.
2) Only completed gifts to a trust are subject to gift or estate taxes. Since the grantor exchanges property for units of interest, a completed gift has not occurred.
3) Real or personal property transferred to a trust may be converted into business or rental use by the trust. Then all expenses associated with the property can be claimed as business deductions for the trust.
4) The charitable trusts they organize would benefit genuine charities.
5) Foreign trusts are not a part of the portfolio they offer.
6) Civil and/or criminal penalties would only apply to promoters that do offer trusts with the exaggerated tax benefits outlined in the notice. We are a conscientious company that would not promote such trust arrangements as discussed in the notice.

It is our opinion that the tax positions outlined in Trust Abuse Inc. promotional materials are essentially the same as the examples cited in the public notice.

6. Penalty Calculation

Mr. Cooper has refused to provide a detailed client list (Exhibit W1-1c) as requested by the summons issued on 4-28-98. Consequently, the government does not know how many trust arrangements Mr. Cooper or his company Trust Abuse Inc sold.

Mr. Cooper currently owes the government a substantial amount of unpaid taxes (Exhibit W12-1a) and the corporation has not filed income tax returns for the last two years. It is doubtful that monetary penalties asserted under IRC 6700 would cause Mr. Cooper or his company to discontinue selling this abusive Trust Abuse. Therefore, it is recommended that civil penalties under IRC 6700 not be asserted at this time.

7. Injunction Action Under IRC 7408

a. Penalty Conduct

The prior discussion has shown that Mr. Cooper is engaged in conduct that is subject to an IRC 6700 penalty. Mr. Cooper is actively selling trusts arrangements based upon the false statements or fraudulent statements regarding the tax benefits of the trust arrangements.

b. Likelihood of Recurrence:

Since the initiation of the IRC 6700 case, Mr. Cooper and Trust Abuse Inc. have continued to market their abusive trust arrangement. Trust Abuse Inc. has produced and circulated a position paper that states that the trust arrangements marketed by Trust Abuse Inc. are fully compliant with federal income tax laws and do not have any of the characteristics described in Public Notice 97-24. Obviously, Mr. Cooper did not heed the warning in the notice that abusive trust promoters may be subject to civil and/or criminal penalties.

Mr. Cooper has refused to cooperate in any manner with the examining agent since the initial interview. In addition, Mr. Cooper has a history of failing to file income tax returns. Currently, Mr. Cooper has not filed any personal income tax returns since 1997. Trust Abuse Inc. has not filed any income tax returns since it was formed in 1996. Also, Mr. Cooper has not paid his outstanding tax liability for the years of 1993, 1994, 1995, and 1996, which total $361,978 (Exhibit W12-1a).

8. Venue:

   a. Location of Assets, Documents, Books and Records:

      Mr. Cooper is currently operating the Trust Abuse Inc. business from a leased professional office complex (Exhibit 15-1) located at:

      Trust Abuse Inc.
      XXX Concord Ave.
      Anywhere, Any State, XXXXX

      It is presumed that all the business records are in Mr. Cooper's custody, located at this office.

   b. Market of Promotion:

      The bank deposit records (Exhibit W13-1a) for Trust Abuse Inc. suggest that Mr. Cooper is marketing the trusts all over the United States. Mr. Cooper may have a number of agents earning commissions for bringing in customers. However, the government has not determined the identity of the sales agents.

   c. Residence of Promoter:

      Mr. and Mrs. Cooper's personal residence is located at:

      Calvin & Winona Cooper
      XXX Fisk Street
      Anywhere, Any State, XXXXX

9. Pre-filing Notification:

   a. Basis for use:

      Revenue Ruling 84-84, 1984-2 C.B., Section 3, states that the requirement for taking pre-filing action is warranted where it is highly likely that there is a gross valuation overstatement, or a false or fraudulent statement with respect to the tax benefits to be secured by holding an interest in a Trust Abuse entity or arrangement. It is our determination that the "highly likely" standard as it applies to false statements made by Mr. Cooper has been established.

      The bank account records provides some of names and addresses of persons who may have purchased and utilized the abusive tax features marketed by Mr. Cooper and/or Trust Abuse Inc. Mr. Cooper has refused to comply with a summons issued to him on 4-28-99 (Exhibit W1-1d) which requested a complete client list for Trust Abuse Inc. Since enough information has been secured to proceed with the injunction case, summons enforcement was not requested. The Department of Justice can secure a complete client list during development of the IRC 7408 case. Therefore, it is recommended that pre-filing notification should be conducted once an accurate client list is secured.

10. Closing Conference:

a. Summary of Closing Conference:

On 2-1-00, Revenue Agent Emory Keen and District Counsel Attorney Langston Taft met with Mr. Cooper at the Anywhere IRS office (Exhibit W1-1f). It was explained to Mr. Cooper that the Service believes that Mr. Cooper and Trust Abuse Inc. have been marketing trusts for tax avoidance and the tax advantages that advocated by Mr. Cooper and Trust Abuse Inc. are false or fraudulent. Consequently, the Service is considering seeking an injunction to stop Mr. Cooper and Trust Abuse Inc. from continuing to market the abusive trust arrangements.

It was pointed out to Mr. Cooper that the Service believes that the following tax avoidance features found in the promotional brochure "The Business Trust A-Z" (Exhibit W3-1d) are false or fraudulent:

1) Elimination of self-employment taxes by placing the
2) taxpayer's business into a business trust (page 11);
3) The tax free exchange of assets for Units of Beneficial Interest in the trusts (page 15);
4) Claiming a new basis at fair market value for depreciable property (pages 14 & 20);
5) Conversion of the taxpayer's residence into rental property and claiming utilities, repairs, maintenance and depreciation on the house and furnishings as deductions (pages 12 & 45);
6) Claiming deductions for life insurance, disability insurance, medical expenses, education expenses, pension plan, and other personal expenses of the grantor or beneficiary as employee benefits (page 9 & 27); and
7) Deductions can be claimed for contributions to the taxpayer's personal charitable foundation with benefits coming back to the taxpayer in the form of wages, per diem payments, and grants (pages 11 & 41).

b. Defenses Raised:

Mr. Cooper indicated that he does not believe any of these statements made in the brochure are false or fraudulent. He claimed that there are several cases pending with Tax Court regarding these issues and that the court will settle the matter as to whether any improper tax positions have been claimed.

Mr. Cooper claimed that he did not write the promotional brochure but that it was drafted and reviewed by several accountants and attorneys including Mr. Ashland and Mr. Mills. Furthermore, Mr. Cooper is not a licensed tax return preparer, therefore, how can he be held liable for the tax positions claimed by his clients.

Mr. Cooper stated that he did not understand why the Service was targeting his business when there are many companies advocating the use of foreign entities to evade tax. Those companies suggest that after you create the foreign entity, income can be channeled to the foreign entity and no income tax returns are required to be filed and no taxes are ever paid.

c. Efforts Made to Verify Assertions of Promoter:

Mr. Ashland, a CPA, was interviewed on 6-2-98 (Exhibit W3-1a). During the interview, he stated that he had attended 2 seminars put on by Mr. Cooper. He indicated that he disagreed with Mr. Cooper on all the key tax avoidance issues. Mr. Ashland indicated that on several occasions he told Mr. Cooper that the tax advantages being promoted were not valid. As a consequence, Mr. Cooper discontinued referring any clients to Mr. Ashland.

d. Discussion of Facts that Rebut Defenses:

During the initial interview with Mr. Cooper stated that he prepares tax returns for only those trust clients who hire Trust Abuse Inc. to be their independent trustee (Exhibit W1-1c). Mr. Cooper also indicated that Trust Abuse Inc. was trustee for about 30 clients. Of course, Mr. Cooper is not required to sign the return as a paid tax return preparer since he serves as the trustee.

11. Recommendations and Conclusions of Revenue Agent:

Mr. Cooper has made false or fraudulent statements as to the tax benefits available to taxpayers using his trust arrangements. Mr. Cooper knows or has reason to know that the tax benefits of his contractual trusts are not allowable under federal tax laws. Nevertheless, Mr. Cooper continues to market these trust arrangements. Mr. Cooper should be held liable for civil penalties under IRC 6700, and an injunction should be sought under IRC 7408 in an effort to prevent Mr. Cooper and his company Trust Abuse Inc. from continuing to promote the creation and use of these abusive trust arrangements.

Lesson 11

THE ROLE OF DISTRICT COUNSEL

Introduction

Background

This lesson discusses the role of the District Counsel attorney in the 6700/ 6701/7408/pre-filing letter process.

Objectives

At the end of this lesson you will be able to describe the role of District Counsel in the:

- 6700 Committee
- ensuing examination
- recommendation for action
- defense of the 6700 or 6701 penalties, including defense letters
- pre-filing letters
- 7408 injunction suit letter

Contents

In General

Overview

This lesson describes the roles and responsibilities of District Counsel in cases involving IRC 6700 and 6701 penalties, injunctions under IRC 7408, and pre-filing notification letters.

6700 Committee

In each district a 6700 Committee will be formed with representatives from:

- District Counsel
- Criminal Investigation
- Examination Branch

A senior trial attorney from District Counsel will also serve on the Committee. In those districts serviced by more than one District Counsel office, only the District Counsel attorney whose office has jurisdiction over the promoter/salesman will act as the Counsel voting member.

The Committee will meet as often as necessary to review the submitted information and select promoters/shelters for IRC 6700 examinations. These examinations may result in:

- IRC 7408 injunction referrals,
- the assessment of penalties under IRC 6700 or 6701, and/or
- the mailing of pre-filing notification letters.

These remedies are nonexclusive. The use of pre-filing notices does not eliminate or reduce the need to seek an injunction nor to impose penalties under IRC 6700 or 6701.

If there is disagreement among the committee members as to whether a specific promoter/scheme should be selected, the matter will be forwarded to the District Director and the District Counsel for resolution.

Attorney responsibilities

The District Counsel attorney role is that of legal adviser to the Committee. In those instances when more than one District Counsel office covers an IRS district, the District Counsel office having jurisdiction over the promoter/salesman will be the office to be represented on the committee for that promotion. Multi-district promotions must be coordinated with other affected District Counsel offices.

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Preliminary determination

If the Committee determines that there is significant potential for developing the case as an abusive tax shelter, it will

- forward the case to Examination to open a 6700 case, and
- notify District Counsel that an investigation will be opened.

Examination will assign a revenue agent to the case, and District Counsel will assign an attorney to provide ongoing legal assistance throughout the case.

Burden of proof

The Committee does not need to determine at this point whether there is "proof" of a violation under 6700 or 6701, only whether there is a reasonable probability that the promoter's conduct violates the tax laws and that an investigation into such conduct is warranted.

To put this in other terms, at this point in the 6700 process, there must only be "probable cause" to investigate to determine whether a violation exists, not proof of such violation.

Responsibilities During the 6700 Examination

In general

When an agent and an attorney are assigned to a 6700 investigation, the attorney assigned to the case will meet with the revenue agent to discuss what information is needed for a determination as to the abusive nature of the shelter.

The District Counsel attorney will assist the revenue agent in preparing a contact letter informing the promoter that a 6700 case has been opened and requesting books and records including:

- accounting records
- information on the shelter's assets
- names of investors
- other appropriate documentation

The request for information in the letter should be in a format suitable for summons enforcement. The District Counsel attorney should work closely with the agent to prepare summonses promptly and assist in development of the case to make certain that there are no delays in referring the case for an injunction or other appropriate relief.

Continued on next page

Summons

When a promoter refuses to cooperate with the examination by providing the requested information, issuance and enforcement of an IRC 7602 summons may be used to develop the case. *United States v. Tiffany Fine Arts*, 469 U.S. 310 (1985).

The purpose of an IRC 7602 summons is to develop evidence that the shelter is abusive and to determine the amount of penalties due.

Speedy processing will ensure that pre-filing notices are issued timely and that the activity is promptly enjoined. A special unit has been established in the Department of Justice for 7408 injunctions. The unit will promptly review summons requests and other actions in such a case.

If it becomes necessary to enforce a summons, an enforcement letter should be sent directly to:

Department of Justice
Attention: Chief, Civil Trial Section, Central Region
Assistant Attorney General
Tax Division
Washington, D.C. 20530

Copies should be sent to Chief Counsel, Field Service Division, Attn: Chief, Passthroughs & Special Industries Branch.

Summons timing: The summons should be issued in the examination phase of a 6700/6701/7408 case when the promoter refuses to respond to informal document requests. However, use of the summons should not delay concurrent Examination activity dealing with other aspects of the shelter

Counsel will assist Examination in:

- determining if additional examination work is necessary
- issuing the summons
- drafting the 30/90 day letter

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Statutory Notice coordination

Counsel will work with Examination and Appeals to develop preapproved, "pattern" notice-of-deficiency or FPAA language applicable to recurring types of shelter promotions, thereby reducing the need for case-by-case approval by Counsel.

Where review of shelter notices by Counsel is necessary, Counsel will ensure expeditious review. In discussing preapproval, pattern notice-of-deficiency language, and reviewing specific notices, Counsel will ensure that each shelter notice to be issued by Examination or Appeals reflects the shelter name and type and, if already assigned, a TL-CATS "project code" or "project number" (CCDM Exhibit (35)300-6). The issuance of statutory notices or FPAAs may be concurrent with the 6700 investigation.

Valuations for non-docketed cases

If the 6700 case depends on a valuation overstatement, the agent and the District Counsel attorney should consider carefully, on a case-by-case basis, whether the Service can meet its burden of proof without a formal valuation report, either by a revenue agent engineer or an outside expert. A formal report will normally be obtained prior to any judicial hearing.

In regard to concurrent examinations of investors: experience has shown that appraisals on a representative-sampling basis with respect to a "cookie-cutter" promotion may be sufficient, depending upon the specific facts and circumstances.

There may be independent evidence of the asset's value or gross overvaluation so that a formal appraisal is not necessary at the pre-statutory notice stage. Counsel should not routinely require pre-statutory notice formal appraisals or valuations for each shelter asset promoted. If a formal valuation is not obtained, Counsel should be satisfied prior to the issuance of a statutory notice that the case file contains sufficient documentation and supporting facts.

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Responsibilities During the 6700 Examination, Continued

Referral to CI

If the agent determines that there are firm indications of fraud, the case will be promptly referred to CI. CI will either accept or reject the referral within 10 working days. The agent will make no contact with the promoter(s) during this period. If CI accepts the referral, all further contacts with the subjects of the criminal investigation shall be made in accordance with existing procedures governing the conduct of criminal investigations.

The investigation will proceed as a joint CI/Exam investigation. CI will investigate the promoter and other targets. Exam will investigate the investors. The institution of a joint investigation should not impede the progress of the IRC 6700 examination or the decision to proceed with an IRC 7408 injunction.

Upon commencement of a joint investigation the District Counsel attorney will give advice on both the civil and criminal aspects, unless the CI investigation becomes a grand jury investigation. In grand jury cases, another attorney will be assigned to the grand jury proceeding.

Prior to the referral of any potential criminal case to the Department of Justice, or if a grand jury is contemplated or sought, the District Counsel attorney will ensure that the 6700 examination is completed and that the revenue agent will be insulated from any criminal proceedings.

Joint responsibility

The revenue agent and attorney are jointly responsible for recommending whether the shelter is appropriate for a 7408 injunction, 6700 or 6701 assessment, and/or a pre-filing notification. If it appears such procedures are warranted, the promoter(s) will be given the opportunity to present facts or legal arguments to the attorney and agent to show that there is an acceptable basis for believing that the claimed tax benefits comply with the law.

After appropriate consideration of any facts and legal arguments submitted by the promoter(s), the revenue agent and District Counsel attorney will make a recommendation to the District Director. The writing of the recommendation to the District Director (i.e., the RAR) is the responsibility of the agent, as explained in Lesson 10 on report writing. The District Counsel attorney may assist.

Specific Procedures

Pre-filing notification

The revenue agent, with the assistance of District Counsel, will prepare a memorandum briefly summarizing the basis for pre-filing notification (e.g., nonexistent assets, depreciation/investment tax credit on overvalued assets, sham transactions, claiming of false or fraudulent deductions). The attorney will prepare the proposed pre-filing notification letter.

The revenue agent will forward the memorandum supporting the pre-filing notification to the District Director.

The pre-filing notification letter will then be sent to the investors. Copies will be sent to the Service Center so that a "PUSH" code can be entered. This will assure that returns of shelter investors will be screened upon filing to determine whether the shelter benefits are claimed, and to identify returns for examination. The notification letter will only be sent to those who have already invested in the shelter.

6700/6701 penalty

IRM 42(17)11 provides that the District Director's approval is required prior to assessment of the penalty. In addition, District Counsel must concur in the assessment.

Under appropriate circumstances 6700 and 6701 penalties may be assessed as jeopardy assessments under IRC 6862. If the person against whom a jeopardy assessment of a 6700 and 6701 penalty has been made institutes an IRC 7429 action, a copy of the District Counsel attorney's defense letter must be sent to National Office.

The penalties against a promoter or salesman may be assessed simultaneously with referral of a case to the Department of Justice for a 7408 injunctive action.

Following the procedures provided by IRC 6703(c), a person against whom a penalty has been assessed may seek to institute a refund action in federal district court. District Counsel will prepare a refund defense letter following the general refund defense procedures found in CCDM Chapters (35)(17)00 and (35)(18)00. Unlike a 7408 referral letter, a refund defense letter should be sent through National Office for review, rather than directly to the Department of Justice.

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Penalty amount

Pursuant to *Gates v. United States*, 874 F.2d 584 (8th Cir. 1989) and *Bond v. United States*, 872 F.2d 898 (9th Cir. 1989), the Service will calculate the 6700 penalty against the gross income the promoter derived from all sales or organizational activities during the time period of the scheme. The penalty is $1,000 per activity or 100 percent of gross income from each activity.

The alternative $1,000 per sale amount applies only where the percentage of gross income amount from the activity of promoting abusive tax shelters falls below $1,000; in such cases, the Service should not be seeking an injunction.

Defense letters to the Department of Justice should contain a detailed discussion of the gross income calculation. The source of funds upon which the gross income calculation is based should be identified as well as any reduction to gross income for cost of goods sold.

Note that the 6700 penalty is not assessed under the jeopardy provisions of the IRC and is not a divisible penalty. *United States v. Barr*, 89-1 USTC ¶ 9311 (S.D.N.Y. 1989); *United States v. Noske*, 93-1 USTC ¶ 50,087 (D. Minn. 1993), aff'd without published opinion, 8th Cir. 7/5/1994.

Statute of limitations

There is no statute of limitations on 6700 penalties. *United States v. Noske*, 911 F.2d 133 (8th Cir. 1990); *United States v. Capozzi* , 980 F.2d 872 (2nd Cir. 1993); *United States v. Tax Refund Litigation*, 766 F. Supp. 1248 (S.D.N.Y. 1991).

Burden of proof

The Government has the burden of proof regarding all penalties (IRC 6703 and 7491).

Burden of production

IRC 7491(c) provides that the IRS shall have the burden of production in any court proceeding with respect to the liability of any individual for any penalty, addition to tax, or additional amount, for court proceedings arising in connection with examinations commencing after July 22, 1998.

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Burden of persuasion

IRC 6703(a) specifically provides that the burden of proof is on the Service for 6700 and 6701 cases. The standard to be met is "by a preponderance of the evidence."

Note

See *United States v. Barr*, 67 F.3d 469 (2nd Cir. 1995). However, see *United States v. Tax Refund Litigation*, 766 F. Supp. 1248 (S.D. N.Y. 1991), to the effect that the burden of proving the correct amount of the penalty (i.e., that the Government's determination of amount is wrong) is on the promoter.

Elements to be proved

The following items should be briefly discussed in the letter to the Department of Justice to show the elements of the penalty under each section. Witnesses for each element should be referenced in the same manner as is used in a Criminal Reference Letter.

6700 cases

The letter should briefly show that the promoter assisted or participated in the preparation or presentation of a statement regarding some tax benefit, which he or she knows or has reason to know will be presented to the Service and which is false or fraudulent or contains a gross valuation overstatement.

As a matter of practicality, given the nature of the current abusive promotions, it is likely that 6700 penalties will be based on false or fraudulent statements as to tax benefits, rather than on gross valuation overstatements. A brief statement of the law in the area, with citations to a few controlling cases, should suffice to explain the false statements in most common tax shelter promotions.

For new types of shelters on which there are no decided cases, a more detailed discussion of why the shelter violates the IRC may be required. For example, until recently, a detailed discussion of the CISN (contingent installment sale note) shelter would have been necessary; now, an explanation of how your particular variant works, plus a citation to *ACM Partnership v. Commissioner*, T.C. Memo. 1997-115, aff'd in part, rev'd in part, 157 F.3d 231 (3rd. Cir. 1998), cert. denied, 119 S.Ct. 1251 (1999) and ASA Investerings Partnership v. Commissioner, T.C. Memo. 1998-305), would likely be sufficient.

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6701 cases

The letter to the Department of Justice should be directed toward showing that the promoter is implicated in the preparation or presentation of a document, some portion of which he or she knows or has reason to know will be used in connection with a material matter arising under the tax laws and knows that such position would result in an understatement of the tax liability if so used.

A computation of the tax liability of the other person (or, more likely, of the total tax liabilities of the multiple participants in the scheme) will be needed, along with the supporting evidence on how the tax liability is computed.

There is no statute of limitations on 6701 cases. See, *United States v. Mullikin*, 952 F.2d 920 (6th Cir. 1991), cert. denied, 10/5/92; *United States v. Lamb*, 977 F.2d 1296 (8th Cir. 1992); *United States v. Lea*, 882 F.Supp 687 (N.D. Tenn. 1995).

Non-natural persons are liable for the 6700 penalty. *United States v. Robertson & Co.*, 93-2 USTC ¶ 50,392 (N.D. Tex. 1993).

For other cases involving computation of the 6700 penalty, see *United States v. Kuchan*, 679 F.Supp. 764 (N.D. Ill. 1988); *United States v. Mitchell*, 977 F.2d 1318 (9th Cir. 1992); *United States v. Golletz*, 91-1 USTC ¶ 50,233 (N.D. Ill. 1991); *United States v. Berger*, 97-1 USTC ¶ 50,420 (D. Conn. 1997), on remand from 87 F.3d 60 (2nd Cir. 1996).

IRC 6703 considerations

The promoter must show proper jurisdiction for a 6703 case. This means that he must timely pay the 15% within 30 days of the notice and demand **and** file a claim for refund within that same time period. The promoter must **also** bring suit in Federal District Court within 30 days of receiving a Notice of Claim Disallowance, or within 30 days after the expiration of six months from the filing of the claim, whichever is earlier.

If the promoter does not do this, the disallowance will be considered to be final and suspension of collection activities under IRC 6703 will be lifted. He will also have failed to obtain jurisdiction of the court under 6703. This means that he will have to fully pay the penalty (i.e., meet the "full payment" rule of Flora) and then sue for a refund. *United States v. Thomas*, 755 F.2d 728 (9th Cir. 1985); *United States v. Dalton*, 800 F.2d 1316 (4th Cir. 1986); *United States v. Autry*, 889 F.2d 973 (11th Cir. 1989); *United States v. Producers Brokerage Co., Inc.*, 91-2 USTC ¶ 50,358 (D.C. Conn. 1991); *United States v. Korobkin*, 988 F.2d 975 (9th Cir. 1993).

IRC 7408 Injunctions

Preliminary information

Injunctions may be issued to prevent current conduct which would be penalized under 6700 or 6701. Thus, in addition to the elements listed under the above sections, the agent must also show that the promoter is **presently engaged** in such conduct.

Therefore, the letter to the Department of Justice must also show that the promotion is currently ongoing and currently involving a number of participants. Among the exhibits enclosed with the letter should be the current promotional materials, an estimate of the number of current participants, and an estimate of harm to the Government in terms of tax loss.

The District Counsel attorney will prepare a 7408 referral letter authorizing the Department of Justice to institute suit on behalf of the Service.

A legal file should be opened and assigned a TL:INJ-xxxx number. The first digits indicate the number of the shelter injunction assigned since the first of the year and the last two digits indicate the current year.

7408 suit letter

The suit letter should contain the following information (also see the discussion in the lesson on the Department of Justice):

- Promoter's background.
- Promoter's current activity which is covered by 6700, 6701, and 7408. The promoter's prior activities may also be discussed as a means of showing the promoter's familiarity with tax law, particularly in the context of whether the promoter knows (or has reason to believe) that such document or portion or a document will be used in connection with any material matter arising under the internal revenue laws; and knows that such portion (if so used) will result in an understatement of the tax liability of another person, as per IRC 6701.

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7408 suit letter, continued

- Discussion of the proper venue for the suit. Under IRC 7407, the Service may bring a civil action in the U.S. District Court for the district of the:
  - return preparer's residence,
  - return preparer's principal place of business, or
  - residence of the taxpayer with respect to whose return the action arises.

  The attorney may wish to recommend a particular venue for suit, based upon the availability of the evidence or other factors.

- Appropriateness of injunctive relief. The Committee Reports for the Tax Reform Act of 1976 (which enacted IRC 7407) indicate that injunctive relief sought by the Service must be commensurate with the conduct which led to the seeking of the injunction.

  For example, if an income tax return preparer, who is only experienced in preparing individual returns, overstates his qualifications as a preparer by claiming expertise in the preparation of corporate returns, the injunction would be directed toward the misrepresentation itself or the preparation of corporate returns and not toward preventing the preparer from preparing any returns at all.

  Furthermore, if only some of an employer's employee-preparers have engaged in conduct leading to a request for an injunction against the further preparation of returns, any injunction is to be sought only against those preparers and not the employer (or other employees), unless the employer (or other employees) is actively involved in the improper conduct. *Turner v. United States*, 601 F.Supp 757 (E.D. Wisc. 1985), aff'd w/o published opinion (9th Cir. 1/31/1990); *Gates*, supra; *United States v. Robertson & Co.*, 828 F.Supp. 442 (N.D. Tex. 1993).

- A description and a legal analysis of the shelter. This section should contain a clear explanation of the substance of the transaction and an explanation of the basis on which the attorney concludes that there has been a 6700 or 6701 violation (i.e., a discussion of what tax laws have been violated and in what manner).

Continued on next page

7408 suit letter, continued

- A description of the relief sought. If the court finds that the promoter or salesmen have engaged in one or more of the enumerated practices, it may enjoin them from further engaging in such conduct. The court's jurisdiction in this case may be exercised separate and apart from any other action brought by the U.S. against the promoter or any taxpayer.

  Note that if a court finds that a return preparer has continually or repeatedly engaged in prohibited practices, it may also enjoin him or her from acting as an income tax return preparer; however, it is unlikely that a court would enjoin a promoter from selling any tax shelter. Thus, the relief sought must specifically identify the types of false or fraudulent statements or actions that are to be enjoined.

  United States v. Estate Preservation Services, 38 F. Supp. 3d. 846 (E.D. Cal. 1998) *aff'd* 2000-1 USTC ¶ 50,203 (9th Cir. 2000) is in the Appendix.

- Evidence supporting the 6700 or 6701 violation. This evidence may be from the prospectus for the shelter, from interviews with witnesses, etc. All such evidence discussed in the body of the letter should be cross-referenced to the attached exhibits similar to the practice in criminal referral letters.

- A list of potential witnesses with addresses and telephone numbers.

- A one-page summary sheet of these 6 elements in outline form.

The 7408 suit letter should be addressed and sent directly to:

Department of Justice
Attention: Chief, Civil Trial Section, Central Region
Assistant Attorney General
Tax Division
Washington, D.C. 20530

Copies should be sent to Chief Counsel, Field Service Division, Attn: Chief, Passthroughs & Special Industries Branch.

Continued on next page

7408 suit letter, continued

Because of the particular need for expeditious handling for these efforts to be effective, all referrals of summonses involving 6700 examinations and all 7408 suit letters will go directly from District Counsel to the Department of Justice. There will be no prereview of these matters at either the Regional or National Office levels.

To maintain high quality and consistency District Counsel is encouraged to seek necessary pre-referral assistance and advice from either Regional Counsel or the National Office. The appropriate National Office divisions will receive simultaneous copies of all direct referrals made pursuant to this program. These referrals will receive a post review so that the divisions can coordinate issues with the Department of Justice and make necessary adjustments in existing procedures.

Post-referral activities

The agent and District Counsel attorney will be expected to work with and assist the Department of Justice attorney in preparing the injunction action for trial.

The Service does consider offers by defendants and potential defendants to enter into consent agreements in which the defendant or potential defendant party would agree to an order to permanent injunction under 7408. If the Service receives such an offer either formally or informally prior to referral of the case to the Department of Justice, District Counsel and Examination personnel should gather from the defendants or potential defendants the information that was requested in the initial contact letter, in order to ensure that a case can be developed if the negotiations break down.

The Department of Justice has agreed that if they enter in to negotiations subsequent to referral of a case to them, the District Counsel attorney will participate in each item negotiated at all stages. If an agreement cannot be reached between the District Counsel attorney and the Justice Department attorney on negotiated items, the National Office is to be notified.

The attorney should be aware that, even after a 6700/6701 penalty is assessed or an injunction is obtained, further coordination may be needed with the Department of Justice, Collection, Appeals (during the CAP), or Public Affairs.

Summary

A senior trial attorney from District Counsel serves on the District 6700 Committee and assists with the preliminary determination on potential 6700 investigations.
During the investigation, the District Counsel attorney helps the revenue agent determine what information is needed and prepare necessary letters, IDRs, etc.
The District Counsel attorney and revenue agent decide together what action to recommend regarding the abusive promotion.
If penalties or injunctive action are recommended, the District Counsel attorney prepares the letter to the Department of Justice showing the elements of the 6700/6701 penalty or the 7408 injunction

Lesson 12

THE ROLE OF THE DEPARTMENT OF JUSTICE

Introduction

Background

Injunctive actions under IRC 7408 are brought in Federal District Court by attorneys in the Tax Division of the Department of Justice (DOJ).

Objectives

At the end of this lesson you will be able to:

1. Describe DOJ's role in injunctive actions under IRC 7408 and IRC 6700/6701 penalty suits.

2. Identify the elements necessary to obtain an injunction.

Contents

Responsibility for Tax Litigation

In general

The conduct and control of all federal tax litigation, except that in the United States Tax Court, is vested in the Department of Justice. This includes:

- prosecution of criminal cases
- litigation in bankruptcy, probate, and insolvency courts
- defense of mortgage foreclosure suits involving tax liens
- tax refund suits
- wrongful levy suits
- collection suits against delinquent taxpayers
- enforcement of administrative summonses
- injunction suits

There is no authority for Chief Counsel attorneys to handle the actual litigation of general litigation cases unless the Chief Counsel and the Assistant Attorney General (Tax) approve the request This is generally done for Special Assistant United States Attorneys in bankruptcy cases.

The Attorney General

The Attorney General heads the Department of Justice. The Attorney General has delegated the litigation of tax cases to the Tax Division, but has retained the authority to settle cases where the claim of (or against) the United States is in excess of a specific amount.

The Solicitor General

The Solicitor General supervises all litigation in the Supreme Court, including tax litigation, and determines whether the Government shall appeal any case, civil or criminal, including appeals from decisions of the Tax Court.

To make this determination in tax cases, the Solicitor General weighs the recommendations of the Chief Counsel and the Tax Division of the Department of Justice as well as, in certain situations, the United States Attorney.

In the court of appeals, the trial is performed by personnel of the Tax Division or, on occasion, by the United States Attorney.

Continued on next page

Responsibility for Tax Litigation, Continued

The Tax Division

The Assistant Attorney General (Tax) is in charge of the Tax Division and supervises of all tax litigation, except cases before the Tax Court.

The Division is composed of various sections, the most important of which, for IRC 7408 purposes, are the Civil Trial Sections.

Civil Trial Sections

In addition to the Claims Court Section, there are several Civil Trial Sections, each generally handling all civil litigation from a particular region of the country.

All cases involving an injunction against those involved in the promotion of an abusive tax shelter or those who aid and abet the understatement of taxes and cases involving refunds of penalties arising under IRC 6700 and 6701 are transferred to the Civil Trial Section, Central Region, for handling.

The Civil Trial Sections and the Claims Court Section are under the immediate direction of the Deputy Assistant Attorney General (Tax Division).

United States Attorneys

Each judicial district of the United States is assigned a United States Attorney and one or more assistants. In some of the larger offices (e.g., the Southern District of New York and the Northern and Central Districts of California) there are tax sections within the United States Attorney's offices. In other offices, one or more assistants may specialize in tax matters. Jurisdiction over cases in litigation within the judicial district involving the federal government is generally under the United States Attorney.

The extent of the actual handling of tax litigation cases by attorneys from the Civil Trial Sections as opposed to the various United States Attorney's offices may vary from judicial district to judicial district. It is controlled by written directives based on the nature of the case. Some District Counsel attorneys are appointed Special Assistant United States Attorneys, under the authority of the Attorney General, in order to assist the local United States Attorney in some tax matters (primarily in bankruptcy cases).

IRC 7408 Litigation

IRC 7408

IRC 7408 is used to enjoin abusive promotions. It allows suit against the promoters of an abusive tax shelter to enjoin them from further engaging in conduct subject to penalty under IRC 6700 and/or 6701.

An injunction is simply a court order stopping someone from engaging in certain behavior. Injunctions can be obtained against those who promote or sell or participate in the promotion or sale of abusive promotions, to stop them from engaging in that behavior.

The suit can be brought in the Federal District Court for the district where the promoter

- resides,
- has his/her principal place of business, or
- has engaged in conduct subject to penalty under IRC 6700 or 6701.

Enjoining those who promote abusive schemes may have a significant compliance effect. It stops taxpayers from getting involved in the first instance, eliminating tax losses and future audits. It is often the best method of attacking the problem of offshore accounts, as it keeps a promoter from advising taxpayers to improperly move assets out of the country in the first instance.

Typically, when an injunction suit is filed, a press release is issued, which alerts would-be and actual investors that the Government thinks the scheme is abusive, and that associated tax benefits cannot be legitimately claimed. Often another press release is issued when an injunction is obtained. These press releases let the public know that the IRS is looking at abusive transactions, and is interested in protecting the public from those who seek to improperly profit by manipulating (or ignoring) the tax laws.

Continued on next page

IRC 7408 Litigation, Continued

Elements necessary for injunctive relief

To obtain an injunction, the District Court must find that:

- the person is engaged in conduct subject to penalty under IRC 6700 or 6701, **and**
- injunctive relief is appropriate to prevent recurrence of that conduct.

Although IRC 6700 and 6701 provide for the assessment of penalties against promoters and others, it is **not** necessary that a penalty be assessed before an injunction can be obtained. It is necessary that the persons to be enjoined have engaged in conduct that would subject them to either or both of those penalties.

Appropriateness of injunctive relief

Appropriateness is established by showing that harm to the Government will occur if the promoter is allowed to continue. The estimated damage of recurring improper conduct must be weighed against any potential harm to the promoter. There are a number of factors courts look at in determining whether an injunction is necessary:

- Is the abusive activity currently ongoing?
- Does the promoter claim that the abusive promotion is legally correct, even after contact by the IRS?
- Has the promoter switched or modified the promotion after learning it was being investigated?
- How devious is the scheme? Does it involve outright falsehoods and/or altered or backdated documents? Does it actively promote fraud, as opposed to offering a strained interpretation of the revenue laws that have not yet been litigated?
- How widespread is the scheme? Local? Regional? Nationwide?

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Appropriateness of injunctive relief, continued

- How is it marketed? Large sales force? Seminars?
- How many taxpayers are affected or may potentially be affected?
- Did purchasers claim benefits consistent with the promoter's claims?
- How many audits have or will result? What is the estimated revenue loss? What is the estimate of the number of hours the IRS will expend?
- Does the promoter have a history of abusive conduct? Has the promoter engaged in promoting abusive tax shelters in the past, or engaged in securities laws violations?
- Does the promoter still retain the wherewithal to continue the challenged activity? Is there an established sales force in place?
- How much money has the promoter made? Hoe much does he/she stand to make?

Not all, or even most, must be present in order for a court to find that an injunction is appropriate.

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Injunctions can be tailored

Injunctions may be tailored to effectively deal with the type of scheme and the type of promoter involved. Injunctions may require a promoter to:

- Stop promoting the present scheme.
- Avoid violating IRC 6700 and/or 6701, or otherwise interfering with the enforcement of the revenue laws by the IRS.
- Stop making specific representations that have been shown to be false.
- Refrain from telling anyone that he/she may claim tax benefits consistent with the program that was sold.
- Provide a list of all those who purchased or participated in the abusive program.
- Notify all purchasers and participants in the program that the promoter or salesperson has been enjoined and provide each with a copy of the injunction order.
- Order the promoter to place a web site notice of the injunction if the Internet was used to sell the program.
- Require the promoter, for a defined period of time (e.g., for the next five years), to provide the Service with new promotional materials before marketing any other shelter.
- Require the promoter to note in any new materials that he/she has previously been enjoined from promoting abusive schemes.

An injunction may be effective in stopping more than just those who are parties to the suit. In *United States v. Estate Preservation Services,* a copy of the injunction order was served on the parties to the suit, and also to anyone else that was known to have been involved in promoting or selling the scheme. That action is consistent with Rule 65 of the Federal Rules of Civil Procedure, which provides that an injunction is also binding on the parties, "their officers, agents, servants, employees, and attorneys, and upon those persons in active concert or participation with them who receive actual notice of the order by personal service or otherwise."

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IRC 7408 Litigation, Continued

If the injunction is violated

If, after being enjoined, the IRS learns that a promoter has violated the terms of the injunction, contempt proceedings may be instituted in court. Promoters may be fined and/or imprisoned. Once a promoter has been enjoined, he/she cannot promote any more abusive schemes without risking imprisonment.

As a practical matter, to enjoin a person, that person will generally have to be located within the United States. This may not be as difficult as it seems, as many times those appearing to be promoting schemes from an offshore location, are located and/or frequently present in the United States.

Role of the Tax Division

Injunctions

IRS District Counsel, after IRS National Office review, requests the Tax Division to bring an injunction suit.

The Tax Division makes the final decision as to whether a suit will be filed. If the Division does not believe suit should be filed, the District will be provided the reason(s) and will be given an opportunity to persuade the Division to change its mind. The Tax Division may ask for additional information or development of a case.

Injunction actions are brought in Federal District Court and are litigated by lawyers in the Tax Division.

NOTE: Throughout the investigatory process, the Tax Division is available to discuss the merits of an investigation on a formal or informal basis. Consideration must be given to IRC 6103's confidentiality and disclosure strictures.

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Role of the Tax Division, Continued

Penalties

Penalties under IRC 6700/6701 may only be litigated in Federal District Court. A Tax Division Trial Attorney would be assigned the case.

A promoter who has been assessed a penalty and has timely paid all or the statutorily specified portion of it, and filed a timely claim for refund, may bring suit in Federal District Court seeking a refund. If the penalty has not been fully paid, the Government will usually counterclaim for the unpaid balance.

The Tax Division may bring suit, if requested by District Counsel, to reduce the penalties to judgment against a promoter, and to collect the amount owed. These penalties can be litigated at the same time an injunction suit is being litigated.

It is **not** necessary that the penalty be assessed before an injunction may be obtained. All that need be shown is that the persons sought to be enjoined engaged in conduct that would subject them to either or both penalties. If penalties are assessed before an injunction suit is brought (or while it is ongoing) it is likely that the issue of liability for the penalties will be combined in the injunction suit, thus making it potentially more difficult to obtain an injunction. IRS District Counsel should be consulted before assessing penalties if an injunction suit has been, or will be, recommended.

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What evidence must be present before suit will be brought?

There are a variety of factors that bear on the decision to seek an injunction. Some cases may include a large number of these factors, while others do not. There is no requirement that a case include a specific number of factors before the Tax Division will go forward with an injunction. However, the following factors and materials must be addressed and contained in most injunction referrals:

- An analysis of the mechanics of the abusive promotion with specific evidence of falsity, or overvaluation, and how the promotion comes within the purview of IRC 6700/6701.
- The identity of each person sought to be enjoined, and his or her role in the abusive promotion (i.e., organizer, one who assisted in the organization of, seller, or one who assisted in the sale of).
- Prospectuses, offering documents, and other materials reflecting the nature of the abusive promotion.
- In the case of false and or fraudulent statements, evidence that the person(s) sought to be enjoined knew, or should have known, of the statement(s)' falsity.
- In the case of a gross valuation overstatement, evidence of the correct value of the property or services, along with appraisals, if obtained.
- Information about how the abusive promotion is being marketed.
- An explanation of why injunctive relief is appropriate.

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Additional evidence

Evidence or information regarding the following is also desirable:

- Recent activity with respect to the abusive promotion.
- Past, current, and anticipated abusive promotional conduct.
- Names and addresses of potential witnesses, and summaries of their proposed testimony.
- All summons and foreign document requests.
- Legal and/or tax opinions used to market or support positions taken in the abusive promotions.
- Promoter's appraisals and underlying documents, correspondence, etc., as well as any appraisals the Service has obtained, or of which the Service is aware.
- Sample or suggested entries on a tax form, including a Schedule C, reflecting the purportedly allowable deduction or credit.
- SEC and state securities filings.
- Names and addresses of participants in the scheme.
- Estimated revenue loss to the Treasury.
- Estimated enforcement costs if the promotion is not enjoined.
- Estimate of income to be derived by the person to be enjoined.
- Documents intended to disguise the true nature of the transactions involved in the promotion. This may include undisclosed agreements among the participants, side agreements, documents such as letters of wishes in abusive trust promotions, backdated agreements, checks, notes, evidence of non-existent assets, false appraisals, forgiveness of recourse debt, misapplication of funds.

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Role of the Tax Division, Continued

Additional evidence, continued

- In the case of abusive international promotions, information regarding money and other assets entering or leaving the United States.
- Information regarding the prior tax shelter history and/or criminal investigation of the person sought to be enjoined. Include copies of all prospectuses or offering materials the person used in prior tax shelters, court decisions involving the prior promotion(s) and certified copies of any criminal convictions.
- Information of actual sales of the property that is at issue.
- Explanation of the defenses asserted or anticipated.

Who litigates injunction and penalty suits?

All injunction suits and 6700/6701 penalty litigation are litigated by the Civil Trial Section, Central Region.

Summary

DOJ's Tax Division will represent the government Federal District Court for both IRC 6700/6701 penalty suits and IRC 7408 injunctive actions.
IRC 7408 provides for injunctive action against persons involved in abusive tax promotions.
DOJ's Tax Division makes the final decision to pursue an IRC 7408 injunction.

Lesson 13

IRC 7408: AFTER THE INJUNCTION

Introduction

Background

After the injunction has been issued, it is imperative to follow through with a series of actions to guarantee the maximum benefit of all of the work performed. Issuing the injunction should not be the final action on the part of the Service.

Objectives

At the end of this lesson you will be able to:

1. List the various actions to be taken towards the conclusion of the injunction process.
2. Determine which actions will be most effective in deterring the promoter/preparer and the participants.
3. Decide which other functions/offices will be most effective in continuing to follow through with actions.
4. Explain the importance of coordination with other functions/offices.

Contents

Next Steps

After the injunction is issued

The injunction has been approved by Department of Justice and filed with the court. Now what?

- Issue news releases.
- Assess IRC 6700/6701 penalties.
- File or respond to aAppeals.
- Move investor returns into the audit stream.
- Monitor the promoter/preparer.

Examination and District Counsel must be available to cooperate with Department of Justice as needed throughout the proceedings.

Prior to closing the case

It is imperative to coordinate further actions with other offices both within and outside the Service. For example, the following offices may be of assistance in ensuring the injunction is as effective as possible:

- Communications Office (formerly the Public Affairs Office)
- Disclosure Office
- Appeals
- Collection
- Department of Justice

Further income tax examinations may be conducted on other investors not originally included in the injunction process, or on those dropped earlier by the Department of Justice.

The examination of the promoter/preparer should have been completed prior to the issuance of the injunction if he/she was participating in the scheme. This is true particularly if the scheme focuses on excess deductions.

Exercise 1

Once the injunction has been issued, why is it important not to discontinue further action?

Additional Actions

In general

To ensure the most effective results from the injunction process, try to coordinate with other offices. This will make it more likely that all applicable actions will be taken against the promoter/preparer.

Communications

Throughout the course of the injunction procedure, the local Communications Office should be kept informed of the actions against the promoter/preparer. When the Department of Justice (DOJ) issues the injunction, news releases should be released simultaneously by both the Service and DOJ. These news releases are extremely effective in spreading the word to potential investors. They may also encourage investors not previously examined to file amended returns.

News releases (Exhibit 13-1 is a sample) will include the following information:

- The fact that a permanent injunction has been filed preventing the sale of the promotion package.
- The name of the promoter.
- A brief description of what the promoter promised (e.g., inflated expenses, false deductions, off-shore protection).
- If pre-filing notifications were sent to investors, this will be noted.

Once the promoter/preparer is enjoined by the courts, it is imperative to get the news release to the local newspapers as soon as possible. Department of Justice and the local Communications Office will work together to write the news release. Results of an injunction or penalties assessment will be shared with state agencies in accord with disclosure procedures (IRM 42(17)(11).4(8)(c) and (d), in the Appendix).

Exercise 2

Why is it important to contact the Communications Office before the issuance of the final injunction?

Continued on next page

Additional Actions, Continued

Disclosure Office

It is imperative that the Disclosure Office review any information prior to its release. This includes the name of the promoter/ preparer, the name of the abusive shelter promotion, and what the promotion promised to do for the investors.

Collection

The importance of maintaining contact with Collection will be addressed in Lesson 15. This becomes crucial at the conclusion of the injunction process.

Working with a revenue officer (RO) during the course of the examination and injunction process will help ensure the ultimate pursuit of payment.

A specialized group of ROs who are trained in the injunction procedures could be formed within an office. This would result in consistent collection activity.

Exercise 3

Why is it important to include the Collection division in the contacts to be made during the injunction process?

Summary

Coordination with various offices is crucial:

- Communications Office (formerly the Public Affairs Office)
- Disclosure Office
- Appeals
- Collection
- Department of Justice

Thorough coordination ensures maximum impact on the public and on revenue collection.

Answers to Exercises

Exercise 1	In order to ensure the "biggest bang for the buck," appropriate follow-up actions need to be taken. Contacting other offices and divisions within the Service can create a coordinated effort against the promoter/preparer. It can also help ensure that collections pursues collection activity.
Exercise 2	It is imperative that news releases by both the Department of Justice and the IRS be issued simultaneously. Any delay by the Service in issuing the news release to the media could appear to indicate inactivity on our part. The important thing about the news release is to get the point across to the investors and potential investors.
Exercise 3	As a result of mandatory dollar criteria for revenue officers, it is important to stress the public relations aspect of an injunction and related penalties. Consistent contacts during this period can result in knowledge of assets and possible lien/levy sources. All of this aids in the likelihood that collection activity will be pursued.

Exhibit 13-1

News Release
Internal Revenue Service

For Further Information:
Troy Cook 555-555-5555

For Release: May 1, 2000

A complaint for a permanent injunction that will prevent a Chicago man from selling his "Un-Taxing America Program" instructing taxpayers how to evade paying federal income taxes was filed late Tuesday in U.S. District Court. The complaint, against Will Mitchell of 5555 W. Cook Road in Chicago, was filed by the U.S. Department of Justice.

According to the complaint, Mitchell, doing business as "Mesa Consultants," sold the "Un-Taxing America Program" that advised and encouraged taxpayers to unlawfully attempt to evade federal income tax. The program encouraged taxpayers not to file federal income tax returns and contained instructions (including correspondence and forms) to enable the purchasers to file false amended tax returns to recover tax previously paid and to file false Forms W-4 (tax withholding certificates) with their employers claiming that they are exempt from federal income tax withholding.

To back up these actions, according to the complaint, the "Un-Taxing America" packages contained statements that Mitchell knew, or should have known, to be false. These statements questioned the "validity and constitutionality" of the federal income tax laws.

According to William L. Thompson, the Director of the IRS Illinois District, the IRS has sent letters to taxpayers known to have purchased these "Un-Taxing America" packages. The letters advise these taxpayers of the IRS' position on "Un-Taxing America" schemes and the actions the IRS will take if these purchasers follow through with the procedures suggested in the packages. Thompson said that, as a result of the packages sold by Mesa Consultants, the IRS estimates its potential revenue loss to be in excess of $2.5 million.

In the past few years, according to Thompson, the IRS has detected an increasing number of groups throughout the country promoting abusive tax schemes. Said Thompson: "These arguments range from the patently ridiculous to those that sound more plausible but make equally frivolous contentions regarding the legality of the tax laws." Thompson said that these arguments and claims are often part of a "well rehearsed marketing strategy to gain paying members and sell abusive packages. Some of these groups earn substantial income at the expense of people who buy worthless advice included in seminars, books, and videotapes which hold out the promise of freedom from taxes."

Thompson warns consumers that promoters of these programs use "slick sales rhetoric" to sell these "groundless" tax schemes. Notes Thompson: "Taxpayers who choose to follow the advice of abusive tax promoters should know that serious financial consequences and potential criminal prosecution will result for anyone who willfully fails to file any required tax return or fails to pay any required tax."

Adds Thompson: "The courts have long upheld the constitutionality of the tax laws. These frivolous arguments have repeatedly been rejected by the courts. People who buy into these schemes have nothing to win – and everything to lose. The truth is, if it sounds too good to be true, it probably is."

Lesson 14

IRC 6700/6701 PENALTY ASSESSMENT

Introduction

Background

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) added IRC 6700 and 6701 to permit the IRS to assert penalties against promoters of abusive tax shelters and persons who knowingly aid and assist in the understatement of the tax liability of another person. Revenue agents assert these penalties. Written approval by the District Director is needed for the assertion of IRC 6700.

Objectives

At the end of this lesson you will be able to:

1. Compute IRC 6700 and 6701 penalties.
2. Complete IRC 6700 and 6701 penalty case files.

Contents

IRC 6700 Penalty

Definition

The 6700 penalty applies to any person who organizes, assists in the organization, or participates in the sale of any interest in any plan or arrangement, and who, in connection with such sale or organization, either:

1. Makes or furnishes a false or fraudulent statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing the any tax benefit by reason of participating in the entity, plan or arrangement; or
2. Makes or furnishes a gross valuation overstatement as to any material matter.

Return not required

It is not necessary to have a return filed in order to assess this penalty. A "person" for purposes of IRC 6700 includes:

- an individual,
- a partnership,
- a corporation,
- a trust, or
- an estate.

If the promoter is not an individual, the penalty may also be assessed against the entity's directors, officers, employees, and agents who assist in the promotion. There is no statute of limitation under IRC 6700, 6701, and 7408 and the burden of proof is on the government.

Penalty amount

The Omnibus Budget Reconciliation Act of 1989 (OBRA 1989) made changes to IRC 6700. For activities occurring after December 31, 1989, the penalty rate is the lesser of $1,000 per activity or 100% of the gross income from each activity. OBRA also made it clear that it applies to both direct and indirect actions of the promoters.

Continued on next page

Penalty is a tax

This penalty is considered a tax for enforcement purposes and may be assessed in addition to all other penalties that may be imposed under the code except IRC 6701. If the penalty is being assessed against an attorney, certified public accountant, or an enrolled agent, a referral is to be made to the Director of Practice. *See IRM 4297.9 for procedures.*

Additional considerations

Before penalties may be assessed, a memo signed by the District Director indicating approval of IRC 6700 penalty should be received by the revenue agent and included as part of the penalty case file. *See Exhibit 14-1.* In addition to this penalty, the revenue agent may recommend injunctive relief under IRC 7408 and issue pre-filing notification letters to participants. The revenue agent will be working closely with District Counsel. If an injunction is recommended, the revenue agent will also be working with Department of Justice.

IRC 6700 Procedures

Case file

The procedures for a promoter penalty case file are similar to return preparer penalties. IRM 4562.53(3) contains procedures for assessment.

The penalty case file will include the following:

- Form 4665, Report Transmittal
- Form 4549, Revenue Agent Report
- Form 886-A, Explanation of Items (including the penalty calculation)
- Form 8278, Computation and Assessment of Miscellaneous Penalties
- Form 4318, Examination Workpapers
- Form 3198, Special handling Notice

Time spent on 6700 cases should charged to activity code 593.

Form 4665

Form 4665 is required and used to briefly communicate the basis for the penalty, identify related cases, and list pertinent information.

Continued on next page

Form 4549	Form 4549, Revenue Agent Report, is to be issued.
Form 886-A	Form 886-A should be prepared in the special format required for injunction referrals to DOJ under IRC 7408. This format is recommended for penalty cases because the promoter may file suit in District Court to contest the penalty. *See IRM 4236(14) in the Appendix.*
Form 8278	Form 8278 is used to record the amounts. Instructions are located on the back of the form. A separate form is required for each calendar year that applies. If other penalties apply, check the Penalty Handbook for procedures. The tax year is the year the penalty is being assessed.
Form 4318	Form 4318 is the index and cover sheet for the workpapers.
Form 3198	Form 3198, Special Handling Notice, is to be attached to the front of the case file, with the annotation, "Civil Penalty Assessment IRC 6700."
Other considerations	Approved penalty cases are forwarded to District Counsel for preassertion review and approval. Following approval, they may be forwarded to ESP for assessment. If it is determined that the 6700 penalty will not be asserted, Letter 1866, IRC 6700 Discontinuance Letter (Exhibit 9-2), must be sent to the promoter.

Appeals Procedures

IRC 6703

Special claim procedures apply under IRC 6703 with respect to penalties asserted under IRC 6700, and 6701. Penalties cannot be appealed under post-assessment penalty appeals procedures. Normal rules for preparer penalties do not apply. All IRC 6703 claims are to be processed expeditiously.

The revenue agent will work with District Counsel during this process, and will be advised when to assess the penalty. Once the penalty is assessed, the promoter is billed by the Service Center and receives a "Notice and Demand." This Notice may also be delivered concurrently with the 7408 injunction if the Department of Justice approves.

Time limit

The promoter has 30 days from the date the penalty is assessed to pay at least 15% of the amount assessed and file a claim for refund. Thus, there will be **no** collection activity for at least 30 days.

Promoter's suit filing rights

If a claim is filed, Notice of Claim Disallowance procedures should be followed. The promoter may bring suit in Federal District Court within 30 days of claim denial, or if a claim denial is not issued, a suit may be brought 30 days after the expiration of six months from the filing of the claim, whichever is first.

An appeal should not be based on moral, political, constitutional, or religious arguments.

If the penalty is paid in full, the promoter may file a refund suit in either the U.S. Court of Federal Claims or a District Court within two years of the date of denial of the claim or upon the expiration of six months after the date of filing the claim.

Continued on next page

Collection

It is important to involve Collection during this process. Once penalties are assessed, Collection should be notified to ensure the assessments are collected.

If the revenue agent has knowledge of, or if there is an indication that the promoter may put assets beyond the reach of the government, the agent should notify Collection.

No collection activity may be started until 30 days after the assessment is made to allow the promoter to file a claim (after 15% of penalty is paid). If a claim is filed, Collection activity and the statute of limitations on collection are suspended until the claim is resolved. *See Exhibit 14-4.*

IRC 6701 Penalty

IRC 6701

IRC 6701 imposes a $1,000 penalty for aiding and assisting in the preparation of any portion of a return that would result in an understatement of tax. The penalty is $10,000 if the prohibited conduct relates to the tax return of a corporation. As with the 6700 penalty, the government has the burden of proof.

Case development

Case development is important to substantiate the penalty. The procedures for a 6701 penalty are very similar to the 6700 penalty case file except time is charged to activity code 594 and the Form 3198 will be annotated, "Civil Penalty Assessment IRC section 6701." *See Exhibit 14-2.*

6701 v. 6700

After December 31, 1989, a penalty under IRC 6701 may not be applied to the same activities that result in the application of a penalty under IRC 6700. *See Exhibit 14-3.* However, if the same promoter prepares a partnership tax return relating to the same tax plan or arrangement, a penalty can be assessed under IRC 6701 for each Schedule K-1, if an understatement of tax liability is reported on the investor's federal tax returns.

Continued on next page

IRC 6701 Penalty, Continued

Statute of limitation

As with IRC 6700, there is no statute of limitations on the IRC 6701 penalty.

Summary

The government has the burden of proof.
The revenue agent must work closely with District Counsel.

Exercise

Exercise 1

List four of the six forms/letters included in a 6700 penalty case file:

Answer to Exercise

Exercise 1

The penalty case file will include the following:

- Form 4665, Report Transmittal
- Form 4549, Revenue Agent Report
- Form 886-A, Explanation of Items, including the penalty calculation
- Form 8278, Computation and Assessment of Miscellaneous Penalties
- Form 4318 Examination Workpapers
- Form 3198, Special handling Notice

Exhibit 14-1

Title: Handbook 120.1 Penalty Handbook
Body:
SubSubSection 6.5.6.2 Conclusion of an IRC Section 6700 Examination
Date last amended 8/20/98

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(1) The agent and the attorney will jointly determine if the following actions are appropriate:

a. Assessment of the penalty,
b. Issuance of pre-filing notification letters,
c. A request for injunctive relief should be sought, and
d. A referral to criminal investigation division should be made due to an indication of fraud.

(2) The promoter should be offered a closing conference and the opportunity to present any arguments or evidence. No communication regarding the determination of the case should be presented at the meeting. A copy of the letter offering the conference will be kept in the file.

(3) Written approval of the District Director is needed if the penalty will be asserted.

(4) When the penalty will be asserted the case file will include:

- Form 4549, Revenue Agent Report,
- Form 886A, Explanation of Items, including the penalty calculation.
- Form 8278, Computation and Assessment of Miscellaneous Penalties
- Form 4665, Report Transmittal.

(5) F-4665 will indicate whether or not:

a. The key case is subject to TEFRA,
b. The subsequent year will be examined, and
c. Investors are required to file Form 8271, Investor Reporting of Tax Shelter Registration Number.

(6) Letter 1866, IRC section 6700 Discontinuance Letter, is sent to the promoter if the penalty will not be asserted.

Exhibit 14-2

Title: Handbook 120.1 Penalty Handbook
Body:
SubSection 6.6.1 When the Penalty Applies
Date last amended 8/20/98

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(1) IRC section 6701(a) imposes a $1,000 penalty ($10,000 if the prohibited conduct relates to a corporation's tax return) for aiding or assisting in the understatement of tax. The penalty is imposed on a person who:

a. Aids or assists in, procures or advises with respect to, the preparation or presentation of any portion of a return, affidavit, claim or other document (pre 89);

b. Knows (or has reason to know) that such portion will be used in connection with any material matter arising under the internal revenue laws; and

c. Knows that such portion (if used) would result in an understatement of another person's tax liability.

(2) Activities Subject to the Penalty. The key words in the penalty are "document," "knows," and "understatement." For the penalty to be imposed, the person penalized must be implicated in the preparation or presentation of a document some portion of which he or she knows or has reason to know will be used in connection with a material matter arising under the tax laws and knows that such position would result in an understatement of tax liability if so used.

a. In general, targets of the penalty are tax counselors who advise clients to take unsupported filing positions or to file false or fraudulent returns.

b. The authors of legal opinions made available to promoters of tax shelters are another target of the penalty. A carefully fabricated legal opinion may lend credence to an abusive tax shelter. The penalty may be imposed even if the opinion does not contain any false advice if the writer knows that the opinion is based on inaccurate assumptions and/or knows of other facts which render the legal advice false.

Continued on next page

c. The penalty can be imposed for gratuitous advice or assistance in preparing any document. Unlike the IRC section 6700 penalty, the person cannot lower the penalty by establishing the amount of gross income derived from the actions.

d. In order to aid in the understatement of another's tax, it is not necessary to actually prepare the tax return or document that leads to the understatement. A person who controls the activities of subordinates and either orders the subordinate to act, or does not prevent their participation in actions that person knows will produce an understatement is subject to the penalty under IRC section 6701.

(3) Aid, Assist, Procure, or Advise.

a. The term "procures" in the statute includes ordering (or otherwise causing) a subordinate to do an act subject to the penalty. It also includes knowing of, and not attempting to prevent, participation by a subordinate in such an act. "Subordinate " means any other person (whether or not a director, officer, employee, or agent of the taxpayer involved) over whose activities the person has direction, supervision or control. The Senate Report adds that such direction, etc., must be "direct and immediate." Where a subordinate is directed or expected, as a condition of retaining his position, to participate in the prohibited activity by a person who directs, supervises, or controls such subordinate, the latter person is the one potentially subject to the penalty.

b. The term "advises" includes actions of independent contractors such as lawyers and accountants who counsel a particular course of action.

c. Mechanical Assistance. A person furnishing typing, reproduction, or other mechanical assistance with respect to a document is not to be considered as having aided or assisted in the preparation of the document for purposes of the statute solely by reason of such assistance.

(4) The Actor's Requisite Knowledge.

Continued on next page

a. For activities occurring before January 1, 1990, the actor must know that a document (the preparation or presentation of which he or she was in some way instrumental) will be used in connection with a material matter arising under the tax laws and will result in an understatement of tax liability. For example, if an individual assists another in procuring a forged birth certificate, he will not be liable for the penalty unless he knows that the birth certificate will be used for a tax matter, such as to obtain a benefit under the Code and that the use of such benefit will result in an understatement of tax.

b. For activities occurring after December 31, 1989, the actor can be held liable for the penalty if he or she knows or has reason to believe that the document will be used in connection with any material matter arising under the tax laws. However, the statute still requires that the actor have actual knowledge that the document will result in an understatement of tax liability.

(5) Congressional Intent in Enacting the Provision.

a. A tax advisor would not be subject to this penalty for suggesting to a client an aggressive but supportable filing position even though that position was later rejected by the courts and even though the client was subjected to the substantial understatement penalty. However, if the advisor suggested a position which he or she knew could not be supported on any reasonable basis under the law, the penalty would apply.

b. The Senate Report also states that no person will be subject to the penalty unless they are "directly involved in aiding or assisting in the preparation of a false or fraudulent document under the tax laws." Thus, the preparation of a correct schedule by a preparer to be incorporated in a return will not expose the preparer of the schedule to a penalty even though the preparer is aware other portions of the return may be fraudulent.

(6) Single Penalty per Taxpayer Per Period.

Continued on next page.

Exhibit 14-2, Continued

a. If a penalty is imposed on a person with respect to a federal tax document, no penalty shall be imposed under IRC section 6701 on such person with respect to any other federal tax document relating solely to the same taxpayer and the same taxable period, or, if there is no taxable period, the same taxable event. If, however, such other federal tax document also related to another taxpayer or another taxable period or taxable event, a second penalty may be imposed under IRC section 6701 with respect to such other federal tax document.

b. A husband and wife who make a joint return of income tax are considered to be the same taxpayer for the taxable year to which such return relates.

c. Example: Someone who assists two taxpayers in preparing false documents would be liable for a $2,000 penalty whereas the penalty would be only $1,000 if he had advised in the preparation of two false documents for the same taxpayer. Similarly, an advisor who prepares a false partnership return and then false K-1s for 10 individual partners would be subject to a $10,000 penalty.

Exhibit 14-3

Title: Handbook 120.1 Penalty Handbook
Body:
SubSection 6.5.5 Coordination with Other Penalties
Date last amended 8/20/98

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(1) This penalty is in addition to all other penalties that may be imposed under the Code. However, after December 31, 1989, a penalty under IRC section 6701 may not be applied to the same activities which result in the application of a penalty under 6700. (See the discussion in IRM 120.1.6.6.4.3)

(2) IRC section 6694(b) imposes a penalty if a return preparer understates a taxpayer's liability as a result of willful or reckless conduct. In some instances, a person who is subject to the penalty under IRC section 6700 may also be subject to the penalty under IRC section 6694(b).

(3) IRC section 7206(2) relates to any person who willfully aids or assists etc., in making fraudulent and false statements. In some cases, the promoter might be prosecuted under IRC section 7206(2) for assisting, procuring, or advising the preparation or presentation of a return or other document which is fraudulent or false.

(4) IRC section 7408 authorizes the United States to commence a civil action at the request of the Secretary to enjoin any person from further engaging in conduct subject to the penalty under IRC section 6700. The promoter penalty under IRC section 6700 and the injunction actions under IRC section 7408 are more effective when applied prior to the time investors file their returns. Therefore, abusive tax shelters should be identified and penalty investigations initiated promptly.

(5) IRC section 6111 requires tax shelter organizers to register tax shelters with the IRS by the day on which interests in the tax shelter are first offered for sale. This rule applies to tax shelters first sold on or after September 1, 1984. See Treas. Reg. 301.6111-1T(b) (Q&A 58).

a. Tax shelter organizers must use Form 8264, Application for Registration of a Tax Shelter.

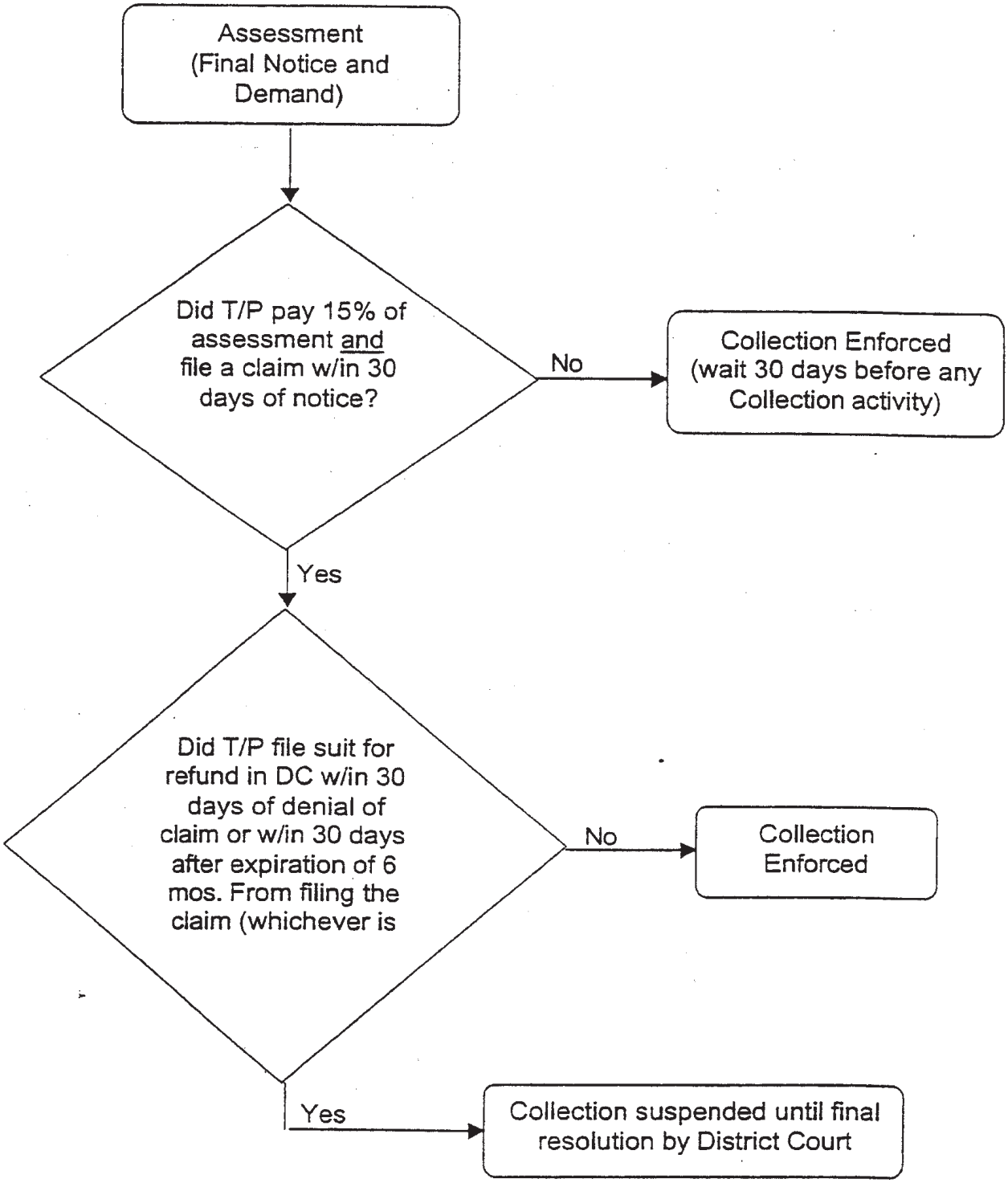
b. A penalty may be imposed under IRC section 6707 for failure to timely register a tax shelter.

Continued on next page

c. Criminal penalties may apply for willful noncompliance with the registration requirements. See IRC section 7203.

(6) IRC section 6112 requires organizers and sellers of potentially abusive tax shelters (for interests sold on or after September 1, 1984) to maintain a list identifying each person who purchases an interest in such tax shelter. See Treas. Reg. 301.6112-1T(D)(1) (Q&A 22). The list will contain any other information the IRS may require and will be available upon request for inspection. For failure to maintain the investors list, the penalty under IRC section 6708 may apply.

Exhibit 14-4 – Special Claim Procedures



Lesson 15

THE ROLE OF APPEALS

Introduction

Background

The IRS Appeals Office will likely impact on the 6700/6701 process in two ways:

- through appeal of the 6700/6701 penalties
- through the Collection Appeals Process

The Appeals Office is an independent administrative body within the Service and is the only formal level of appeal within the Service.

The review by Appeals of a penalty determination is not automatic. Appeals will only review a penalty if the request for relief has been previously denied by a Service employee and the taxpayer requests an appeal. Collection appeals must also be requested by the taxpayer.

Objectives

At the end of this lesson you will be able to:

1. Describe how the Appeals Office handles appeals of 6700/6701 penalties.
2. Describe the Special Claims procedures.
3. Explain the Collection Appeals Program.

Contents

General Considerations

Initial information

A taxpayer will generally appeal a 6700 or 6701 penalty determination to Appeals through the Special Claim for Refund procedure. This is not part of the normal "penalty appeals" procedures and has its own rules.

Taxpayers may also receive Appeals consideration through the Collection Appeals Process. However, this applies to cases only after assessment and currently undergoing collection action.

The taxpayer may fully pay the penalty and file a regular Claim for Refund (on Form 843). In this situation, the taxpayer is not entitled to Appeals consideration. See IRC 7422.

If the claim is disallowed (or if six months goes by without the Service acting on the claim), the taxpayer may file a refund action in the appropriate District Court or in the Claims Court. Any action must be filed within three years of the date of payment. These matters were discussed in Lesson 11.

Timing

No appeal may be made until the penalty has been assessed and the promoter/preparer has been billed.

Statute of limitations

There is no statute of limitations for assessment of a 6700 or 6701 penalty (and, similarly, no statute of limitations on an action to enjoin a promoter under IRC 7408).

Burden of proof

The government has the burden of proof in any proceeding concerning 6700, 6701, or 7408. See IRC 7491. The deficiency procedures do not apply to 6700 and 6701 penalties. See IRC 6667(a).

Post-assessment procedures

Regular post-assessment penalty appeal procedures do not apply to 6700 and 6701 penalties. This means that Appeals has no jurisdiction over appeals of 6700 or 6701 penalties prior to the full payment of the penalty and filing of a claim, unless the request for appellate consideration falls within the provisions of IRC 6703.

Special Claim for Refund

IRC 6703

IRC 6703 provides rules for a special claim for refund of these penalties. The normal rules for preparer penalties do not apply to 6700/6701 penalties.

Suspending collection

Once the penalty is assessed, the taxpayer is billed for the amount due. After the Service issues a notice and demand, the promoter against whom the 6700/6701 penalty is assessed may suspend collection activity by:

1. paying at least 15 percent of the assessed penalty amount and
2. filing a claim for refund within 30 days after the date of notice and demand.

Further collection activities are suspended until the final resolution of the administrative penalty appeal (and subsequent judicial action, if any).

Initial screening

IRC 6703 claims are initially screened at a service center.

Examination will review the claim and, when appropriate, abate the penalty. If the penalty is upheld, the examiner send the promoter a letter advising that the claim will be disallowed unless a written request for Appeals consideration is received within 30 days after the date of the notifying letter. The promoter must also be sent a letter if the penalty is abated. See HB 8.11.1, Penalties Handbook, section 1.10.2; HB 7.3.1, section 10.14.2.

Appeals procedures

The promoter may appeal the district's or service center's denial of a claim for refund. Appeals will consider an IRC 6703 claim for refund in the same manner as any other claim for refund:

- Cases will be settled based on potential hazards of litigation.
- Cases will be rejected if the basis of the claim conflicts with section 601.106(b) of the Statement of Procedural Rules (i.e., an appeal should not be based on moral, political, constitutional, religious, or similar arguments).

Appeals will work IRC 6703 cases expeditiously. Cases will be controlled on ACDS.

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Special Claim for Refund, Continued

District Counsel	Decisions to abate a 6700/6701 penalty must be coordinated with district counsel prior to taking abatement action.
Penalty abated	If Appeals abates the penalty, the promoter will be notified via letter. Abatement actions are processed on Form 8278, Computation and Assessment of Miscellaneous Penalties. If the determination is to sustain the penalty, the promoter should be sent a certified letter of claim disallowance (Form 1774(RO)). See IRM 8.11.1.10.3 (1) through (4).
Penalty sustained	If Appeals sustains the penalty, the promoter is entitled to judicial review of the matter. The promoter must bring suit in Federal District Court within 30 days of receiving a Notice of Claim Disallowance, or 30 days after the expiration of six months from the filing of the claim, whichever is earlier. If the promoter does not do this, the disallowance will be considered to be final and suspension of collection activities under IRC 6703 will be lifted. Alternatively, the promoter may bring a refund suit in either the U.S. Court of Federal Claims or a District Court within two years of the date of denial of the claim or upon the expiration of six months after the date of filing the claim, if the penalty has been paid in full. If the promoter fails to take advantage of the above special claim for refund procedure, he/she is still eligible to proceed under the normal procedures for claims for refund. However, the normal procedure requires payment in full prior to any further consideration.

Collection Appeals Program

RRA 98 procedures

As a result of RRA 98, the Collection function has Collection Due Process (CDP) rules and a Collection Appeals Program (CAP). Each may impact the 6700/6701 penalty case.

CDP v.CAP

Under CDP, the taxpayer may appeal certain collection actions within a specified time frame. See IRC 6320 and 6330. CDP is discussed in the next lesson.

Under CAP procedures, a taxpayer may appeal certain collection actions. CAP allows a longer timeframe for filing an appeal.

Actions that may be appealed under CAP

- Notices of Federal Tax Lien (NFTL). The taxpayer may appeal before or after the Service files the NFTL. Denied requests to withdraw the NFTL may also be appealed. In addition, the taxpayer may appeal denied discharges of property from the FTL, subordinations, and non-attachments of an FTL.
- Notice of Levy. The taxpayer may appeal before or after the Service places a levy on wages, bank accounts, or other property.
- Seizure of property. The taxpayer may appeal before or within a specific time period after the Service makes a seizure.
- Denial or termination of installment agreement. The taxpayer may appeal after notification from the Service of a denial or termination of an installment agreement.

Continued on next page

Collection Appeals Program, Continued

Requesting CAP

CAP is requested by the taxpayer after a conference with a Collection manager by filing a Form 9423. The Service will generally suspend collection activities at this point. Appeals is expected to close CAP cases within five business days.

Assistance from Examination

When the underlying tax deficiency is in dispute, the revenue agent may be asked by Appeals to appear at the conference and meet with the taxpayer.

The agent may still be involved with the case during the CAP period even though the he/she has submitted his 6700/6701 report.

When Appeals requests assistance or investigation from Exam (or Collection) in a CAP case, Appeals will send an "Appeals Referral Investigation" request to the appropriate assisting function.

Due to the statutory requirement of Appeals making an independent determination, the assistance by Examination (or Collection) will be limited to verifying the factual or financial information submitted by the taxpayer.

Merits of the assessment

If the merits of the assessment have already been considered prior to the CAP hearing (e.g., Appeals hearing under the Special Claim for Refund procedure, judicial proceeding), then they will not be reconsidered.

Summary

There are two primary appeal routes:

- Special Claim for Refund, and
- Collection Appeals Program.

Lesson 16

THE ROLE OF COLLECTION

Introduction

Overview

The ultimate goal of a 6700/6701 investigation is to monetarily penalize the promoter of an abusive tax promotion. Unless Collection actually collects the penalty, the objective of the penalty has not been achieved. This lesson discusses collection issues that may occur prior to the final resolution of the 6700/6701 case.

Objectives

At the end of this lesson you will be able to:

1. List the factors that may affect the Collection phase of the 6700/6701 process.
2. Aid revenue officers in collecting 6700/6701 assessments.

Contents

How Collection Cases Are Assigned

Collection's priorities – year 2000

Collection has three first-tier priorities:

1. Resolve all taxpayer-initiated contacts (i.e., walk-in and calls by taxpayers).
2. Resolve offers in compromise.
3. Work bankruptcy cases.

The second-tier priorities are:

1. On-going in-business trust fund taxes over $25,000.
2. Cases with tax liabilities of more that $1,000,000.

Other work is of lesser importance and may be shelved or placed in the "Queue" (described below). These cases will be assigned only if there is available staffing.

Thus, the collection of assessments made by Examination is generally not a priority. The revenue agent will have to work with Collection to ensure the 6700/6701 assessments are collected. If they are not, the effort expended on the investigation will have been wasted.

RWMS score

When the case is closed out of Exam, the IDRS system gives the assessment a RWMS (Resource and Workload Management System) score. This RWMS score is an estimate of the recovery potential of the assessment. Scoring factors include:

- DIF score
- amount shown on latest filed return
- age of case

The RWMS score is used to prioritize cases to be worked in Collection. The RWMS score for Examination assessments are typically one-half to one-third of the assessed amount. For example, if the assessment is $500,000, you can expect a RWMS score of about 200,000). Assessments are then ranked on the basis of the RWMS score and sent to the Automated Collection System (ACS).

Continued on next page

How Collection Cases Are Assigned, Continued

ACS

ACS is a computerized inventory system that maintains balance due accounts and return delinquency investigations.

An ACS "call site" is a "mini-service center" dedicated to collection activities limited to telephone contacts. There are about 20 ACS call sites.

Notices

Notices are automatically generated when a case enters ACS. Although timing varies slightly between business and individual cases, four notices are sent to the taxpayer.

The first notice (or "Notice and Demand") is sent shortly after the assessment has been made. This notice:

- tells the taxpayer how much is due
- requests payment of that amount
- notifies the taxpayer of options for collection (such as entering into an installment payment agreement)
- informs the taxpayer of the possibilities of enforced collection activity (such as liens or levies)

Approximately 8-10 weeks after the First Notice is sent, the Second Notice is issued, followed at 6-week intervals by a Third and Fourth Notice (or "Final Notice").

If no response is received to the Final Notice, the case is to be sent to the field for assignment to a Revenue Officer.

Continued on next page

How Collection Cases Are Assigned, Continued

The Queue

There are not enough revenue officers (ROs) to work every case. Those cases sent to the field are typically:

1. national priority cases
2. very large dollar cases
3. other cases which are manually reassigned

Cases not sent to the field are sent to the collection Queue. They come out of the Queue if the RWMS score exceeds a certain limit that varies from district to district.

Presently the Queue limit in small offices exceeds RWMS 300,000. It exceeds RWMS 1,000,000 in large offices. In other words, unless the Examination assessment exceeds about $800,000 in small offices or $2,500,000 in large offices, it will probably stay in the Queue. Thus, most Examination assessments go to the Queue and are not assigned to an RO for collection.

ACS call site

ACS call sites perform four functions:

1. taxpayer contact ("C," which handles telephone calls),
2. investigation ("I," which searches for taxpayers and/or assets, and initiates or follows up on locator or enforcement actions);
3. research ("R," which responds to taxpayer correspondence, makes adjustments, and handles problem cases); and
4. service center support functions ("S," which inputs IDRS actions, and issues letters, liens, levies, etc.).

ACS work is prioritized according to the Queue for that location. Liens and levies are not done without a prior contact with the taxpayer. Since most 6700/6701 cases involve relatively small dollar amounts, they will not be worked if they go to ACS.

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Coordination

Programming changes to aid in the identification and coordination of cases that Exam has established as priorities have not yet been effected. This means that the only way to ensure that a case goes to a revenue officer in the field is to manually take it out of the normal case issuance process. This may be accomplished in different ways in different offices.

Examination-Collection liaison

Some offices have an employee assigned as a liaison between Exam and Collection. This individual can be contacted when there is a priority case that needs to be extracted from the Queue and manually assigned to an RO.

Collection cases are generally assigned by two criteria:

1. geographical area (the ZIP Code of the individual or entity against which the assessment was made)

2. amount assessed (which determines the grade of the Revenue Officer assigned to the case)

Dedicated Collection group

Some offices have a special RO group primarily assigned to work with:

- abusive trusts
- frivolous nonfilers
- potentially dangerous taxpayer

In these offices, there tends to be close coordination between PSP and the dedicated Collection group. If the revenue agent works in one of these offices, then PSP should be informed of the importance of the case and PSP should contact the supervisor of the dedicated Collection group so that the case can be manually extracted from the Queue and assigned to that group.

Other Collections Factors

CDP v. CAP

Under the CDP, the taxpayer may appeal certain collection actions within a certain time frame, pursuant to IRC 6320 (relating to liens) and 6330 (relating to levies).

Additionally, a taxpayer may appeal certain collection actions CAP. CAP allows a longer timeframe for fling an appeal.

CAP was discussed in Lesson 15.

IRC 6320

CDP may require input from or coordination by the examining agent.

IRC 6320 requires that the Service give notification to the taxpayer in writing (after filing of a notice of federal tax lien) of the taxpayer's right to request a formal administrative hearing.

This notice includes information about administrative appeals rights and procedures and procedures relating to release of liens.

The taxpayer has the right to judicial review if the administrative hearing is unable to resolve the issues.

IRC 6330 requires similar notice and opportunity prior to the filing of levies.

CDP actions

- Liens (IRC 6320). The taxpayer is notified within five business days of the filing of a Notice of Federal Tax Lien (NFTL) and is informed that he/she has the right to request a CDP hearing within 30 days after receipt of the notice of filing.

- Levies (IRC 6330). The taxpayer is notified not less than 30 days prior to the date of the first levy of his right to a hearing regarding the proposed levy.

Continued on next page

Other Collections Factors, Continued

CDP hearings

The taxpayer is entitled to one hearing per tax period before an appeals officer who has no prior involvement with that tax period. Hearings with respect to liens may be held in conjunction with hearings on levies. The taxpayer is allowed to raise any relevant issue, including:

- Challenges to the underlying liability as to existence or amount (if the person did not have a prior opportunity for an administrative or judicial hearing to dispute such liability).
- Appropriate spousal defenses.
- Challenges to the appropriateness of collection.
- Collection alternatives, including the posting of a bond, substitution of other assets in the nature of a bond, an installment agreement, or an offer in compromise.

If the taxpayer timely requests an Appeals conference, the collection statute and all collection activities are suspended during the appeals process (except in jeopardy situations). The taxpayer may appeal the determination of the appeals officer to the United States Tax Court or a United States District Court within 30 days of the determination.

If the taxpayer untimely requests an Appeals conference, the taxpayer will still be allowed an Appeals conference (which is called an "equivalency hearing"), but neither the collection statute nor collection activities will be suspended, nor will the taxpayer be allowed judicial review of Appeals' determination.

If, after exhausting all other administrative remedies, the taxpayer believes a change in circumstances has occurred (or that Collection did not comply with an Appeals determination), a Retained Jurisdiction hearing before Appeals may also be requested. This may delay the ultimate resolution of the 6700/6701 case further, but it is unlikely to require further participation by the examining agent.

Continued on next page

Other Collections Factors, Continued

Other new rules

The other major procedural rules which will impact on the collection of 6700/6701 assessments are the new third-party contact rules and modifications of the approval process for instituting liens and levies on outstanding collection accounts. Neither will require further coordination by the revenue agent with the revenue officer. They will delay the ultimate collection of the 6700/6701 assessment.

Summary

Collection of the penalties is the ultimate goal of the 6700/6701 case.
The revenue agent must coordinate with Collection to ensure that Collection has sufficient information to uphold and collect the penalties.

Abusive Tax Promotions
APPENDIX

SEC. 6700. PROMOTING ABUSIVE TAX SHELTERS, ETC.

6700(a) Imposition of Penalty.--

Any person who–

6700(a)(1)(A) organizes (or assists in the organization of)--

6700(a)(1)(A)(i) a partnership or other entity,

6700(a)(1)(A)(ii) any investment plan or arrangement, or

6700(a)(1)(A)(iii) any other plan or arrangement, or

6700(a)(1)(B) participates (directly or indirectly) in the sale of any interest in an entity or plan or arrangement referred to in subparagraph (A), and

6700(a)(2) makes or furnishes or causes another person to make or furnish (in connection with such organization or sale)--

6700(a)(2)(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, or

6700(a)(2)(B) a gross valuation overstatement as to any material matter, shall pay, with respect to each activity described in paragraph (1), a penalty equal to the $1,000 or, if the person establishes that it is lesser, 100 percent of the gross income derived (or to be derived) by such person from such activity. For purposes of the preceding sentence, activities described in paragraph (1)(A) with respect to each entity or arrangement shall be treated as a separate activity and participation in each sale described in paragraph (1)(B) shall be so treated.

6700(b) Rules Relating to Penalty for Gross Valuation Overstatements.--

6700(b)(1) Gross valuation overstatement defined.--For purposes of this section, the term "gross valuation overstatement" means any statement as to the value of any property or services if–

6700(b)(1)(A) the value so stated exceeds 200 percent of the amount determined to be the correct valuation, and

6700(b)(1)(B) the value of such property or services is directly related to the amount of any deduction or credit allowable under chapter 1 to any participant.

6700(b)(2) Authority to waive.--The Secretary may waive all or any part of the penalty provided by subsection (a) with respect to any gross valuation overstatement on a showing that there was a reasonable basis for the valuation and that such valuation was

made in good faith.

6700(c) Penalty in Addition to Other Penalties.--

The penalty imposed by this section shall be in addition to any other penalty provided by law.

SEC. 6701. PENALTIES FOR AIDING AND ABETTING UNDERSTATEMENT OF TAX LIABILITY.

6701(a) Imposition of Penalty.--

Any person--

6701(a)(1) who aids or assists in, procures, or advises with respect to, the preparation or presentation of any portion of a return, affidavit, claim, or other document,

6701(a)(2) who knows (or has reason to believe) that such portion will be used in connection with any material matter arising under the internal revenue laws, and

6701(a)(3) who knows that such portion (if so used) would result in an understatement of the liability for tax of another person, shall pay a penalty with respect to each such document in the amount determined under subsection (b).

6701(b) Amount of Penalty.--

6701(b)(1) In general.--Except as provided in paragraph (2), the amount of the penalty imposed by subsection (a) shall be $1,000.

6701(b)(2) Corporations.--If the return, affidavit, claim, or other document relates to the tax liability of a corporation, the amount of the penalty imposed by subsection (a) shall be $10,000.

6701(b)(3) Only 1 penalty per person per period.--If any person is subject to a penalty under subsection (a) with respect to any document relating to any taxpayer for any taxable period (or where there is no taxable period, any taxable event), such person shall not be subject to a penalty under subsection (a) with respect to any other document relating to such taxpayer for such taxable period (or event).

6701(c) Activities of Subordinates.--

6701(c)(1) In general.--For purposes of subsection (a), the term "procures" includes--

6701(c)(1)(A) ordering (or otherwise causing) a subordinate to do an act, and

6701(c)(1)(B) knowing of, and not attempting to prevent, participation by a subordinate in an act.

6701(c)(2) Subordinate.--For purposes of paragraph (1), the term "subordinate" means any other person (whether or not a director, officer, employee, or agent of the taxpayer involved) over whose activities the person has direction, supervision, or control.

6701(d) Taxpayer Not Required To Have Knowledge.--

Subsection (a) shall apply whether or not the understatement is with the knowledge or consent of the persons authorized or required to present the return, affidavit, claim, or other document.

6701(e) Certain Actions Not Treated as Aid or Assistance.--

For purposes of subsection (a)(1), a person furnishing typing, reproducing, or other mechanical assistance with respect to a document shall not be treated as having aided or assisted in the preparation of such document by reason of such assistance.

6701(f) Penalty in Addition to Other Penalties.--

6701(f)(1) In general.--Except as provided by paragraphs (2) and (3), the penalty imposed by this section shall be in addition to any other penalty provided by law.

6701(f)(2) Coordination with return preparer penalties.--No penalty shall be assessed under subsection (a) or (b) of section 6694 on any person with respect to any document for which a penalty is assessed on such person under subsection (a).

6701(f)(3) Coordination with section 6700 .--No penalty shall be assessed under section 6700 on any person with respect to any document for which a penalty is assessed on such person under subsection (a).

§ 6703. Rules applicable to penalties under sections 6700, 6701, and 6702.

(a) Burden of proof. In any proceeding involving the issue of whether or not any person is liable for a penalty under section 6700, 6701, or 6702, the burden of proof with respect to such issue shall be on the Secretary.

(b) Deficiency procedures not to apply. Subchapter B of chapter 63 (relating to deficiency procedures) shall not apply with respect to the assessment or collection of the penalties provided by sections 6700, 6701, and 6702.

(c) Extension of period of collection where person pays 15 percent of penalty.

(1) In general. If, within 30 days after the day on which notice and demand of any penalty under section 6700 or 6701 is made against any person, such person pays an amount which is not less than 15 percent of the amount of such penalty and files a claim for refund of the amount so paid, no levy or proceeding in court for the collection of the remainder of such penalty shall be made, begun, or prosecuted until the final resolution of a proceeding begun as provided in paragraph (2).

Notwithstanding the provisions of section 7421(a), the beginning of such proceeding or levy during the time such prohibition is in force may be enjoined by a proceeding in the proper court. Nothing in this paragraph shall be construed to prohibit any counterclaim for the remainder of such penalty in a proceeding begun as provided in paragraph (2).

(2) Person must bring suit in district court to determine his liability for penalty. If, within 30 days after the day on which his claim for refund of any partial payment of any penalty under section 6700 or 6701 is denied (or, if earlier, within 30 days after the expiration of 6 months after the day on which he filed the claim for refund), the person fails to begin a proceeding in the appropriate United States district court for the determination of his liability for such penalty, paragraph (1) shall cease to apply with respect to such penalty, effective on the day following the close of the applicable 30-day period referred to in this paragraph.

(3) Suspension of running of period of limitations on collection. The running of the period of limitations provided in section 6502 on the collection by levy or by a proceeding in court in respect of any penalty described in paragraph (1) shall be suspended for the period during which the Secretary is prohibited from collecting by levy or a proceeding in court.

INTERPRETIVE NOTES AND DECISIONS

5. Burden of proof

IRS must prove by preponderance of evidence that person subject to aiding and abetting penalty has actual knowledge of overstatement of value of assets upon which tax credits are based; preponderance standards applicable since there is no requirement of proof of fraud; clear and convincing standard is too high and is not justified absent direct reference to fraud or tax evasion in § 6701. *Mattingly v United States (1991, CA8 Mo) 91-1 USTC P 50068, 67 AFTR 2d 91-494,* reh den, en banc (CA8) *1991 US App LEXIS 4128.*

IRS must prove by clear and convincing evidence violation of § 6701 for direct involvement in aiding and abetting in preparation or presentation of return, affidavit, claim or other document, since Congress intended to impose greater standard of proof then mere preponderance of evidence standard. *Warner v United States (1988, SD Fla) 700 F Supp 532, 62 AFTR 2d 88-5916,* summary judgment gr, summary judgment den (SD Fla) 90-1 *USTC P 50115, 64 AFTR 2d 89-5464; Re Mitchell (1989, BC WD Wash) 109 BR 434, 89-2 USTC P 9494, 64 AFTR 2d 89-5535,* later proceeding (BC WD Wash) *109 BR 441, 65 AFTR 2d 90-579,* affd (WD Wash) 90-2 *USTC P 50495, 66 AFTR 2d 90-5890.*

§ 6707. Failure to furnish information regarding tax shelters.

(a) Failure to register tax shelter.

(1) Imposition of penalty. If a person who is required to register a tax shelter under section 6111(a)--

(A) fails to register such tax shelter on or before the date described in section 6111(a)(1), or

(B) files false or incomplete information with the Secretary with respect to such registration,

such person shall pay a penalty with respect to such registration in the amount determined under

paragraph (2) or (3), as the case may be. No penalty shall be imposed under the preceding sentence with respect to any failure which is due to reasonable cause.

(2) Amount of penalty. Except as provided in paragraph (3), the penalty imposed under paragraph (1) with respect to any tax shelter shall be an amount equal to the greater of--

(A) 1 percent of the aggregate amount invested in such tax shelter, or

(B) $500.

(3) Confidential arrangements.

(A) In general. In the case of a tax shelter (as defined in section 6111(d)), the penalty imposed under paragraph (1) shall be an amount equal to the greater of--

(i) 50 percent of the fees paid to all promoters of the tax shelter with respect to offerings made before the date such shelter is registered under section 6111, or

(ii) $10,000.

Clause (i) shall be applied by substituting '75 percent' for '50 percent' in the case of an intentional failure or act described in paragraph (1).

(B) Special rule for participants required to register shelter. In the case of a person required to register such a tax shelter by reason of section 6111(d)(3)--

(i) such person shall be required to pay the penalty under paragraph (1) only if such person actually participated in such shelter,

(ii) the amount of such penalty shall be determined by taking into account under subparagraph (A)(i) only the fees paid by such person, and

(iii) such penalty shall be in addition to the penalty imposed on any other person for failing to register such shelter.

(b) Failure to furnish tax shelter identification number.

(1) Sellers, etc. Any person who fails to furnish the identification number of a tax shelter which such person is required to furnish under section 6111(b)(1) shall pay a penalty of $100 for each such failure.

(2) Failure to include number on return. Any person who fails to include an identification number on a return on which such number is required to be included under section 6111(b)(2) shall pay a penalty of $250 for each such failure, unless such failure is due to reasonable cause.

§ 6708. Failure to maintain lists of investors in potentially abusive tax shelters.

(a) In general. Any person who fails to meet any requirement imposed by section 6112 shall pay a penalty of $50 for each person with respect to whom there is such a failure, unless it is shown that

such failure is due to reasonable cause and not due to willful neglect. The maximum penalty imposed under this subsection for any calendar year shall not exceed $100,000.

(b) Penalty in addition to other penalties. The penalty imposed by this section shall be in addition to any other penalty provided by law.

SEC. 7408. ACTION TO ENJOIN PROMOTERS OF ABUSIVE TAX SHELTERS, ETC.

7408(a) Authority to Seek Injunction.--

A civil action in the name of the United States to enjoin any person from further engaging in conduct subject to penalty under section 6700 (relating to penalty for promoting abusive tax shelters, etc.) or section 6701 (relating to penalties for aiding and abetting understatement of tax liability) may be commenced at the request of the Secretary. Any action under this section shall be brought in the district court of the United States for the district in which such person resides, has his principal place of business, or has engaged in conduct subject to penalty under section 6700 or section 6701 . The court may exercise its jurisdiction over such action (as provided in section 7402(a)) separate and apart from any other action brought by the United States against such person.

7408(b) Adjudication and Decree.--

In any action under subsection (a), if the court finds--

7408(b)(1) that the person has engaged in any conduct subject to penalty under section 6700 (relating to penalty for promoting abusive tax shelters, etc.) or section 6701 (relating to penalties for aiding and abetting understatement of tax liability), and

7408(b)(2) that injunctive relief is appropriate to prevent recurrence of such conduct, the court may enjoin such person from engaging in such conduct or in any other activity subject to penalty under section 6700 or section 6701 .

7408(c) Citizens and Residents Outside the United States.--

If any citizen or resident of the United States does not reside in, and does not have his principal place of business in, any United States judicial district, such citizen or resident shall be treated for purposes of this section as residing in the District of Columbia.

§ 7601. Canvass of districts for taxable persons and objects.

(a) General rule. The Secretary shall, to the extent he deems it practicable, cause officers or employees of the Treasury Department to proceed, from time to time, through each internal revenue district and inquire after and concerning all persons therein who may be liable to pay any internal

revenue tax, and all persons owning or having the care and management of any objects with respect to which any tax is imposed.

(b) Penalties. For penalties applicable to forcible obstruction or hindrance of Treasury officers or employees in the performance of their duties, see section 7212.

§ 7602. Examination of books and witnesses.

(a) Authority to summon, etc. For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, the Secretary is authorized--

(1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry;

(2) To summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the Secretary may deem proper, to appear before the Secretary at a time and place named in the summons and to produce such books, papers, records, or other data, and to give such testimony, under oath, as may be relevant or material to such inquiry; and

(3) To take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry.

(b) Purpose may include inquiry into offense. The purposes for which the Secretary may take any action described in paragraph (1), (2), or (3) of subsection (a) include the purpose of inquiring into any offense connected with the administration or enforcement of the internal revenue laws.

(c) Notice of contact of third parties.

(1) General notice. An officer or employee of the Internal Revenue Service may not contact any person other than the taxpayer with respect to the determination or collection of the tax liability of such taxpayer without providing reasonable notice in advance to the taxpayer that contacts with persons other than the taxpayer may be made.

(2) Notice of specific contacts. The Secretary shall periodically provide to a taxpayer a record of persons contacted during such period by the Secretary with respect to the determination or collection of the tax liability of such taxpayer. Such record shall also be provided upon request of the taxpayer.

(3) Exceptions. This subsection shall not apply--

(A) to any contact which the taxpayer has authorized;

(B) if the Secretary determines for good cause shown that such notice would jeopardize collection of any tax or such notice may involve reprisal against any person; or

(C) with respect to any pending criminal investigation.

(d) No administrative summons when there is Justice Department referral.

(1) Limitation of authority. No summons may be issued under this title, and the Secretary may not begin any action under section 7604 to enforce any summons, with respect to any person if a Justice Department referral is in effect with respect to such person.

(2) Justice Department referral in effect. For purposes of this subsection--

(A) In general. A Justice Department referral is in effect with respect to any person if --

(i) the Secretary has recommended to the Attorney General a grand jury investigation of, or the criminal prosecution of, such person for any offense connected with the administration or enforcement of the internal revenue laws, or

(ii) any request is made under section 6103(h)(3)(B) for the disclosure of any return or return information (within the meaning of section 6103(b)) relating to such person.

(B) Termination. A Justice Department referral shall cease to be in effect with respect to a person when--

(i) the Attorney General notifies the Secretary, in writing, that--

(I) he will not prosecute such person for any offense connected with the administration or enforcement of the internal revenue laws,

(II) he will not authorize a grand jury investigation of such person with respect to such an offense, or

(III) he will discontinue such a grand jury investigation,

(ii) a final disposition has been made of any criminal proceeding pertaining to the enforcement of the internal revenue laws which was instituted by the Attorney General against such person, or

(iii) the Attorney General notifies the Secretary, in writing, that he will not prosecute such person for any offense connected with the administration or enforcement of the internal revenue laws relating to the request described in subparagraph (A)(ii).

(3) Taxable years, etc., treated separately. For purposes of this subsection, each taxable period (or, if there is no taxable period, each taxable event) and each tax imposed by a separate chapter of this title shall be treated separately.

(e) Limitation on examination on unreported income. The Secretary shall not use financial status or economic reality examination techniques to determine the existence of unreported income of any taxpayer unless the Secretary has a reasonable indication that there is a likelihood of such unreported income.

§ 7603. Service of summons.

(a) In general. A summons issued under section 6420(e)(2), 6421(g)(2), 6427(j)(2) or 7602 shall be served by the Secretary, by an attested copy delivered in hand to the person to whom it is directed, or left at his last and usual place of abode; and the certificate of service signed by the person serving the summons shall be evidence of the facts it states on the hearing of an application for the enforcement of the summons. When the summons requires the production of books, papers, records, or other data, it shall be sufficient if such books, papers, records, or other data are described with reasonable certainty.

(b) Service by mail to third-party recordkeepers.

(1) In general. A summons referred to in subsection (a) for the production of books, papers, records, or other data by a third-party recordkeeper may also be served by certified or registered mail to the last known address of such recordkeeper.

(2) Third-party recordkeeper. For purposes of paragraph (1), the term "third-party recordkeeper" means--

(A) any mutual savings bank, cooperative bank, domestic building and loan association, or other savings institution chartered and supervised as a savings and loan or similar association under Federal or State law, any bank (as defined in section 581), or any credit union (within the meaning of section 501(c)(14)(A));
(B) any consumer reporting agency (as defined under section 603(f) of the Fair Credit Reporting Act *(15 U.S.C. 1681a*(f)));
(C) any person extending credit through the use of credit cards or similar devices;
(D) any broker (as defined in section 3(a)(4) of the Securities Exchange Act of 1934 *(15 U.S.C. 78c*(a)(4)));
(E) any attorney;
(F) any accountant;
(G) any barter exchange (as defined in section 6045(c)(3));
(H) any regulated investment company (as defined in section 851) and any agent of such regulated investment company when acting as an agent thereof,
(I) any enrolled agent, and
(J) any owner or developer of a computer software source code (as defined in section 7612(d)(2)).

Subparagraph (J) shall apply only with respect to a summons requiring the production of the source code referred to in subparagraph (J) or the program and data described in section 7612(b)(1)(A)(ii) to which such source code relates.

§ 7604. Enforcement of summons.

(a) Jurisdiction of district court. If any person is summoned under the internal revenue laws to appear, to testify, or to produce books, papers, records, or other data, the United States district court for the district in which such person resides or is found shall have jurisdiction by appropriate process to

compel such attendance, testimony, or production of books, papers, records, or other data.

(b) Enforcement. Whenever any person summoned under section 6420(e)(2), 6421(g)(2), 6427(j)(2) or 7602 neglects or refuses to obey such summons, or to produce books, papers, records, or other data, or to give testimony, as required, the Secretary may apply to the judge of the district court or to a United States commissioner for the district within which the person so summoned resides or is found for an attachment against him as for a contempt. It shall be the duty of the judge or commissioner to hear the application, and, if satisfactory proof is made, to issue an attachment, directed to some proper officer, for the arrest of such person, and upon his being brought before him to proceed to a hearing of the case; and upon such hearing the judge or the United States commissioner shall have power to make such order as he shall deem proper, not inconsistent with the law for the punishment of contempts, to enforce obedience to the requirements of the summons and to punish such person for his default or disobedience.

(c) Cross references.

(1) Authority to issue orders, processes, and judgments. For authority of district courts generally to enforce the provisions of this title, see section 7402.

(2) Penalties. For penalties applicable to violation of section 6420(e)(2), 6421(g)(2), 6427(j)(2), or 7602, see section 7210.

§ 7605. Time and place of examination.

(a) Time and place. The time and place of examination pursuant to the provisions of section 6420(e)(2), 6421(g)(2), 6427(j)(2), or 7602 shall be such time and place as may be fixed by the Secretary and as are reasonable under the circumstances. In the case of a summons under authority of paragraph (2) of section 7602, or under the corresponding authority of section 6420(e)(2), 6421(g)(2), or 6427(j)(2), the date fixed for appearance before the Secretary shall not be less than 10 days from the date of the summons.

(b) Restrictions on examination of taxpayer. No taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

(c) Cross reference. For provisions restricting church tax inquiries and examinations, see section 7611.

Rev. Proc. 83-78 n1

n1 Also released as News Release IR-83-129, dated October 19, 1983.

26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.

(Also Part I, Sections 6700, 7408.)

1983-2 C.B. 595; 1983 IRB LEXIS 218; REV. PROC. 83-78

July, 1983

[*1]

SECTION 1. PURPOSE

This revenue procedure describes the program implemented by the Internal Revenue Service to identify and investigate abusive tax shelter promotions. The purpose of this revenue procedure is to discuss the procedures to be followed in identifying and investigating abusive tax shelters and to describe the options available to the Service once an abusive tax shelter has been identified and investigated. These options include a request for injunctive relief under section 7408 of the Internal Revenue Code, assertion of penalties under section 6700, and issuance of pre-filing notification to investors.

SEC. 2. BACKGROUND

.01 Historically, the Service has approached abusive tax shelters by examining the returns of taxpayers who claim tax benefits from investments in such shelters. This approach will be continued. However, to ensure more effective compliance with the tax laws and more efficient use of resources, action should be initiated before tax returns are filed.The Service will attempt to curb the marketing of abusive tax shelters by issuing prefiling notices to investors, by asserting penalties under section 6700 of the Code and/or by seeking injunctions [*2] under section 7408.

.02 Section 6700 of the Code contains penalty provisions that are specifically directed toward promoters of abusive tax shelters and other tax avoidance schemes. The penalties imposed by section 6700 are in addition to all other penalties provided by law. Persons subject to the penalties include not only the promoter but any other person who organizes, assists in the organization of, or participates in the sale of, any interest in an entity, plan or arrangement, and who makes or furnishes a statement with respect to any material tax matter either that the person knows or has reason to know is a false statement or that is a gross valuation overstatement.

.03 Section 7408 of the Code provides that a civil action in the name of the United States may be commenced at the request of the Secretary of the Treasury or his delegate to enjoin any person from further engaging in conduct subject to the penalty under section 6700.

SEC. 3. TAX SHELTER IDENTIFICATION

.01 In order to identify and investigate abusive tax shelter promotions, each district will designate a coordinator(s) to be responsible for gathering information on promotions being marketed. Tax shelter [*3] promotions will be identified from the following:

(a) federal, state, and local information agencies;

(b) other IRS investigations; and

(c) magazines and newspapers and any other information available.

.02 A committee ("Committee") will be established in each district comprised of designated representatives from District Counsel, Criminal Investigation Division, and Examination Division. The Committee will review the information submitted by the coordinator and select those promotions in which the promoter penalty, pre-filing notification and/or injunction action may be applicable. In analyzing the promotions the Committee will consider the past activity of the promoter; the type of the shelter involved; the size of the promotion and the tax deductions or credits claimed; the regional and/or national impact; the specific issues involved; and any other relevant factors.

.03 Once a particular promotion has been selected by the Committee a revenue agent will be assigned to the case to determine:

1) whether the promoter penalty in section 6700 of the Code is applicable;

2) whether there is a basis for concluding that the investors will not be in compliance with the tax law [*4] if they claim the tax benefits represented by the promoter to be available; and

3) whether injunctive relief under section 7408 of the Code should be sought.

SEC. 4. REVENUE AGENT'S RESPONSIBILITY

.01 The revenue agent will commence a section 6700 examination of the promotion after selection of the promotion by the Committee. Concurrently, a District Counsel attorney will be assigned to provide assistance to the revenue agent.

.02 The Service will advise the promoter by letter that it is considering possible penalties and/or injunction action under sections 6700 and 7408 of the Code for promoting an abusive tax shelter. In addition, the Service will advise the promoter that it is considering the issuance of pre-filing notification letters to the investors in the promotion. The letter to the promoter will request a list of documents (including investor information), books, and records that the promoter must make available for examination within 10 days. The letter will also advise the promoter that if, after examination of the promoter's books and records, and/or third party information, the Service concludes that penalty, injunction or prefiling notification action is [*5] appropriate, the promoter will be afforded the opportunity of a meeting to present any facts or legal arguments that the promoter believes indicate that action should not be taken. Failure to provide the information and documentation requested in the letter may result in summonses being issued.

.03 If the revenue agent determines that there are indications of fraud in the promotion, the matter will be referred to the Criminal Investigation Division (C.I.D.). If C.I.D. accepts the referral, the investigation will then proceed as a joint C.I.D./ Examination investigation.

.04 Based upon an examination of the promotional material, the promoter's books and

records and/or third party information, the revenue agent and attorney will determine whether there is a basis for concluding that the investors will not be in compliance with the tax laws if they claim the tax benefits represented by the promoter to be available. At this time, the promoter will be offered an opportunity to meet with the revenue agent and attorney.

SEC. 5. PROMOTER MEETING

.01 The agent will establish a date for the meeting with the promoter. At the meeting the promoter will be given the opportunity to present [*6] any facts or legal arguments that demonstrate that there is a basis for concluding that the shelter's claimed tax benefits comply with the tax law.

.02 Generally, no extensions of time will be granted for the meeting except in extenuating circumstances. The promoter will not be entitled to any additional meetings with the Service. No final decision will be made at the meeting concerning the determination that the Service will finally make. If the promoter fails to attend the meeting or fails to provide the requested documents or information, the Service will proceed based on the available promotional materials, books, records, and/or third party information.

.03 Based upon the recommendations of the agent and the attorney, the District Director will determine the appropriate action, which may include any or all of the following:

(1) assertion of the promoter penalty referred to in section 6700 of the Code;

(2) application for injunctive relief under section 7408;

(3) issuance of pre-filing notification to investors.

SEC. 6. PRE-FILING NOTIFICATION OF INVESTORS

.01 In deciding whether there is a basis for sending pre-filing notification letters to investors the Service [*7] will consider, among other things, whether there has been. (1) overvaluation of assets, (2) false or fraudulent statements as to a material matter; (3) an aberrational use of technical positions, such as the Rule of 78's in time-sharing transactions. When a basis is established for pre-filing action, the case will be forwarded to the District Director for approval of the issuance of pre-filing notification letters to investors. Upon approval by the District Director, pre-filing notification letters will be issued to the investors in the promotion.

.02 The pre-filing notification letters will advise investors in the promotion that based upon review of the promotion it is believed that the purported tax benefits are not allowable and will also advise the investors of the possible consequences if such tax benefits are claimed on their tax returns. Notification letters may also be issued to investors after their tax returns are filed. If the investors have already claimed such tax benefits on their tax returns, they will be advised that they may file amended tax returns. However, any applicable penalties, including the substantial understatement penalty provided by section 6661 [*8] of the Code, still may be asserted.

SEC. 7. SERVICE ACTION AFTER ISSUANCE OF PRE-FILING NOTIFICATION LETTERS

.01 After the pre-filing notification letters are issued, the district will forward a list of the investors to the appropriate service centers. In addition to providing investor information to the service centers, the district will also identify the name and type of tax shelter, and if possible, the type and amount of tax benefits that an investor would be reporting.

.02 If taxpayers claim the tax benefits after issuance of the pre-filing notification, or fail to file amended returns, they will be notified that their tax returns are being examined. Normal audit and appeal procedures will be followed during the examination of the tax returns, and negligence, civil or criminal fraud, overvaluation, substantial understatement, and/or any other penalties will be considered and, when appropriate, asserted.

SEC. 8. OTHER REMEDIES

.01 The Service may also seek injunctive relief under section 7408 of the Code and/or assert the penalty for promoting abusive tax shelters under section 6700 whether or not pre-filing notification letters are sent to investors. In any event, [*9] the Service may assert additional tax liability and any penalty, as appropriate, upon examination of an investor's tax return. The District Director's approval will be obtained prior to seeking injunctive relief and/or asserting the promoter penalty.

.02 As appropriate, the penalty provided by section 6700 of the Code will be asserted and/or an injunction under section 7408 will be requested against the promoters, salespersons, and any other persons whose conduct is subject to the penalty.

Rev. Proc. 84-84

26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.

(Also Part I, Sections 6213, 6231, 6411, 6700, 7408; 1.6411, 301.6213, 301.6231(c)-1T and -2T).

1984-2 C.B. 782; 1984 IRB LEXIS 217; REV. PROC. 84-84

July, 1984

[*1]

SECTION 1. PURPOSE

.01 This revenue procedure describes the Abusive Tax Shelter Detection Program implemented by the Internal Revenue Service at Internal Revenue service centers. Under this program the Service will detect and identify those returns that claimed benefits from abusive tax shelter promotions before processing and before refunds are paid (front end

identification), will reduce refunds of investors when appropriate, and will offset deficiencies assessed under the provisions of section 6213(b)(3) of the Internal Revenue Code against scheduled refunds resulting from tentative carryback adjustments under section 6411(b). Returns subject to review under this program include those in which pre-filing notification letters have been issued to the investors and returns that are selected based upon certain criteria with emphasis on identifying particularly abusive tax shelter promotions. For purposes of this revenue procedure, an income tax return showing a refund due is considered a claim for refund.

.02 This revenue procedure also explains the manner in which the Service will make the determination that it is highly likely that there is (1) a gross valuation overstatement, [*2] or (2) a false or fraudulent statement with respect to the tax benefits to be secured by holding an interest in the tax shelter entity or arrangement, that would be subject to a penalty under section 6700 (relating to a penalty for promoting abusive tax shelters, etc.).

.03 Further, this revenue procedure concerns the special rules provided under sections 301.6231(c)-1T and -2T of the Regulations on Procedure and Administration for certain applications for tentative carryback and refund adjustment under section 6411 of the Code and certain claims for credit or refund based on the original reporting on the partner's income tax return of partnership losses, deductions or credits.

.04 Finally, this revenue procedure modifies *Rev. Proc. 83-78, 1983-2 C.B. 595,* which describes procedures implemented by the Service to identify and investigate abusive tax shelter promotions.

SEC. 2. BACKGROUND

GENERAL

.01 The Service is concerned about the increase in abusive tax shelters that generate refunds for taxpayers. Paying out refunds attributable to losses, deductions or credits when the available relevant information indicates that those losses, deductions or credits are attributable to [*3] an abusive tax shelter and, consequently likely to be excessive, imposes a heavy burden on the collection resources of the Service. To meet this concern, the Service has developed procedures to identify potential abusive tax shelter returns and certain claims for credit or refund, including applications for a tentative carryback adjustment, during initial front-end processing at the service centers before any refund is paid.

.02 Under section 6411(b) of the Code, the Secretary is to make, to the extent deemed practical, a limited examination of an application for a tentative carryback adjustment to discover omissions and errors of computation and to determine the amount of the decrease in tax attributable to the carryback. Within 90 days from the date on which the application is filed, or from the last day of the month in which falls the last date prescribed by law (including extensions) for filing the return for the taxable year of the net operating loss, whichever is later, the examination must be completed. Section 6411 (b) also provides that the Secretary may disallow, without further action, any application that contains either errors of computation that cannot be corrected [*4] within the 90-day period or material omissions. The section further provides that the decrease in tax

attributable to the carryback will be applied against any unsatisfied amount of any tax for the taxable year immediately preceding the taxable year of the loss, the time for payment of which tax is extended under section 6164. Any reminder will, within the 90-day period, either be credited against any tax or installment then due from the taxpayer, or refunded to the taxpayer.

.03 Section 6213(a) of the Code, provides, with certain exceptions, that no assessment of a deficiency and no levy or proceeding in court for its collection will be made, begun, or prosecuted until a notice of deficiency has been mailed to the taxpayer.

.04 Under section 6213(b)(3) of the Code, if the Secretary determines that the amount applied, credited or refunded under section 6411 is in excess of the overassessment attributable to the carryback, the Secretary may assess, without regard to the provisions of section 6213(b)(2) (relating to abatement of assessment of mathematical or clerical errors), the amount of the excess as a deficiency as if it were due to a mathematical or clerical error appearing [*5] on the return. For purposes of the program described in this revenue procedure, the determination that it is highly likely that there is (1) a gross valuation overstatement, or (2) a false or fraudulent statement with respect to the tax shelter entity or arrangement that would be subject to a penalty under section 6700 will be the basis for a determination that will permit an assessment under section 6213(b)(3). See, *Rev. Rul. 84-175, page 296,* this Bulletin.

.05 Under section 6402(a) of the Code, the Secretary, within the applicable period of limitations, may credit the amount of any overpayment against any liability in respect of an internal revenue tax on the part of the person who made the overpayment and refund any balance to the person.

SPECIAL RULES FOR PARTNERSHIPS

.06 Section 6225(a) of the Code provides a restriction on the assessment of deficiencies attributable to partnership items (as defined in section 6231(a)(3)). That section states that, except as otherwise provided in subchapter C of chapter 63 of the Code, no assessment of a deficiency attributable to any partnership item may be made (and no levy or proceeding in any court for the collection of the deficiency [*6] may be made, begun, or prosecuted) before

(1) the close of the 150th day after the day on which a notice of a final partnership administrative adjustment was mailed to the tax matters partner (as defined in section 6231(a)(7)), and

(2) if a proceeding is begun in the tax court under section 6226 of the Code during the 150 day period, the decision of the court in the proceeding has become final.

.07 Section 301.6231(c)-1T of the regulations permits the Service to make assessments under section 6213(b)(3) of the Code (relating to assessments arising out of tentative carryback or refund adjustments) to recover refunds attributable to applications for tenative refund adjustments filed by partners. The regulations permit an assessment only if the application is based on the partner's original reporting on the partner's income tax return of losses, deductions, or credits of a partnership with respect to which the

Commissioner or his delegate, after review of the available relevant information, makes the determination described in section 1.02 above. Notwithstanding section 6225 (relating to restrictions on assessment with respect to partnership items), an assessment may be made before [*7] there is a final partnership-level determination with respect to the losses, deductions or credits on which the application is based. As provided in section 6213(b)(1), the Service will mail notice of any such assessment to the partner filing the application. The notice will inform the partner of the partner's limited right to elect to treat partnership items as nonpartnership items.

.08 Under section 301.6231(c)-2T of the regulations, the Service may suspend certain refunds attributable to claims filed by partners based on the partners' original reporting on the partners' income tax returns of partnership losses, deductions or credits. The regulation permits the suspension only if the Commissioner or his delegate, after review of the available relevant information, makes the determination described in section 1.02 above with respect to the partnership. For purposes of this section, any income tax return requesting a credit or refund will be treated as a claim for credit or refund. The Service may mail to the partner a notice of suspension of the partner's claim until completion of partnership-level proceedings. The notice will inform the partner of the partner's limited right [*8] to elect to treat partnership items as nonpartnership items.

REV. PROC. 83-78

.09 *REV. PROC. 83-78,* in section 6 therein, describes the circumstances under which the Service will send pre-filing notification letters to investors advising them that, based upon the review of all available promotional material, the purported tax benefits are not allowable, and also advising the investors of the possible consequences if such tax benefits are claimed on their tax return. Section 6.01 states that the Service will consider, among other things, whether there has been: (1) overvaluation of assets; (2) false or fraudulent statement as to a material matter; (3) an aberrational use of technical positions.

SEC. 3. DETERMINATIONS IN CASES WHEN PRE-EILLING NOTIFICATION LETTERS ARE SENT

.01 Under sections 6.01 and 6.02 of *Rev. Proc. 83-78,* when a basis is established for pre-filing action, the case will be forwarded to the District Director for approval of the issuance of a pre-filing notification letter. The District Director may approve the issuance of the latter only if the District Director, after review of the available relevant information, makes the determination that it is highly [*9] likely that there is (1) a gross valuation overstatement, or (2) a false or fraudulent statement with respect to the tax benefits to be secured by holding an interest in the tax shelter entity or arrangement that would be subject to a penalty under section 6700 of the Code. The pre-filing notification letters described in *Rev. Proc. 83-78* will be sent to investors only if the standard in the immediately preceding sentence has been satisfied. Therefore, such letters will no longer be sent on other grounds, such as an aberrational use of technical positions.

.02 Returns in which pre-filing notification letters have been issued for the current or prior year will automatically be selected for review. These returns will not be referred to district offices for the determination described in Section 4 of this revenue procedure. In

the case of refund claims, refunds will be reduced by any portion attributable to the abusive tax shelter. In the case of an application for tenative carryback adjustment, the Service will make an assessment under section 6213(b)(3) of the Code and offset the amount assessed against the scheduled refund.

SEC. 4. DETERMINATIONS IN OTHER CASES (WHERE NO [*10] PRE-FILING NOTIFICATION LETTER HAS BEEN SENT)

TEAM ACTIVITIES

.01 Each service center will have an Abusive Tax Shelter Detection Team (Team). The Team will be comprised of representatives from the Examination Division, the Criminal Investigation Division and other affected functions. The Team responsibilities include requesting, receiving and analyzing returns, listings and other information related to the questionable tax shelters in order to make recommendations for review of returns or promotions before refunds are issued. The Team will also identify tax shelter schemes, promoters and investors for the Criminal Investigation Division and/or the Examination Division in order to secure injunctions under section 7408 of the Code against persons engaged in conduct subject to a penalty under section 6700.

.02 Sources of information for the Team include: Returns such as Forms 1040, 1041, 1065, and 1120S; amended returns, such as Form 1040X, and Applications for Tentative Refund (Form 1045). Forms SS-4, Application for Employer Identification Number; W-4, Employee's Withholding Allowance Certificate; and Tax Shelter Registration information will serve as additional leads.

.03 [*11] Investor returns which exhibit certain pre-determined characteristics will be selected for review. To suspend refunds requested on these returns, or to make recommendations for assessments under section 6213(b)(3) of the Code, the Team must determine with reasonable certainty that deductions and/or credits are not allowable and that the shelter is abusive. Only when there are strong affirmative indications of a deficiency will a taxpayer's refund be suspended or a recommendation be made for a section 6213(b)(3) assessment. The procedures described in this section apply to these returns.

REFERRAL TO DISTRICT

.04 After assembly of evidence of an abusive tax shelter case, the service center Team will refer the cases to the Criminal Investigation Division and/or the Examination Division via the District Director in the district with jurisdiction over the promoter. A case is considered ready for referral to the district when, for example, a promoter is identified or the key return is secured. In situations where complete cases cannot be developed, the Team will forward the information to the district for further development.

.05 The Chief, Criminal Investigation Division, and/or [*12] the Chief, Examination Division, will make an evaluation of the case, secure any necessary additional data, and present a summary of the evaluation, including a recommendation for continuation of refund suspension or assessments under section 6213(b)(3) of the Code, to the District Section 6700/7408 Committee described below.

REFERRAL TO SECTION 6700/7408 COMMITTEE

.06 The Section 6700/7408 Committee (Committee) is established in each district and is comprised of designated representatives from District Counsel, Criminal Investigation Division and Examination Division. (See Section 3.02 of *Rev. Proc. 83-78* for a description of this committee). The Committee will review the information submitted by the Criminal Investigation Division and/or the Examination Division and select those cases in which the promoter penalty and/or injunction and/or pre-filing notification action may be applicable.

.07 The Committee will:

1 Determine if the deductions and/or credits will be allowed and, if not, recommend either the continued suspension of the requested refunds, or assessments under section 6213(b)(3) of the Code, relating to the promotion/scheme,

2 Determine if the deductions and/or [*13] credits might be allowable and, if so, recommend the release of requested refunds relating to the promotion/scheme,

3 Review the case for potential section 6700/7408 action and indicate the Committee's disposition,

4 If investor lists under section 6112 of the Code are available, review the case for potential pre-filing notification for investors who have not yet filed and indicate the Committee's recommendation,

5 Develop a complete case and refer it to the Assistant Regional Commissioner (ARC) (Examination) for action,

6 Return unreferred cases to the service center Team for appropriate action, and

7 Forward a written notice to the service center Team to show disposition.

.08 The Committee will meet as often as needed to expeditiously review and arrive at a decision concerning information submitted by the Chief, Examination Division and/or Chief, Criminal Investigation Division. Disagreements among Committee members as to the disposition of a case will be forwarded to the District Director who, in consultation with District Counsel, will resolve the disagreement.

REFERRAL TO ARC (EXAMINATION), EXECUTIVE COMMITTEE, AND ASSISTANT COMMISSIONER (EXAMINATION)

.09 The ARC (Examination) [*14] for the region in which the district is located will consider the information referred and select cases that will be presented to the Executive Committee. The Executive Committee is comprised of the Assistant Regional Commissioners (Examination).

.10 The Executive Committee will periodically meet to expeditiously review the

information submitted by each region and arrive at a decision. The Executive Committee will decide whether a case should be referred to the Assistant Commissioner (Examination) for final approval.

.11 If the Executive Committee does not select the case for referral to the Assistant Commissioner (Examination), the service centers will be notified to release the refunds.

.12 If the Executive Committee refers a potentially abusive tax shelter entity or arrangement for consideration, the Assistant Commissioner (Examination) may, after review of the available relevant information, make the determination that it is highly likely that there is a (1) gross valuation overstatement or (2) a false or fraudulent statement with respect to the tax benefits to be secured by holding an interest in the tax shelter entity or arrangement.

.13 If the Assistant Commissioner (Examination) [*15] makes such a determination, the service centers will immediately initiate refund freeze procedures, or in the case of tentative refund adjustments, the Service will schedule the refund, make an assessment under section 6213(b)(3), and offset the amount assessed against the scheduled refund.

SEC. 5. ADJUSTMENT PROCEDURES

.01 As soon as notification is received by the service center, the return will be analyzed to determine what portion of the refund claim is attributable to the abusive tax shelter. Only that portion of the refund claim attributable to the abusive tax shelter will be affected. The balance, if any, will be released.

.02 In the case of refund claims, the taxpayer will be notified that the Service has reduced the refund by the portion which was attributable to the tax shelter promotion. In the case of tentative refund adjustments, the taxpayer will also be notified of an assessment under section 6213(b)(3) of the Code.

SEC. 6. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 83-78 is modified.

SEC. 7. EFFECTIVE DATE

This revenue procedure is effective with respect to returns, claims or applications filed after December [*16] 10, 1984.

CHAPTER: Chapter 4200 Income Tax Examinations [Supplemented by MS CR 42G-442 Automated Issue Identification System Field Test -- Tax Year 1990 May 26, 1994] [Supplemented by MS CR 42G-444 Multi-Functional Nonfiler Assistance Program Exp. Date: Sept. 10, 1994] [Supplemented by MS CR 42G-443 Multi-Functional Installment Agreement Authority Exp. date: August 5, 1994] [Supplemented by MS 42G-445 General Guidelines for Accessing and Using the CFOL Command Codes in Examination Functions] [Amended and Supplemented by MS 42G-438, Notification Required Under Article IX -- Related Persons U.S. -- Canada Income Tax Treaty EXPIRATION DATE: MAY 23, 1993] [Supplemented by MS 42G-445 General Guidelines for Accessing and Using the CFOL Command Codes in Examination Functions] [Supplemented by MS 42G-445 General Guidelines for Accessing and Using the CFOL Command Codes in Examination Functions] [Supplemented by MS 42G-445 General Guidelines for Accessing and Using the CFOL Command Codes in Examination Functions] [Supplemented by MS 42G-445 General Guidelines for Accessing and Using the CFOL Command Codes in Examination Functions] [Supplemented by MS 42G-445 General Guidelines for Accessing and Using the CFOL Command Codes in Examination Functions]

SECTION: 42(17)0 Tax Shelter Program

SUBSECTION-1: **42(17)(11)** Penalties, Pre-Filing Notification, and Injunction Procedures

SUBSECTION-2: 42(17)(11).1 Background

(1) In the past, the Tax Shelter Program has used an "after-the-fact" approach by identifying, selecting, and examining returns involving tax shelters that utilize improper or implausible interpretations of the law or the facts to secure for investors substantial tax benefits which are clearly disproportionate to the economic reality of the transaction. This approach has resulted in an increasing inventory of old cases at all levels of the administrative process.

(2) The Tax Equity and Fiscal Responsibility Act of 1982 provided sections 6700 and 7408 which are specifically aimed at curbing the promotion of abusive tax shelters. Section 7408 contemplates front end approach by identifying promoters of abusive schemes who are subject to promoter penalties (*IRC 6700*) and injunctions (*IRC 7408*).

(3) IRC 6700, Promoting Abusive Tax Shelters, provided for a civil penalty equal to the greater of $1,000 or 10% of the gross income derived, or to be derived from the promotion of the shelter. The Deficit Reduction Act of 1984 increased the *IRC 6700* penalty to the greater of $1,000 or 20% of the gross income derived, or to be derived, from the promotion of the abusive shelter. (see IRM 4563.63. Promoter Penalty (*IRC 6700*).

(4) IRC 7408, Action to Enjoin Promoters of Abusive Tax Shelters, permits the United States to seek injunctive relief and for district courts to enjoin any person from further engaging in conduct subject to the penalty under *IRC 6700*, or *IRC 6701* (Penalty for Aiding and Abetting Understatement of Tax Liability).

(5) Revenue procedure 83-78, *1983-2 CB 595,* discusses the procedures to be followed in identifying and investigating abusive tax shelters and to describe the options available to the service once an abusive tax shelter has been identified and investigated. Based upon the recommendations of the

agent and the district counsel attorney assigned to examine the *IRC 6700* case, the district director may approve the issuance of pre-filing notification letters to investors. The pre-filing notification letters will advise investors in the promotion that based upon a review of the promotion it is believed that the purported tax benefits are not allowable and will also advise the investors of the possible consequences if such tax benefits are claimed on their tax returns.

(6) *Revenue Procedure 84-84, 1984-2 C.B. 782* describes the abusive tax shelter detection program implemented by the internal revenue service at internal revenue service centers. Under this revenue procedure the service will detect and identify those returns that claimed benefits from abusive tax shelter promotions before processing and before refunds are paid.

(7) Examination will continue to examine and identify abusive tax shelters "after-the-fact" in addition to the "front-end" approach.

(8) Any problems that concern disclosure issues that arise in connection with the implementation of any of these procedures should be brought to the attention of your disclosure officer who should consult with the Disclosure Litigation Division about their resolution.

(9) Reference should be made to Law Enforcement Manual Supplement CR LEMS IV-14 Rev. 1 dated April 2, 1986, and IRM 42(17)0 for further information regarding Abusive Tax Shelter Detection.

SUBSECTION-2: 42(17)(11).2 Objectives

(1) The objectives of this program and the Tax Shelter Program (IRM 42(17)1) are parallel. Additional objectives under the "front-end" approach of identifying promoters of abusive schemes for asserting promoter penalties, issuing pre-filing notification letters to investors, and seeking injunctions are as follows.

(a) For the promoter:

1 To stop the marketing of the shelter;

2 To prevent future promotional activity of abusive tax shelter schemes;

3 To deter other potential promoters; and

4 to penalize the promoters of abusive shelters.

(b) For the investor:

1 To encourage the filing of a correct return and

2 To discourage future investments in abusive tax shelters.

SUBSECTION-2: 42(17)(11).3 Organizational Responsibilities

(1) In addition to the actions in IRM 42(17)3 each Regional Commissioner and District Director is responsible for:

(a) Being involved personally with emphasizing and implementing promoter penalties, the pre-filing notification program and the *IRC 7408* injunction program.

(b) Monitoring the selection of cases to ensure that only abusive tax shelter cases are included in the Program.

(c) Ensuring that adequate resources are available and applied to the proper development of the case (s) so that the objectives of the front-end program are obtained within the established time periods.

(d) Where resources are inadequate, the District Director should immediately notify the Assistant Regional Commission (Examination). Where the region cannot resolve the problem, the matter should be referred to the Assistant Regional Commissioner's (Examination) Executive Committee.

(2) Each district will designate an Abusive Tax Shelter Coordinator who is responsible for gathering information on abusive tax shelter schemes currently being marketed. This individual will also be responsible for screening the material using the criteria in IRM 42(17)11.5:(8)(a)-(e). Time expended in gathering information to identify schemes for presentation to the 6700 committee and for possible promoter penalties (*IRC 6700*), pre-filing notification letters, an injunctive action (*IRC 7408*), should be charged to code 593000 in accordance with IRM 4810, Examination Reports Handbook.

(3) Each Service Center will designate a coordinator to serve as the contact point for this program.

(4) If a promoter or seller is located in another district, this information should be forwarded to the appropriate District Director, Attention: Abusive Tax Shelter coordinator.

SUBSECTION-2: 42(17)(11).4 Identification of Promoters and Schemes

(1) A concerted team effort on the part of all Service personnel will be required to identify promoters/schemes. The shelter schemes being promoted frequently cross district and regional boundaries. To properly investigate and/or examine these cases, close coordination, cooperation, and the sharing of information and techniques are required.

(2) The Collection Division, in the scope of their daily activity, could learn of the promotion of a potentially abusive tax shelter. This information should be forwarded to the District (Abusive Tax Shelter Coordinator). In a similar manner, Taxpayer Service personnel who are questioned on the merits of a particular scheme/promotion should gather as much information as possible and forward it to the District Coordinator.

(3) During the course of their examinations, each revenue agent and tax auditor upon learning of a potentially abusive tax shelter should forward such information to the Abusive Tax Shelter Coordinator.

(4) Service Center employees should be aware of the Promoter Penalty Program, Pre-Filing

Notification Program and the 7408 Promoter Injunction Program. For example, in the W-4 Program, information could come to the attention of Service Center personnel which would indicate that the taxpayer has invested in a potentially abusive tax shelter promotion or other tax avoidance scheme. The service center should forward this information to the attention of the appropriate Abusive Tax Shelter Coordinator. Classifiers should be aware of potential examinations which come to their attention during their classification activity. Information contained on Form 1045, Application for Tentative Carryback, may be a potential lead for an examination. The Questionable Refund Detection Team and the Tax Protestor Team are also sources of information. Abusive Tax Shelter Coordinators should furnish the service center classification function with a list of known abusive tax shelter promoters/promotions for classifier use. Use should be made of all available "in house" information in the Service Center.

(5) Another source available to Service Centers is the Applications for Employer Identification Numbers (EIN). Entity Control in the Service Centers issues EINs in response to taxpayers' filing Forms SS-4. Local procedures to effect the transfer of the portion of the form retained by the Service Center to the Examination function can be adopted. Examination could develop criteria for selecting the Forms SS-4 that appear to indicate an application by a tax shelter promotion. Those that are selected during the screening process could be disseminated to the applicable districts who in turn could use them to evaluate their potential for *IRC 6700* examination activity.

(6) Information may be supplied to the Abusive Tax Shelter Coordinator from Criminal Investigation function, District Counsel, and Appeals.

(7) Information may also be obtained from the following sources. This list is not all inclusive.

(a) State securities "blue sky" agencies;
(b) State securities board enforcement personnel;
(c) Advertisements in periodicals;
(d) Liaison meetings with professional societies;
(e) Attendance at seminars;
(f) Review of open and closed inventories in Criminal Investigation and Examination to determine the names of promoters, salespersons, appraisers, and others that are common to abusive and/or fraudulent shelter promotions. If Examination is aware of a previously determined abusive tax shelter promotion, an effort should be made to track the promoter(s). Previously convicted promoters should be tracked to determine if they are back in business;
(g) Better Business Bureau; and
(h) Other Federal agencies, such as the Federal Bureau of Investigation or Securities and Exchange Commission.

(8) Additional actions which may enhance the sharing and exchange of tax shelter related information between state securities departments and the Service are:

(a) All contacts with state agencies will be coordinated through the district office;
(b) All contacts with state agencies, will be timely, prior to presentations to the *IRC 6700* Committee;
(c) All *IRC 6700*/7408 News Releases will be provided to the appropriate state agencies; and
(d) All *IRC 6700*/7408 results will be shared with the proper state agency, in accordance with proper disclosure procedures.

(9) Revenue agents are not to engage in undercover activity or surveillance of any subject of an

examination. (See section 6(10)0 of IRM 4235, Techniques Handbook for In-Depth Examinations). Undercover includes assuming a false identity or providing misleading information about employment status. Obtaining public information such as a prospectus or attendance at public seminars by revenue agents is allowable as long as no deception is involved or misleading information is given. It is the role of the Criminal Investigation function to conduct any undercover operations that may be warranted.

SUBSECTION-2: 42(17)(11).5 Selection of Cases

(1) IRC 6700 is broad in its scope. For example, promoters, organizers, salespersons, appraisers, accountants, and attorneys, including persons who are in active concert with them, could be subject to the penalty.

(2) Upon obtaining a prospectus and/or other promotional material, indicating a potential abusive tax shelter, the Abusive Tax Shelter Coordinator will periodically present such information in a written or oral format to a committee of designated representatives from District Counsel, Criminal Investigation, and Examination. Criminal Investigation and Examination managers will serve on the committee.

(3) The purpose of the Committee is to review the information submitted by the coordinator and to select these promotions on which the promoter penalty, pre-filing notification and/or injunction action may be warranted. It is not the role of the Committee to set forth an examination plan or to direct the examination of the case. Likewise, it is not necessary to have a completed examination prior to submission of a promotion to the Committee. The Committee is to decide if an examination is to be started or to resolve disagreements between revenue agents and attorneys regarding the conclusion of an examination.

(4) Prior to submission of a potential case to the Committee, the Abusive Tax Shelter Coordinator should copy relevant portions of the prospectus and other promotional material for submission to the Committee for their review.

(5) Prior to the time that the *IRC 6700* Committee meets to review information presented by the Abusive Tax Shelter Coordinator, the Criminal Investigation member should query TECS-INTEL to determine whether any *IRC 6700*/7408 activity is pending against the promoter/salesperson. Where action is pending, the proposed *IRC 6700* examination should be coordinated.

(6) Per Section 5.02 of Manual Supplement 9G-147 (CR42G-415), dated September 10, 1984, the Examination member of the *IRC 6700* committee will provide information regarding the status of any injunctive action to the Criminal Investigation representative of the committee. The Criminal Investigation representative is responsible for reviewing this information and assuring that it is input on TECS INTEL.

(7) The following describes the role of the various committee members:

(a) Examination -- Presents the promotional material(s) to the committee for the purpose of showing that there is a "likely basis" of a possible *IRC 6700* examination. Also presents cases referred from ATSDT's in service centers. (In certain cases, these cases may also be presented by criminal investigation.)

(b) Criminal Investigation --

1 The Criminal Investigation role is by design limited. This role includes participating in the decision making as to whether or not a shelter promotion should be pursued as a potential *IRC 6700*/7408 examination and to provide to the committee any information that Criminal Investigation has either in case development files or from an active investigation file. Criminal Investigation in appropriate situations will also recommend to the Committee that the shelter promotion presented is appropriate for immediate referral to Criminal Investigation.

2 It is important that all Committee members, and in particular Criminal Investigation representatives, recognize that advice cannot be given by Criminal Investigation regarding what needs to be done to make a proposed promotion acceptable after the Committee has decided it is not at the time of presentation a suitable vehicle. In other words, Criminal Investigation cannot direct that certain actions be taken in order that the promotion may subsequently be accepted by the Committee. Policy Statement P-4-84 indicates that civil enforcement actions with respect to taxable periods of the same and other types of tax not included in a criminal investigation generally do not imperil successful criminal investigation or subsequent prosecution. Therefore, civil enforcement actions under *IRC 6700*/7408 may proceed concurrently unless there is agreement between Division Chiefs of the responsible field functions to withhold civil action during the pendency of the criminal investigation. However, at any time a grand jury is impaneled, the Division Chiefs of the affected functions should decide how to proceed. If the Division Chiefs cannot decide, the District Director should make the decision. If more than one District or Region is involved, the Assistant Regional Commissioners will make the decision.

(c) District Counsel -- serve as the legal advisers to the Committee. In those instances when more than one District Counsel office covers a district, the District Counsel office having jurisdiction over the promoter/salesman will be the office to be represented on the committee for that promotion.

(8) The Committee will review the submitted information and select promoters/schemes for which the promoter penalty/pre-filing notification and/or injunction action may be applicable. The following criteria may be considered by both the Abusive Tax Shelter Coordinator and the Committee in selecting appropriate promoters/schemes:

(a) Past History of the Promoter. The prior promotion of abusive shelters raises the possibility that the current offering may be abusive.

(b) Type of Shelter. Asset sale or lease, charitable contribution, research and development, mining, family trust/protester, time share, etc., are some examples of potentially abusive tax shelters. The type of shelter ordinarily indicates the degree of difficulty and time necessary to conclude an examination.

(c) Size of Promotion. The potential number of investors and potential revenue loss must justify pre-filing action and resources required to develop the case.

(d) National Impact. To the extent that handling a promotion with "up-front" actions will have a favorable impact, resources should be concentrated on National shelters/promoters. District personnel should not overestimate the weight of this factor since abusive tax shelters may surface at the local level and these must be considered for compliance impact.

(e) Issues Involved. Asset overvaluation, (see *IRC 6700(b)*), or false or fraudulent statements of a material nature (see *IRC 6700(a)(2)(A)*) are indicators of a potential 6700 case. The potential for one of these issues must be identified prior to forwarding the case to the committee.

(9) The Abusive Tax Shelter coordinator should expeditiously review all prospectuses, offering memorandums, etc., and be prepared to present any that have potential to the committee for consideration. Committee meetings should be held within two weeks after the district coordinator determines that he/she has a potential case to present.

(10) Disagreements among committee members on whether a specific promoter scheme should be selected for promoter penalty/pre-filing notification letter and/or *IRC 7408* injunction referral action will be forwarded to the District Director who, in consultation with District Counsel, will resolve the disagreement.

(11) Where a salesperson of a potential *IRC 6700* activity is identified, an *IRC 6700* examination should not be commenced independently of the key district. The examination should be coordinated with the district where the promoter resides. Where the key district has not initiated an examination, formal correspondence and appropriate follow up should be initiated to coordinate the examination.

(12) If the Committee selects the promoter/scheme for examination, a revenue agent will be assigned per IRM 42(17)(11).61. However, if the Committee rejects the promoter/scheme for examination consideration, the file will be documented, as deemed appropriate, and forwarded to the Abusive Tax Shelter Coordinator for whatever action is deemed appropriate.

SUBSECTION-2: 42(17)(11).6 Development of Cases

SUBSECTION-3: 42(17)(11).61 Assignment of a Revenue Agent

(1) After the promoter/scheme has been selected by the Committee, a revenue agent will be assigned to the case unless the promoter is the target of a grand jury investigation. An assigned revenue agent will be responsible for:

(a) Determining whether the promoter penalty in *IRC 6700* is applicable and obtaining appropriate documentation to support such a determination.

(b) Determining whether there is a basis for concluding that the investors will not be in compliance with the tax law if they claim the tax benefits represented by the promoter to be available and obtaining appropriate documentation to support such a determination determining that pre-filing notification letters be issued.

(c) Determining whether injunctive relief under *IRC 7408* should be sought and obtaining appropriate documentation to support such a determination.

(2) A basis for concluding that the investors will not be in compliance with the tax law if they claim the tax benefits represented by the promoter to be available could exist when one of the following is present:

(a) Overvalued asset within the meaning of *IRC 6700(b)*;

(b) False or fraudulent statement as to a material matter;

(3) Adequate documentation must be secured to meet the criteria in (2) above.

(4) Time expended by revenue agents in developing identified cases for promoter penalty (*IRC 6700*), pre-filing notification, and injunction action (*IRC 7408*) should be charged to time Code 593007 in accordance with IRM 4810, Examination Reports Handbook, cases will be listed individually on the Examination Technical Time Report, Form 4502.

(5) At the time the revenue agent is assigned to the case, a request should be forwarded to District Counsel requesting the assignment of a senior trial attorney to provide assistance to the revenue agent.

SUBSECTION-3: 42(17)(11).62 Commencement of an IRC 6700 Examination

(1) The promoter will be contacted by the revenue agent (unless the promoter is the subject of a grand jury investigation) through the issuance of Letter 1844(DO), Notice of Commencement of *IRC 6700* Examination, and advised that we are examining all tax shelter promotions. If the promoter furnishes the service with a power of attorney in connection with an *IRC 6700* examination, the power of attorney will be retained in the administrative case file.

(2) A senior trial attorney from District Counsel's office will provide pre-referral assistance and suggestions on what books and records and other documents should be requested. The attorneys will work hand-in-hand with the revenue agent in preparing a document request. This request should be prepared in a format that could be included in a summons, if appropriate.

(3) Per Section 4.02 of *Revenue Procedure 83-78,* the promoter must make the requested documents available within 10 days. Consideration should then be given to issuing a summons, if necessary.

(4) If the promoter refuses to provide the needed information and documentation, summonses may have to be issued and enforced. To meet certain critical dates, this must be done expeditiously. Thus, while the revenue agent is contacting the promoter, the attorney can be preparing summonses for the books, records, and other documents including investor information.

(5) If summons enforcement is required, the revenue agent should continue the *IRC 6700* examination. For example, third party contacts could be made and asset appraisals could be secured. In the event that a summons is enforced by court action, the agent must see that the court order is complied with on the date the promoter is to appear to present the requested documents. In no case shall there be an extension granted by the agent or the group manager. If records are not properly furnished, the agent will promptly notify the Government attorney in the case and request that a contempt charge be sought.

(6) For enforcement purposes, the *IRC 6700* penalty is considered a tax. Therefore, Examination can open an *IRC 6700* examination and not be precluded from subsequently conducting an income tax examination of the promoter's tax return.

(7) Where possible, the same examiner should perform the *IRC 6700* examination and any income tax examinations of the promoter.

(8) Revenue Agents should ensure that a detailed, documented examination history of his/her action (s) is maintained in the case file.

(9) IRC 982, which was added by Section 337(a) of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) provides that, "If the taxpayer fails to substantially comply with any formal document request arising out of the examination of the tax treatment of any item any court having jurisdiction of a civil proceeding in which the tax treatment of the examined item is an issue shall prohibit the introduction by the taxpayer of any foreign-based documentation covered by such request."

(a) When *IRC 982* is used in conjunction with *IRC 6700*, it could provide a means of barring promoters from introducing foreign based documentation. Reference should be made to IRM 4233, Tax Audit Guidelines, Individuals, Partnerships, Estate and Trusts, and Corporations, for procedures prior to the issuance of formal document requests.

(b) In order to ensure that both the promoter and tax matter partner are precluded from presenting additional information at a later date, the agent will need to issue two formal document requests: for the *IRC 6700* examination and for the income tax examination.

(10) When the revenue agent discovers additional promotions offered by the same promoter and the *IRC 6700* committee's original authorization clearly includes the examination of other shelters (for example, if the *IRC 6700* committee meeting minutes provided for the examination of "The A Shelter and Mr. John Doe for Promotion of any Abusive Tax Shelters"), the examination may be enlarged to include the additional shelters with no further *IRC 6700* committee involvement. The revenue agent will consult the attorney assigned to the case and obtain the approval of the group manager before enlarging the examination. Separate letters (Forms 1844) should be provided to the promoter for each additional promotion which the agent believes may be subject to *IRC 6700*, PFN Action, or *IRC 7408* injunction, and the promoter should be provided an opportunity to present his position as to each additional promotion in the meeting provided by *Rev. Proc. 83-78*. If the committees original authorization does not clearly encompass other shelters, the revenue agent may with the approval of the group manager, continue the examination of the other shelters. However, the agent should promptly present the additional shelters to the *IRC 6700* committee at its next meeting and seek the *IRC 6700* committee approval to enlarge the examination.

(11) Where both the *IRC 6700* penalty and an *IRC 7408* injunction are being considered, the assertion of the *IRC 6700* penalty will not ordinarily be suspensed pending the completion of the injunction suit unless requested by the Dept. of Justice or there is criminal investigative activity. See text 2(17)(11).66 of LEM IV for a discussion of the computation and assessment of the Section 6700 penalty and processing of Section 6703(3) refund claims, penalties under *IRC 6694*, understatement of taxpayers liability by income tax return preparer will be held in abeyance.

SUBSECTION-3: 42(17)(11).63 Potential Fraud Referrals of IRC 6700 Examinations

If the agent determines that there are firm indications of fraud, the matter will be promptly referred to the Criminal Investigation function in accordance with the procedures contained in IRM 4565, General Fraud Procedure.

SUBSECTION-3: 42(17)(11).64 Conclusion of an IRC 6700 Examination

(1) The revenue agent and attorney shall determine whether the case qualifies for assessment of the *IRC 6700* penalty, issuance of Pre-Filing Notification Letters, and/or request for injunctive relief. The agent and attorney should agree on the appropriate action. If there are any disagreements, they should be forwarded to the committee for immediate resolution.

(2) If any of the actions discussed in (1) above are recommended, the revenue agent will establish a date for a meeting with the promoter. At the meeting the promoter will be given the opportunity to present any facts or legal arguments that demonstrate that there is a basis for concluding that the shelter's claimed tax benefits comply with the tax law.

(a) Generally, no extensions of time shall be granted for the meeting except in extenuating circumstances. The promoter will not be entitled to any additional meetings with the Service regarding possible action of the Service. No final decision shall be communicated at the meeting concerning the determination that the Service will finally make.

(b) If the promoter declines the offer to attend the meeting, fails to attend the meeting, or fails to provide the requested documents or information pursuant to the summons, the Service shall proceed based on the available promotional materials, books, records and/or third party information.

(c) A copy of the letter offering the promoter a closing conference shall be maintained in the administrative file and a copy of the letter will also be used as an exhibit in the *IRC 7408* Injunction Case file, if there is one.

(d) If the Revenue Agent and attorney determine that there is not a basis for the assertion of the *IRC 6700* penalty, the promoter will be issued Letter *1866(DO), IRC* 6700 Discontinuance Letter. No changes to the letter will be made.

(3) Where there is an overvalued asset within the meaning of *IRC 6700(b)* and/or false or fraudulent statement as to a material matter and upon concurrence of the District Counsel Attorney, the case will be forwarded to the district director for written approval to assert the *IRC 6700* penalty, after *IRC 6700* penalties are determined to be appropriate, consideration will be given to issuing Pre-Filing Notification Letters to investors and/or referral for *IRC 7408* injunction action. (Procedurally, this would occur after the action described in IRM 42(17)(11).64:(2)). This approval will be maintained in the case file.

(4) If the Revenue Agent and District Counsel Attorney conclude that an *IRC 6700* penalty is appropriate and the District Director approves, the Revenue Agent will prepare a Revenue Agent Report (RAR) establishing the basis for assertion of the penalty and a statement showing the computation of the amount of the penalty. Form 886A, explanation of items, should be used to explain the computation of the *IRC 6700* penalty. Form 8278 computation and assessment of miscellaneous penalties will be made part of the case file. All *IRC 6700* case files will include Form 4665. (See text 520 of IRM 4237 Report Writing Guide). Form 4665 will furnish examination employees information about the examination, (1) indicate whether or not the key case is subject to TEFRA and explain; (2) indicate whether or not the subsequent year will be examined and furnish an explanation in order to facilitate the suspension of investors returns and; (3) indicate whether or not investors are required to file Form 8271, Investor Reporting of Tax Shelter Registration Numbers, based on registration requirements of the promotion.

SUBSECTION-3: 42(17)(11).65 Processing Claims for Penalties Assessed Under IRC 6700

Special claim procedures apply under *IRC 6703* with respect to penalties asserted under *IRC sections 6700*, 6701, and 6702.

SUBSECTION-3: 42(17)(11).66 Investor Penalties

(1) The Internal Revenue Code provides in appropriate cases for the application of the negligence penalty under *IRC 6653(a)*, the valuation overstatement of income tax penalty under *IRC 6659* and/or the substantial understatement of income tax penalty under *IRC 6661*. In computing the *IRC 6661* penalty, examiners will exclude that portion of the substantial understatement for which a penalty was imposed under *IRC 6659* (see *IRC 6661(b)(3)*).

(2) All *IRC 6659* and 6661 penalties proposed by a district or service center are subject to review by the Penalty Screening Committee and the Quality Review Staff (see IRM 4563.61:(3)). The Penalty Screening Committee will ensure that no assessments are made which are contrary to Service policies, or which could result in adverse consequences to the Service.

(3) Decisions to abate the negligence penalty under *IRC 6653(a)*, the valuation overstatement penalty under *IRC 6659* and/or the substantial understatement of income tax penalty under *IRC 6661* will receive the concurrence of District Counsel. This concurrence applies only to the application of penalties in instances where Pre-filing Notification Letters have been issued.

(4) If the investor is known to be a witness in either an IRS grand jury investigation or an administrative criminal investigation, penalties will be suspensed upon the request of the Criminal Investigation function.

SUBSECTION-3: 42(17)(11).67 Pre-filing Notification

(1) Upon approval by the District Director, Letter 1843(DO), Investor Pre-filing Notification Letter, will be issued to all investors in non-TEFRA entities advising that we believe that certain purported deductions and/or credits are not allowable and advising of the possible consequences if such deduction(s) and/or credit(s) are claimed on the tax return including the reduction of refunds attributable to the tax shelter item when applicable. Where it cannot be determined what portion of the credits relate to the abusive tax shelter, the entire amount of credits will be used to reduce the taxpayers refund; however, a reasonable effort to determine the amount related to the abusive tax shelter should be made. (Non-TEFRA entities are all entities other than as described in *IRC 6221* and 6241.)

(a) The District Director may authorize a representative to sign the Pre-filing Notification Letters. Facsimile signatures are acceptable with initials indicating person who affixed signature.

(b) The issuing district office will forward a list of all PFN's issued, copies of each investor's letter and the letter of approval to the Service Center where the investor is required to file his/her tax return. These copies should be forwarded to the attention of the Service Center Pre-filing Coordinator. Information concerning the type and amount of deduction(s) and/or credit(s) that the investor would be reporting and whether TEFRA will also be forwarded to the Service Center. When there are multiple districts within a state, District Offices should use IRM Exhibit 4100-18, "Zip Code Listing

for States with More than One District" to ensure proper distribution of the pre-filing notification letters.

(c) The Service Center Pre-Filing Coordinator will maintain a list of all taxpayers who have been issued Pre-filing Notification Letters. A copy of the letter of approval which contains the District Director's signature will also be kept with this information.

(d) A pro-forma RAR establishing the basis for disallowance of the deductions and/or credits on the investors' returns should be developed by the revenue agent and forwarded to the service center Pre-filing Notification Coordinators. This should be done as soon as possible to avoid prolonged delays in contacting those investors who claimed the deductions and/or credits. The subsequent year's investor return will be controlled in the service center where the pro-forma RAR's for the first examined year are sent. In addition to the initial year pro-forma, districts must prepare the subsequent year(s) RAR's as soon as possible, and distribute copies of these RAR's to all affected service centers. Districts must also notify service centers on Form 4665, Transmittal Letter, if subsequent year examinations are not needed so the service centers can keep their inventories current. Service centers should screen subsequent year returns for tax shelter investments which may be claimed as a theft loss, capital loss or Schedule C Deduction. Since some of the investor returns controlled in service centers show promotions from outside their jurisdictions, interregional cooperation and prompt action are required in order to prevent a build-up of investor cases and statute problems in the service centers.

(2) If the promotion is a partnership covered by TEFRA (see *IRC 6231*), Letter 1845 (DO), TEFRA Partnership Pre-filing Notification Letter, will be issued to the Tax Matters Partner (TMP). Non-TEFRA flow-through entities, as defined in IRM 4221, will be issued Letter 1843(DO), Investor Pre-filing Notification Letter. S Corporation TEFRA entities will be issued Letter 1976(DO), S Corporation Shareholder Pre-Filing Notification Letter -- TEFRA.

(3) All other individual partners will be issued Letter 1842(DO), TEFRA Partner Notification Letter, apprising them of the letter to the TMP and their options under TEFRA. S Corporation TEFRA entities will be issued Letter 1977(DO), S Corporation Pre-Filing Notification Letter -- TEFRA. If the flow-through entity contains multiple tiers, the letters will not be issued to entities beyond the first tier.

(4) To derive the greatest effectiveness from the PFN program, beginning in 1987, no Pre- Filing Notification letters are to be issued after July 15.

(a) If investor information is secured after July 15 in a case where PFN letters were previously issued, PFN letters are not to be issued to the additional investors. However, a list containing the required information (i.e., investors, names, TIN's, addresses, and information related to the deductions and credits that might be taken and any other related information) will be provided to the affected Service Center and they will input the data and establish a requisition. Such lists will only be sent when the following three conditions are met: the *IRC 6700* PFN case had been approved by July 15th, PFN letters had been sent to at least some investors by July 15th, and the list pertains to investors in the same promotion that were not issued PFN's by July 15th but should have been. A transmittal memorandum will be sent with the list requesting that the service center input the data to requisition the subsequent year return, and stating that the three conditions mentioned above have been met. This procedure is to be followed for both the current and subsequent years of the promotion.

(b) Taxpayers other than individuals may file tax returns on dates including automatic extensions

other than August 15. Where these taxpayers are identified, every effort should be made to issue the pre-filing letters prior to the presumed filing date. For example, a partnership with a December 31 year-end would have a presumed filing date of June 15th of the following year, including extensions.

(5) All cases with Pre-Filing Notification Letters and/or Frozen refunds must be flagged on the Form 3198, "Special Handling Notice," to indicate that the case is a Pre-Filing Notification Case and/or a case with a frozen refund. The Service Center PFN Coordinator will establish NMF control (see Exhibit 200-4 of IRM 48(13)1, AIMS-Use of Forms and Special Handling Procedures) on all investors where they cannot determine the correct TIN for the taxpayer. Where the correct TIN is determined, the procedures in Exhibit 400-2 of IRM 48(13)1 will be followed by the Service Center PFN Coordinator to establish Master File control.

(6) With the implementation of the Abusive Tax Shelter Detection Teams (ATSDT) in the Service Centers, certain procedures in *Rev. Proc. 83-78* impacting on Pre-filing Notification (PFN) letters need clarification. It is anticipated that various other returns related to an approved PFN case will be identified by the ATSDT. Questions have been raised as to whether these related returns should be controlled as part of the previously-approved PFN case or whether the approval procedures for ATSDT-identified cases under *Rev. Proc. 84-84* should be followed. The following examples clarify this inter-relationship in order to avoid duplication of efforts:

(a) All returns identified by the ATSDT that are the subject of a PFN Letter where the benefits of the promotion were claimed on the tax return will have the case processed under the procedures described in *Rev. Proc. 83-78.*

(b) When additional investors in a previously-approved PFN promotion are identified, the function that makes the determination will coordinate with the issuing district (except in the case of a Service Center function which will provide the information to the Service Center PFN Coordinator). Since the issuing District Director has already determined that the shelter is abusive, the additional investors will also be considered PFN cases. However, the approval of the District Director will be required to freeze each investor's refund in lieu of having signed the PFN letter. The portion of the refund attributed to the previously-approved PFN promotion will be suspensed for those taxpayers claiming the tax shelter benefits even though letters were not issued. The issuing District Office should coordinate with the appropriate Service Centers.

(c) Where PFN letters are issued to a second tier Partnership or S Corporation, the district 6700/7408 Coordinator having jurisdiction over the second tier will secure the return. A listing of investors will be compiled by the Coordinator, showing the required information for each investor. The list will be provided to the affected Service Center(s) in order that they can input TC 810-1 to insure that the subsequent tier investors are controlled. There will be no suspension of refunds for second tier investors unless otherwise approved by the district director of the examining district of the second tier Partnership or S Corporation.

(d) *Rev. Proc. 83-78* is applicable when an investor claims tax benefits on a subsequent year's return from an abusive tax shelter acquired in a prior year on which PFN letters were issued. Since the district director has already determined that the shelter is abusive in the prior year, subsequent year returns will also be considered PFN cases. Accordingly, the claimed refund will be frozen on the subsequent year's return for the portion attributable to the abusive tax shelter. When subsequent year returns are not yet available, an explanation should be provided to the taxpayer that our procedure will automatically cause the return to be reviewed and a deduction/credit related to the abusive tax

shelter identified in the PFN letter will result in the examination of the tax return.

(e) *Rev. Proc. 83-78* is applicable where excessive investment credits, deductions, etc., are generated and carried back either on Forms 1040X, 1045, 1120X, or 1139 from an initial year PFN case. Since the district director has already determined that the shelter is abusive in the initial year of the loss/credit, the carryback years will also be considered PFN cases. Accordingly, the portion of the refunds claimed that are attributable to tax benefits claimed from a previously approved PFN case will be frozen. It should be noted that in the case of an application for tentative carryback adjustment, the Service will make an assessment under £ 6213(b)(3) of the Code and offset the amount assessed against the scheduled refund (See Section 3.02 of *Rev. Proc. 84-84.)* In addition, penalties that apply to gross overvaluations and understatement of tax liabilities should be imposed for the portion of the increased tax liability related to the claimed PFN case tax shelter benefits in these cases.

(f) PFN letters should not be issued to the investors in a promotion where the determination is made after July 15 of the subsequent year. Instead of issuing PFN letters, the promotion should be referred to the Assistant Commissioner (Examination) under *Rev. Proc. 84-84* procedures. The district should advise the appropriate service centers as to their respective investors and the details of the promotion/scheme. Such cases should be appropriately coordinated by the issuing District with the Abusive Tax Shelter Detection Team and the service center PFN coordinator.

SUBSECTION-3: 42(17)(11).68 IRC 7408 Promoter Injunctions

(1) If the Revenue Agent and District Counsel Attorney conclude that an *IRC 7408* referral is appropriate and the District Director approves, the following procedures should be adopted with respect to submitting 7408 Cases.

(a) A copy of the RAR will be submitted with the 7408 file;
(b) The RAR will be referenced to the exhibits and the exhibits correspondingly numbered;
(c) The Revenue Agent should retain a complete copy of the submitted documents in order to facilitate telephone discussions between the trial attorneys and the Revenue Agent who prepared the report; and
(d) When tapes whether video or audio are forwarded as evidence, a transcript should be forwarded with the tape.

(2) Following the granting of an injunction, copies of the injunction and opinion, if available, should be forwarded to the districts in which the known salesmen reside for appropriate action.

(3) Another penalty which should be given consideration is the penalty under *IRC 6701*, Penalties for Aiding and Abetting Understatement of Tax Liability. *IRC 7408*, action to enjoin promoters of abusive tax shelters, has been amended to include *IRC 6701*, text (14)10 of IRM 4236, Examination Tax Shelters Handbook.

1/31/86

PART IV - Examination

CHAPTER: Chapter (14)00 IRC 7408 Report Procedure

SECTION: (14)10 Background

A special format is required for referrals to the Department of Justice for *IRC 7408* injunctive action. The referral report consists of five parts: a case summary, facts and findings, an appendix of attached exhibits, investigating agent data, and a list of witnesses. Exhibit (14)00-1 provides an outline to follow when preparing *IRC 7408* referrals. This format may also be used for *IRC 6700* cases where no *IRC 7408* referral is anticipated, especially where it appears that the promoter/salesperson may bring suit under *IRC 6703* in District Court to determine liability for the 6700 penalty.

SECTION: (14)20 Case Summary

(1) The summary of the report should be the first page of the report. The summary should include:

(a) The name and address of each person under investigation.
(b) The years involved.
(c) A statement regarding whether the case is based on false or fraudulent statements or gross valuation overstatement, or a combination thereof.
(d) The actions recommended.

(2) If there are several people involved, there should be a separate paragraph of the summary portion that discusses each person under investigation.

(3) The summary portion may be in narrative or outline form.

(a) The summary portion should be specific.
(b) It should not include a detailed overview of the 6700/7408 area.

SECTION: (14)30 Facts and Findings

(1) This is the body of the report and contains a detailed discussion of the case. This portion of the report will contain eleven sections.

(2) Section 1, personal history, contains information regarding the personal history of each person under investigation. Personal history is a factor when determining whether to initiate court action.

(a) There should be a separate section for each person containing the following information:

1 Age
2 Marital status
3 Educational background

4 Health
5 Reputation in the community.

(b) The personal history section will be important if the subject of part or all of the 6700 penalty is raised for consideration.

(3) Section 2, business background, includes information regarding the business background of those under investigation. It should include such information as:

(a) Business experience.
(b) Occupation.
(c) Knowledge of tax matters, prior selling experience, involvement in fraudulent schemes, or experience in valuation matters.
(d) Prior tax shelter involvement.
(e) Other past and present Internal Revenue Service investigations.

(4) Section 3, CID involvement, discusses the involvement of CID in the case.

(a) If the case is a joint investigation, this section includes a statement that the Chief, Criminal Investigation Division, has been advised of the examiner's recommendations and has concurred in writing. (Attach it as exhibit 3-1 to the report.)

(b) If CID places any restrictions or makes any request, prepare a memo to the file outlining the restrictions and requests. (Attach this as exhibit 3-2 to your report.)

(c) If there was no involvement by CID in this case, the report should so state.

(5) (a)Section 4, mechanics of shelter, includes the specific details of the operation of the promotion. This section should include information pertaining to:

1 How the promotion works.
2 The abusive nature of the promotion.
3 The size of the promotion.
4 The estimated revenue loss from the promotion.
5 The participation in the shelter of the person under investigation.

(b) This is the most detailed portion of the report. Make sure to refer to the exhibits. Also include a discussion of the mandatory and desirable items. (See LEM IV Section 2(17)(11).66) If the promotion operated as a partnership, the names and addresses of the known partners should be included in this section. A copy of the partnership agreement should also be included. If the promotion operated as a corporation, a copy of the articles of incorporation and the names and percentages of ownership of the shareholders should be included in this section.

(6) *Section 5, IRC* 6700, contains a discussion of *IRC section 6700*. Discuss each element of the statute with emphasis on how the facts in this case satisfy each element of the statute. If the case is based on false statements, point out the false statements in the exhibits. This section should include statements and documents establishing that the statement is false. If the case is based on a gross valuation overstatement, this section should include a discussion pointing out the value assigned to the asset by the promotion and the basis for the Government assertion that the value of the asset is

grossly overstated. If there are several people under investigation, the participation of each should be discussed. It should be shown how their participation constitutes a violation of *IRC section 6700.*

(7) Section 6, penalty calculation, discusses the penalty calculation and the basis for the calculation. It should include:

(a) The amount of the penalty to be assessed against each participant.
(b) How the penalty is calculated.
(c) Why the penalty is appropriate.

(8) *Section 7, IRC* 7408, discusses *IRC section 7408* and why it is appropriate. The business history section of the report can be expanded here. There must be some facts to suggest that the person will probably engage in conduct subject to *IRC section 6700* in the future. The report should emphasize any current activity of the participants under investigation in this promotion.

(a) Current activity makes a strong case for the injunction.
(b) If there is no current activity, but there is evidence to suggest that the person will engage in conduct subject to *IRC section 6700* in the future, injunctive relief may be appropriate. This type of evidence should also be emphasized.

(9) Section 8, venue, includes a discussion of the place the examiner recommends venue be located.

(a) An action to enjoin the person may be commenced in the District Court of the United States for the district in which the person:

1 Resides.
2 Has his or her principal place of business.

3 Has engaged in conduct subject to *IRC section 6700.*

(b) When determining venue, consider where the Service can get the most deterrent effect from the action. If the promoter lives in one district and sells the promotion in another district, venue consideration should include:

1 Where the majority of investors in the promotion live.
2 Where the promoter derives the major portion of his or her income from promoting abusive shelter.

(10) Section 9, pre-filling notification, discusses the remedies and effectiveness of PFN's:

(a) Appropriateness of the use of pre-filing notification letters.

(b) What effect the letters will have.

(c) If pre-filing notification letters were issued, a list containing the names of those sent a letter should be attached. (Attach this list as exhibit 9-1.)

(11) Section 10, closing conference, contains a discussion of the closing conference and the defenses raised by those persons under investigation in this promotion. Attach this memorandum of closing conference as exhibit 10-1. A memorandum or pro forma RAR outlining the defenses or positions of

Form 872 (Rev. January 2001)	Department of the Treasury-Internal Revenue Service **Consent to Extend the Time to Assess Tax**	In reply refer to: SA-3111 Taxpayer Identification Number 558-11-9611

Russell Errigo and Michelle Errigo
(Name(s))

taxpayer(s) of Russell Errigo: 8898 North Safflower Lane, Tucson AZ 85743
Michelle Errigo: 5128 Prior Ridge, Granite Bay, CA 95746
(Number, Street, City or Town, State, ZIP Code)

and the Commissioner of Internal Revenue consent and agree to the following:

(1) The amount of any Federal Income tax due on any return(s) made by or
(Kind of tax)

for the above taxpayer(s) for the period(s) ended December 31, 2000

may be assessed at any time on or before June 30, 2005. However, if
(Expiration date)

a notice of deficiency in tax for any such period(s) is sent to the taxpayer(s) on or before that date, then the time for assessing the tax will be further extended by the number of days the assessment was previously prohibited, plus 60 days.

(2) The taxpayer(s) may file a claim for credit or refund and the Service may credit or refund the tax within 6 months after this agreement ends.

MAKING THIS CONSENT WILL NOT DEPRIVE THE TAXPAYER(S) OF ANY APPEAL RIGHTS TO WHICH THEY WOULD OTHERWISE BE ENTITLED.

YOUR SIGNATURE HERE → _____ (Date signed) _____

SPOUSE'S SIGNATURE → _____ (Date signed) _____

TAXPAYER'S REPRESENTATIVE

SIGN HERE → _____ (Date signed) _____

CORPORATE NAME → _____

CORPORATE OFFICER(S) SIGN HERE → _____ (Title) _____ (Date signed) _____

→ _____ (Title) _____ (Date signed) _____

INTERNAL REVENUE SERVICE SIGNATURE AND TITLE

_____ (Division Executive Name - see instructions) _____ (Division Executive Title - see instructions)

BY _____ (Authorized Official Signature and Title - see instructions) _____ (Date signed)

Instructions

If this consent is for income tax, self-employment tax, or FICA tax on tips and is made for any year(s) for which a joint return was filed, both husband and wife must sign the original and copy of this form unless one, acting under a power of attorney, signs as agent for the other. The signatures must match the names as they appear on the front of this form.

If this consent is for gift tax and the donor and the donor's spouse elected to have gifts to third persons considered as made one-half by each, both husband and wife must sign the original and copy of this form unless one, acting under a power of attorney, signs as agent for the other. The signatures must match the names as they appear on the front of this form.

If this consent is for Chapter 41, 42, or 43 taxes involving a partnership or is for a partnership return, only one authorized partner need sign.

If this consent is for Chapter 42 taxes, a separate Form 872 should be completed for each potential disqualified person, entity, or foundation manager that may be involved in a taxable transaction during the related tax year. See Revenue Ruling 75-391, 1975-2 C.B. 446.

If you are an attorney or agent of the taxpayer(s), you may sign this consent provided the action is specifically authorized by a power of attorney. If the power of attorney was not previously filed, you must include it with this form.

If you are acting as a fiduciary (such as executor, administrator, trustee, etc.) and you sign this consent, attach Form 56, Notice Concerning Fiduciary Relationship, unless it was previously filed. If the taxpayer is a corporation, sign this consent with the corporate name followed by the signature and title of the officer(s) authorized to sign.

Instructions for Internal Revenue Service Employees

Complete the Division Executive's name and title depending upon your division.

If you are in the Small Business /Self-Employed Division, enter the name and title for the appropriate division executive for your business unit (e.g., Area Director for your area; Director, Compliance Policy; Director, Compliance Services).

If you are in the Wage and Investment Division, enter the name and title for the appropriate division executive for your business unit (e.g., Area Director for your area; Director, Field Compliance Services).

If you are in the Large and Mid-Size Business Division, enter the name and title of the Director, Field Operations for your industry.

If you are in the Tax Exempt and Government Entities Division, enter the name and title for the appropriate division executive for your business unit (e.g., Director, Exempt Organizations; Director, Employee Plans; Director, Federal, State and Local Governments; Director, Indian Tribal Governments; Director, Tax Exempt Bonds).

If you are in Appeals, enter the name and title of the appropriate Director, Appeals Operating Unit.

The signature and title line will be signed and dated by the appropriate authorized official within your division.

those under investigation is attached as exhibit 10-2. This section should also include a discussion of the facts which rebut the defenses raised by the person under investigation.

(12) Section 11 gives the recommendations and conclusions of the revenue agent.

SECTION: (14)40 Appendix of Attached Exhibits

The report should also include an appendix wherein the exhibits are listed and attached. The different sections of the report should refer to the exhibits by page number. The mandatory and desirable documents and information should be included as exhibits. Any memorandums of interviews or affidavits should be included as exhibits.

SECTION: (14)50 Investigating Agent Data

A list of IRS employees involved in the case is attached here. It should include employees' name, posts of duty, telephone numbers, and their role in the case.

SECTION: (14)60 List of Witnesses

The referral report should include a list of witnesses. See Exhibit (14)00-1 for the items it should cover.

OUTLINE FOR PREPARING
RAR FOR SECTION 7408 INJUNCTION CASE

NAME OF PROMOTION

CASE SUMMARY

1. Introduction

a.Subject of investigation
b.Representative of subject
c.Type case and years involved
d.Agent's recommendation
e.Origin of case
f.Related cases

2. Summary of Findings

a.Violations determined
b.Mechanics of promotion
c.Basis of each charge

FACTS AND FINDINGS

1. History of Promoter

a.Individual
b.Partnership
c.Corporation

2. Business Background

a.Business of individual, partners, or corporate officers
b.Occupation of individual or business activity of partnership or corporation
c.Knowledge of tax matters, sales or fraud, or valuation matters
d.Connection with tax shelter
e.Prior tax shelter involvement
f.Other past or present Internal Revenue Service investigations

3. CID Involvement

a.Joint investigations
b.Request or restrictions by CID

4. Analysis of Promotion

a.In-depth description of the mechanics of the promotion and how it functions
b.Description of abusive characteristics of promotion
c.Size of promotion and tax harm to Treasury
d.Each person's role in the promotion
e.Evidence related to 6700 violations

1)Mandatory items

2)Desirable items

5. IRC Section 6700

a.Elements of statue
b.False statement(s)
c.Gross valuation overstatement

6. Penalty Calculation

a.Amount of penalty per person
b.Basis of calculation
c.Appropriateness of penalty

7. Injunctive Action Under Section 7408

a.Summary of reason for action
b.History of prior tax shelter activity
c.Probability of future tax shelter activity
d.Current tax shelter activity

SECTION: (14)60 List of Witnesses

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8. Venue

a.Location of assets, documents, and books and records
b.Market of promotion
c.Where promotion sold
d.Residence and business location of:

1) Promoter or other salesperson

2) Investors

9. Pre-filing Notification

a.Basis for use
b.List of investors issued letters

10. Closing Conference

a.Summary of closing conference (attach copy of memorandum of conference to report)
b.Defenses raised (attach pro forma report as an exhibit)
c.Efforts made to verify assertions of promoter
d.Discuss facts that rebut defenses

11. Recommendations and Conclusions of Revenue Agent

APPENDIX OF ATTACHED EXHIBITS

Exhibits should be numbered to indicate the section to which it corresponds (for example, 9-1 would indicate list of investors issued letters).

INVESTIGATING AGENT DATA

1.Revenue agent

2.Group manager of agent

3.District Counsel attorney

4.Attorney's supervisor (list name, address, and telephone number

for each)

LIST OF WITNESSES

1.May be listed:

a.Alphabetically

b.Order of probable appearance at trial

2.Name, address, telephone number, and title or other identification of each witness should be set forth, together with a reference to any exhibit or appendix (page number) that is pertinent to his or her testimony and to the records or other he or she may be expected to produce or identify.

3.It will be helpful if a summary of the testimony of key witnesses is included on the list of witnesses. This would be a brief outline or statement concerning all matters about which the witness can be expected to testify.

4.In the event a witness can present evidence to rebut a probable defense, the witness should be identified as a rebuttal witness as to a specific issue.

5.Try to prepare the list of witnesses as the report is written, try to see if a witness has been listed for each item of evidence.

6.Witness testimony may be summarized as follows:

a.Will produce _ (partnership agreement, sales data, budget, sales contracts, appraisal, etc.) which he or she prepared from _ (information provided by X).

b.Will testify concerning preparation of _ . Will describe _. Will testify regarding his or her own knowledge of _ .

c.If defense of _ raised that _ occurred, can testify in rebuttal that _ .

IRM 4200 Income Tax Examinations

SubSection 4245 Audio Recording of Examination Interviews

Date document last amended (7-23-90)

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(1). Under IRC 7521(a) and Notice 89-51, 1989-1 C.B. 691, taxpayers and their authorized representatives can make an audio recording of in-person interviews relating to the determination or collection of any tax.

(2). An in-person interview for the purpose of establishing a taxpayer's liability for filing a return is an interview relating to the determination of tax for purposes of IRC 7521(a).

(3). Requests to videotape or otherwise film examination proceedings will be denied.

(4). Telephone conversations are specifically not recordable.

(5). Stenographic/verbatim recordings are allowable and will be processed under the same provisions as audio recordings.

(6). All recorded interviews will contain the following information:

(a). The date, time, and place of the interview,

(b). The taxpayer's name and SSN/EIN,

(c). The purpose of the proceeding,

(d). The tax year(s) under examination,

(e). A clear description of written documentation provided in support of the issues, and,

(f). At the conclusion, a statement indicating:

1. The total recording time for the interview (i.e., the time the tape was running in making the recording), and

2. That the interview has been completed and the recording is ended.

(7). The cassette will be labeled with the taxpayer's name, SSN, year(s) examined, date of interview, and total time of the recording. Recording of multiple interviews relating to one taxpayer's examination will begin on one side of a cassette or on an additional cassette, and be labeled in sequence. Exhibit 7-1

(8). The completed cassette recording will be put in a manila envelope, sealed, and securely stapled into the body of workpapers. At the top of F-5344, Examination Closing Document, write RECORDED INTERVIEW--CASSETTE ENCLOSED.

(1). Requests by taxpayers or their authorized representatives will be approved under the following conditions:

(a). Taxpayers supply their own recording equipment,

(b). The Service may produce its own recording of the proceeding,

(c). The recording takes place in a suitable location (usually a Service office),

(d). All participants consent to and identify themselves in the recording and state their roles in the proceedings, and

(e). The taxpayer provides the Service with no less than 10 calendar days advance notice of the intent to record.

(2). The requirement in (1)(e) allows the Service sufficient time to have recording equipment in place. However:

(a). If the taxpayer appears for an interview with a request to record but has not given advance notice, the Service will accommodate the request if equipment is readily available, or,

(b). If advance notice has been given but the Service does not or will not have equipment in place, the interview can be rescheduled; the taxpayer's statutory right to record is not being denied, it is only being postponed.

(3). The Service is not required to give the taxpayer 10 calendar days advanced notice that the Service will produce its own recording of the proceedings.

(4). If the equipment of the taxpayer or the Service malfunctions during the recording, the interview may be rescheduled.

(1). IRC 7521(a)(2) allows the Service to initiate an audio recording of an in-person interview relating to the determination or collection of any tax.

(2). An authorized representative may appear for the taxpayer in the absence of an administrative summons.

(3). In the rare instance of a Service initiated recording, the taxpayer will be notified no less than 10 calendar days in advance of the interview.

(4). Using the District Director's letterhead, the taxpayer will be mailed Pattern Letter 2156 (3-89). (See Exhibit 4245-1).

(5). The text of this letter can be issued in connection with an administrative summons.

(6). In addition to the items in 4245.1:(6), the examiner will clearly state that the recording has been initiated by the Service.

(7). Division Chief approval is required for all Service initiated recordings.

(1). Taxpayers or their authorized representatives have 30 calendar days from the date of the completed recording to request a copy (cassette reproduction) or transcript of the Service recording.

(2). If the statute of limitations permits, the case file may be suspended for the 30 calendar day period, or the examiner may ask the taxpayer if a copy/transcript is being requested.

(3). If an imminent expiration of the statutory period for assessment precludes suspending the case for 30 calendar days, or there is insufficient time remaining under the statute to process the request for a copy/transcript, secure Form 872, Consent to Extend the Time to Assess Tax. If the extension cannot be secured, the taxpayer can request a copy/transcript under the Freedom of Information Act following Statement of Procedural Rules section 601.702.

(4). If the taxpayer requests a copy/transcript more than 30 calendar days after the date of the completed recording, the request should be honored if it is administratively feasible and the case file is still in the examination group.

(5). The requested copy/transcript will be produced by Service pesonnel under locally established guidelines.

(6). The cost for each cassette reproduction of the Service recording is $10.00. The cost for a transcript of the Service recording is $97.00 per hour of recording time calculated to the nearest ten minute interval; e.g., the cost for a transcript of an interview taped for two hours and eighteen minutes would be $226.33.

(7). Action will not be taken on the taxpayer's request until payment in full by check or money order is received.

(8). The payment will be forwarded to Chief, Regional Accounting Section (RM:F), using Form 3210, Document Transmittal, indicating:

(a). The taxpayer's name,

(b). SSN/EIN,

(c). Date of recorded interview,

(d). Tax year(s),

(e). Date, amount, and number of check or money order,

(f). Payment is for copy/transcript of Service recorded interview under IRC 7521(a)(2)(B), and

(g). The following instructions: Credit to Account 3220.3, Freedom of Information Act Request.

(9). A copy of Form 3210 and a photocopy of the taxpayer's payment will be retained in the case file.

(10). The examiner will proofread the transcript in relation to the recording, make any necessary corrections for retyping, and retain a copy in the case file before sending it to the taxpayer by certified mail.

INTERNAL REVENUE SERVICE

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PART IV - Examination

CHAPTER: Chapter 4500 Collateral Income, Estate, and Gift Tax Procedure [Supplemented by MS CR 45G-345 High-Income Nonfiler Procedures (Selection Code 38) Expiration Date: June 30, 1992] [Supplemented by MS CR 45G-346 EP/EO Application of Discrepancy Adjustments to Forms 1040 and 1120 Exp. date: February 28, 1992] [Supplemented by MS CR 45G-347 Multi-Functional Nonfiler Assistance Program Exp. Date: September 10, 1994] [Supplemented by MS CR 45G-348 General Guidelines for Accessing and Using the CFOL Command Codes in Examination Functions] [Supplemented by MS 45G-342, Abatement of Interest Due to IRS Error or Delay, Expiration Date: May 2, 1990] [Amended and Supplemented by MS CR 45G-341 Statute of Limitations for Civil Penalties. Expiration Date: November 10, 1989.]

SECTION: 4560 Penalties and Fraud Procedure

SUBSECTION-1: 4563 Application of Penalties

SUBSECTION-2: 4563.6 Procedures for Assertion of Civil Penalties Under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and Economic Recovery Tax Act of 1981 (ERTA)

SUBSECTION-3: 4563.64 Abusive Tax Shelter Promoter Penalty (IRC 6700)

(1) The penalty can be imposed against any person who organizes, assists in the organization, or participates in the sale of a tax shelter. The penalty is the greater of $1,000 or 20 percent of the gross income derived, or to be derived, from the activity. The penalty is immediately assessable; therefore, it is not necessary to have a return filed in order to assess the penalty.

(2) For enforcement purposes, this penalty is considered a tax. Therefore, Examination can open an *IRC 6700* examination. They can request books and records, and issue summonses for books and records. However, if there is a criminal investigation on an earlier year, Criminal Investigation will be contacted prior to assessing the penalty on a subsequent year. In any event, prior to the assessment of a Section 6700 penalty, District Counsel should be contacted for approval.

(3) For a definition of an abusive tax shelter see text 360 of IRM **4236** Examination Tax Shelters Handbook. The assessment of the Section 6700 penalty, however, is not limited to cases involving abusive tax shelters.

(4) A "person," for purposes of *IRC 6700*, is the same definition as in *IRC 7701*. However, if the promoter is a corporation, partnership, or other entity, consideration should be given to also assessing a penalty against the individuals involved in that entity as they are assisting in the promotion of an abusive tax shelter.

(5) The penalty can be computed based on the gross income to be derived from the activity. Therefore, if the prospectus or other information indicates the gross income which should be derived, consideration should be given to assessing, based on this rather than actual sales. For example, a prospectus indicates that there are 250 limited partnership interests for sale at $5,000 per interest, or the prospectus indicates that the promoter has 4,000 books for sale at $10,000. The assessment in this case should be based on 250 partnership interests or 4,000 books.

(6) The assessment of a promoter penalty under *IRC 6700* against an attorney, certified public accountant, or enrolled agent will be cause for a referral to the Director of Practice. See IRM 4297.9 for procedures. The referral should be made at such time that the penalty is imposed.

(7) Assessment instructions are shown in IRM 4562.53:(3).

Part 120 - Multifunction

Handbook 120.1 Penalty Handbook

SubSubSection 6.6.3.2 Procedures for Developing IRC Section 6701 Cases

Date last amended 8/20/1998

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(1) The following factors, although not all inclusive, apply to the person under investigation in IRC section 6701 cases. These factors should be developed to the extent applicable:

a. Education level, degrees, certifications (CPA, LLM in taxation, MBA, etc.);

b. Expertise in accounting and tax law (evidence by seminars/courses taken or given);

c. Occupation and relevant work experience (as an accountant, bookkeeper, tax advisor, etc.);

(2) The following factors pertain to the evidence on facts and circumstances and must be fully developed. This is information that establishes:

a. The assistance or advice upon which the penalty is based (who, when, where, how, and form of assistance or advice);

b. Any documents prepared by the person which reflect the advice given;

c. How the advice or assistance affected the taxpayer's tax liability; (How was it reflected on the tax return? What actions did the taxpayer take to change the liability based on the advice?)

d. How the advice or assistance would create an understatement of tax;

e. The relationship between the person and the taxpayer; (Although not required to assess the IRC

section 6701 penalty, was the person compensated for the advice given? Is the person an employee of the taxpayer or an independent contractor?)

f. How the person knew or should have known that the advice would be used in connection with a material matter arising under the tax laws;

g. How the person knew that the advice would cause an understatement of tax, e.g., what facts were considered by the person making the advice.

(3) The following factors relate to tax shelter advisors, brokers, dealers, organizers, promoters, and other personnel (referred to as promoters) involved in organizing or promoting a tax plan or arrangement which results in the understatement of the tax liability of another person. The revenue agent will:

a. Complete a detailed overview of the financial structure and organization of the scheme, shelter, plan, or arrangement (referred to as plans). The details of the financial transactions and how tax liabilities would be reduced.

b. Determine the promoter's relationship to the plan: Did the promoter participate in organizing the plan? How much control did the promoter have in the promotion and organization of the plan?

c. Determine the relationship of the sales personnel to the promoter: 1.) What instructions were given by the promoter? 2.) How much control was exercised by the promoter? 3.) Did sales personnel make independent representations?

d. Determine how commissions were earned and paid: 1.) Did the promoter receive a commission from each taxpayer or investor? 2.) If so, how much?

e. Investigate the details of the investor's acquisitions: 1.) How was the transaction reported on the return? 2.) Did the transaction result in an underpayment on each return? 3.) If so, how much?

f. Determine the tax benefits promised by the promoter: 1.) How were the benefits presented? 2.) Who received the tax reporting information? 3.) Who determined how the transaction was reported?

g. Review all documentation furnished to the investor: 1.) Who furnished the information? 2.) Did the promoter personally provide the information and instruct the preparers on its use?

h. Determine the relationship between the promoter and each taxpayer: 1.) If the promoter was not the actual preparer, how was the promoter liable for the penalty? 2.) Was the promoter's activity sufficient to support the penalty?

i. Obtain evidence to establish that the promoter knew the document would result in an understatement of each participant's tax liability.

j. Gather information to establish consistent treatment of all promoters. State the type of false documents prepared and how these documents affected tax returns. Retain copies.

k. Determine whether the promoter had a reasonable basis for the position taken: what authority, if any, supports the promoter's position?

l. Reference federal court decisions at all levels, congressional records, Tax Court decisions, regulations, public and private rulings, notices, and other Service publications and written documentation to support the application of the penalty.

(4) The IRC section 6701 penalty should be imposed only after review of the person under investigation, the surrounding circumstances, and the reasons for the position taken. This position must be contrary to clear authority and without reasonable basis.

INTERNAL REVENUE SERVICE
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PART XXXV - Chief Counsel Directives Manual

CHAPTER: Chapter (35)300 Coordination

SECTION: (35)3(12)0 Coordination, Handling, and Control of Tax Shelter Cases

SUBSECTION-1: (35)3(12)4 Nondocketed Cases

TEXT:

(1) The procedures adopted by IRM 42(17)0, Manual Supplement 42G-417, and the section 6700/6701/7408 program contemplate increased coordination and cooperation between Counsel and District Director in processing nondocketed shelter cases and in using the project issue approach.

(2) Nondocketed Cases and Manual Supplement 42G-417

(a) Manual Supplement 42G-414 provided procedures for withdrawal of out-of-pocket settlement offers on selected tax shelter cases. This procedure was often referred to as SWOOPS.

(b) Manual Supplement 42G-417 replaced Manual Supplement 42G-414 thereby changing the program philosophy and the SWOOPS terminology. Manual Supplement 42G-417 is premised on a target and blocker concept.

1 A target is a key shelter promotion. It may be a single shelter or a multiple shelter promotion. The investors are referred to as key investors. The returns of each key investor are analyzed to see if that investor invested in more than one shelter ("blocking investment").

2 Traditionally, blocking investments would result in an investor's return being suspended until all investments had been audited.

3 Under Manual Supplement 42G-417, the blockers for all key investors in a specific target will be audited, and RARs will be written. The multiple issue investors are therefore ready to move forward along with the single issue investors.

(c) Counsel's role in the target/blocker program is to assist Examination in selecting targets and in providing legal advice that will assist the completion of blocking examinations (including prompt preparation of any necessary summonses).

(3) Tax Shelter Injunction Cases and Related Proceedings

(a) Background

1 Texts (35)3(12)5 through (35)3(12)7 set forth guidelines with respect to processing Tax Court tax shelter cases. These instructions set forth guidelines for coordination, handling and control of tax shelter injunction cases (and related proceedings) under I.R.C. £ 7408.

2 TEFRA and DRA provide authorization for the Service to assess civil penalties upon those involved in organizing or selling abusive tax shelters (I.R.C. £ 6700) or aiding and abetting the understatment of the tax liability of another (I.R.C. £ 6701), and further provides for enjoining further violations of section 6700 or 6701 (I.R.C. £ 7408). The Service may also notify investors in an abusive shelter that it intends to examine the returns of those who claim benefits on their return due to their investments in the shelter. These letters will be sent by the District Director to investors prior to filing of returns when possible (hence, the designation "Pre-Filing Notification"). It is, however, recognized that some investors may have filed, and therefore the prefiling notices include reference to filing amended returns. These front-end measures are intended to be an efficient method of stopping abusive tax shelters and will be used in conjunction with the usual postfiling identification and examination of taxpayers' returns.

(b) Procedures

1 IRM 42(17)11 requires that a section 6700 coordinator will be designated by the District Director in each District. The coordinator will be responsible for gathering information on abusive tax schemes currently being marketed. Possible sources will include not only information developed with the Service (e.g., through criminal investigation and examinations) but through state securities agencies, newspaper articles and advertisements, and other outside sources. The coordinator conducts an initial screening of cases to determine whether there exists potential that a given shelter is abusive. The following criteria are used in selecting appropriate promoters/schemes: past activity of promoter(s); type of shelter; size of promotion (number of investors); national and local impact; and issues involved. When the coordinator finds a potentially abusive shelter, he or she will be responsible for presenting the case to the section 6700/7408 committee.

2 In each District a section 6700/7408 committee will be formed with designated representatives from District Counsel, the Criminal Investigation Branch, and the Examination Branch. The Regional Counsel will ensure that there is representation by a District Counsel attorney on each District's committee. In those Districts serviced by more than one District Counsel office, only the District Counsel attorney whose office has jurisdiction over the promoter/salesman will act as the Counsel voting member. The committee meets as often as necessary to review the submitted information and select promoters/shelters for section 6700 examinations. These examinations may result in section 7408 injunctions referrals, the assessment of penalties under section 6700 or 6701, and/or the mailing of prefiling notification letters. These remedies are nonexclusive, and the use of prefiling notices does not eliminate or reduce the need to seek an injunction nor to impose penalties under section 6700 or 6701. In the event that there is disagreement among the committee members as to whether a specific

promoter/scheme should be selected, the matter will be forwarded to the District Director and the District Counsel for immediate resolution.

3 If the committee determines that there is significant potential for developing the case as an abusive tax shelter, the committee will forward it to Examination to open a section 6700 case and to notify District Counsel of the opening of the section 6700 case. Examination will assign a revenue agent to the case, and District Counsel will immediately assign an attorney to provide legal assistance on an ongoing basis.

4 The District Counsel attorney assigned to the case will meet with the revenue agent to discuss what information is needed for a determination as to the abusive nature of the shelter. The District Counsel attorney will assist the revenue agent in preparing a contact letter informing the promoter that a section 6700 case has been opened and requesting books and records (including accounting records and information on the shelter's assets where appropriate), the names of investors and investors and other appropriate documentation for the examination. The District Counsel attorney should work closely with the agent to prepare summonses promptly and to assist in development of the case to make certain that there are no delays in referring the case for an injunction or other appropriate relief.

5 When a promoter refuses to cooperate with the examination by providing the requested information, issuance and enforcement of a section 7602 summons may be used to develop the case. See *United States v. Tiffany Fine Arts, 469 U.S. 310 (1985)*. The purposes of issuing a section 7602 summons are to develop evidence with respect to whether the shelter is abusive and to determine the amount of penalties that may be owing. In order to issue prefiling notices timely, to enjoin promptly further sales or promotions or to take other appropriate action, all efforts should be made to speed the processing of summonses. A special unit has been established in the Department of Justice for section 7408 injunctions that will promptly review summons requests and other actions in such a case. Accordingly, if it is necessary to enforce a summons, an enforcement letter should be sent directly to the Assistant Attorney General, Tax Division, Department of Justice, Washington, D.C. 20530, Attention: Chief, Special Litigation Unit. Copies should be sent to the General Litigation and Tax Litigation Divisions.

6 If the agent determines that there are firm indications of fraud, the matter will be promptly referred to the Criminal Investigation Division (CID). CID will either accept or reject the referral within 10 working days. The agent will make no contact with the promoter(s) during this period. In the event CID accepts the referral, all further contacts with the subjects of the criminal investigation shall be made in accordance with existing procedures governing the conduct of criminal investigations. The investigation will proceed as a joint CID/Examination investigation. Upon commencement of a joint investigation the District Counsel attorney will give advice on both the civil and criminal aspects. Normally, the institution of a joint investigation will not impede the progress of the section 6700 examination or the decision to proceed with a joint investigation.

Code Section: SECTION 6700 -- PROMOTING ABUSIVE TAX SHELTERS; Section 7408 -- Abusive Tax Shelter Injunctions
Author: Schwartz, Milton L.
Institutional Author: United States District Court for the Eastern District of California
Citations: United States v. Estate Preservation Services, et al.; 83 AFTR2d Par. 99-769; No. S-97-1166-LS-GGH (October 5, 1998)
Tax Analysts Reference: 1999 TNT 90-13

Court Enjoins Abusive-Shelter Promoter, Attorney, CPA

A U.S. district court has granted the government preliminary injunctions against the promoter, attorney, and CPA who were involved in the marketing and sale of abusive tax shelters.

====== CASE NAME ======

UNITED STATES OF AMERICA,
Plaintiff,
v.
ESTATE PRESERVATION SERVICES, ETC., ET AL.,
Defendants.

====== SUMMARY ======

A U.S. district court has granted the government preliminary injunctions against the promoter, attorney, and CPA who were involved in the marketing and sale of abusive tax shelters.

Robert Henkell organized Estate Preservation Services (EPS) and conducted seminars to advise individuals on how to create and use Asset Preservation Trusts (APTs) to generate tax deductions and reduce tax liability. Attorney Charles Scott Grace was involved in reviewing and producing the trust documents. CPA William Sefton was EPS's executive vice president.

The IRS began investigating EPS in 1995, concerned that APTs were abusive tax shelters. The Service eventually assessed $1.25 million in penalties against both Henkell and EPS under section 6700. Soon thereafter Henkell began marketing Estate Management Trusts instead of APTs. He also formed New Dynamics Foundation (NDF) to advocate the creation of private charitable foundations as mechanisms for reducing tax liability. In 1997 the government filed suit against EPS, Henkell, Sefton, and Grace, seeking to reduce the penalties to judgment and to enjoin all the defendants under section 7408 from giving further advice about abusive tax shelters.

District Judge Milton L. Schwartz first ruled against Henkell and EPS, finding that they engaged in conduct subject to penalty under section 6700 because they (1) participated in the sale of APTs, (2) made false statements in the brochures they distributed regarding APTs, and (3) knew or had reason to know that the statements were false. The court also found that the statements pertained to a "material" matter because they pertained to the availability of deductions or credits for reducing tax liability. Judge Schwartz concluded that an injunction was necessary because Henkell's prior action indicated that he was likely to repeat his conduct. The court rejected Henkell's contention that an injunction would infringe his First Amendment right to free speech.

In ruling against Grace, the court found that he was involved with APTs and became president and board member of NDF after Henkell resigned, that he also made false

statements to clients regarding APTs, and that he knew or had reason to know that the statements were false. As to Sefton, the court noted that he did not directly sell APTs but he was EPS's vice president and he actively solicited EPS sales agents. Judge Schwartz further found that Sefton caused others to make false statements regarding the APTs' tax benefits and that he knew or had reason to know that those statements were false or fraudulent.

====== FULL TEXT ======

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF CALIFORNIA

MEMORANDUM OF DECISION AND ORDER
(Findings of Fact and Conclusions of Law Included)

October 5, 1998

[1] This case is presently before the court on plaintiff's motion for preliminary injunction pursuant to sections 7402(a) and 7408 of the Internal Revenue Code. The court conducted an extended evidentiary hearing on this motion on February 3-4, 17-18, March 24- 25, and May 5, 1998. Throughout these proceedings, the following appearances were made: Charles P. Hurley, Esq., appeared on behalf of plaintiff, the United States of America (also "the government"); Joe Alfred Izen, Jr., Esq., appeared on behalf of defendants Estate Preservation Services, a Trust, Estate Preservation Services, Inc., and Robert L. Henkell; Stephen J. Russell, Esq., appeared on behalf of defendant Charles Scott Grace; and Spencer K. Malysiak, Esq., appeared on behalf of defendant William L. Sefton.

I. FACTUAL AND PROCEDURAL BACKGROUND.

[2] Defendant Estate Preservation Services ("EPS") /1/ is in the business of, inter alia, marketing trusts and other asset protection tools. In 1992, EPS began selling irrevocable, non-grantor trusts called "Asset Preservation Trusts" ("APTs"). EPS marketed and sold these trusts through a nationwide multi-level marketing network of financial planners.

[3] Defendant Robert L. Henkell was the central figure in promoting and organizing the activities of EPS and created a variety of different trust entities to facilitate his business operations. As part of his effort to market APTs, Henkell drafted a training manual entitled "Asset Preservation Trusts -- Description, Use & Benefits" ("APT Manual"). The APT Manual contains numerous statements with respect to the allowability of tax deductions or credits that could purportedly be derived from APTs. Henkell also conducted seminars, during which he advised individuals on how to create and use these trusts to generate tax deductions and reduce tax liability. Defendant Charles Scott Grace is an attorney who was involved in reviewing and producing the actual trust documents. Defendant William L. Sefton is a certified public accountant who was an executive vice president of EPS. The precise involvement of defendants Grace and Sefton in this venture will be addressed separately infra.

[4] In 1995, the Internal Revenue Service ("IRS") learned of APTs while conducting

audits of individual taxpayers. Suspecting illegal tax-sheltering activity, the IRS launched an investigation and subsequently concluded that APTs were abusive tax shelters being used as mechanisms for claiming excessive and/or unwarranted tax deductions. As a result, the IRS formally assessed penalties in the amount of $1,254,000 each against Henkell and EPS pursuant to section 6700 of the Internal Revenue Code. /2/ Shortly thereafter, Henkell began marketing "Estate Management Trusts" in lieu of "Asset Preservation Trusts," and distributed new brochures. At this time, Henkell also formed New Dynamics Foundation ("NDF"), and advocated the creation of private charitable foundations as mechanisms for reducing tax liability. According to the government, these changes in approach were prompted by defendants' efforts to mask their illegal activities and further evade the IRS.

[5] The government initiated this action on June 23, 1997, naming the following five defendants: (1) Robert L. Henkell; (2) Estate Preservation Services, a Trust; (3) Estate Preservation Services, Inc.; (4) William L. Sefton; and (5) Charles Scott Grace. The government seeks to reduce to judgment tax penalties previously assessed against Henkell and EPS and also seeks to enjoin all defendants from giving any further abusive tax-sheltering advice.

[6] After considering the admissible evidence proffered by all parties during the course of the preliminary injunction hearing, the written submissions, and the record herein, the court now renders its decision on the motion.

II. STANDARD OF REVIEW

[7] The government's request for injunctive relief is governed by section 7408 of the Internal Revenue Code, which provides as follows: (a) Authority to seek injunction. -- A civil action in the name of the United States to enjoin any person from further engaging in conduct subject to penalty under section 6700 (relating to penalty for promoting abusive tax shelters, etc.) . . . may be commenced at the request of the Secretary. . . . (b) Adjudication and decree. -- In any action under subsection (a), if the court finds -- (1) that the person has engaged in any conduct subject to penalty under section 6700 (relating to penalty for promoting abusive tax shelters, etc.) . . . and (2) that injunctive relief is appropriate to prevent recurrence of such conduct, the court may enjoin such person from engaging in such conduct or in any other activity subject to penalty under section 6700 or section 6701. Section 7408 (West 1989). Therefore, in order to be entitled to an injunction, the government must prove that: (1) the defendants have engaged in conduct that subjects them to penalty under section 6700; and (2) an injunction is necessary to prevent recurrence of such conduct.

[8] Section 6700(a) authorizes the imposition of a penalty on 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 or plan or arrangement referred to in subparagraph (A), 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, or (B) a gross valuation overstatement as to any material matter, shall pay, with respect to each activity described in paragraph (1), a penalty equal to $1,000 or, if the person establishes that it is lesser, 100 percent of the gross income derived (or to be derived) by such person from such activity. . . . Section 6700(a) (West Supp. 1998).

[9] In the alternative, the government seeks injunctive relief under section 7402(a). This section authorizes district courts to issue injunctions "as may be necessary or appropriate for the enforcement of the internal revenue laws." Section 7402(a).

[10] The government bears the burden of proving each element necessary for the issuance of an injunction by a preponderance of the evidence. See United States v. H & L Schwartz, Inc., 1987 WL 45223, at *6 (C.D.Cal.1987), affd sub nom Bond v. United States, 872 F.2d 898 (9th Cir. 1989). Because section 7408 expressly authorizes the issuance of an injunction, the traditional requirements for equitable relief need not be satisfied. See Trailer Train Co. v. State Bd. of Equalization, 697 F.2d 860, 869 (9th Cir.), cert. denied, 464 U.S. 846, 104 S.Ct. 149, 78 L.Ed.2d 139 (1983); United States v. Buttorff, 761 F.2d 1056, 1059 (5th Cir. 1985).

[11] Because each of the individual defendants has had a different type and level of involvement with the allegedly abusive tax shelters challenged here, the court will separately address each defendant in determining whether the government is entitled to a preliminary injunction.

III. WHETHER THE GOVERNMENT IS ENTITLED TO AN INJUNCTION AGAINST
DEFENDANTS HENKELL AND EPS.

[12] The court will first jointly consider whether the government is entitled to an injunction against Henkell and EPS. Because Henkell was the creator of EPS and directed its business activities, the same analysis applies and the same result should obtain as to both of these defendants.

A. WHETHER HENKELL AND EPS HAVE ENGAGED IN CONDUCT SUBJECT TO PENALTY
UNDER SECTION 6700.

[13] In order to be entitled to injunctive relief under section 7408, the government must first establish that the defendants have engaged in conduct subject to penalty under section 6700. This requires the following four elements to be satisfied: (1) Defendant has organized or sold (or assisted in the organization or sale of) an entity, plan or arrangement; (2) defendant has made or caused to be made false or fraudulent statements concerning tax benefits to be derived from the entity, plan, or arrangement; (3) defendant knew or had reason to know the statements were false or fraudulent; and (4) the false or fraudulent statements pertained to a material matter.

1. WHETHER HENKELL AND EPS PARTICIPATED IN THE SALE OF AN ENTITY,
PLAN, OR ARRANGEMENT.

[14] The government must first establish that Henkell and EPS participated in the organization or sale of an entity, plan, or arrangement. It is undisputed that both of these defendants were participating in the sale of APTs and/or charitable foundations, both of which qualify as an entity, plan, or arrangement within the meaning of section 6700(a)(1)(A).

2. WHETHER HENKELL AND EPS MADE FALSE STATEMENTS.

[15] The APT Manual contained numerous statements with regard to the allowability of tax deductions or credits that could purportedly be derived from an APT. Materials produced by NDF with respect to charitable foundations also contained statements as to the tax benefits that could be derived from a charitable foundation. In support of its request for a preliminary injunction, the government appears to target four specific representations contained in these materials. The court will separately address each of these in determining whether Henkell and EPS made false statements within the meaning of section 6700(a)(2).

a. THE BASIS FOR PROPERTY TRANSFERRED INTO TRUST.

[16] First, the government contends that Henkell and EPS falsely represented that taxpayers can transfer equipment into a trust at no cost to the trust, giving the trust a higher basis in the equipment than that available to the taxpayer. Specifically, the government targets the following statements contained in the APT Manual: End up with the asset placed into the APT having a new income tax basis equal to the asset's current fair market value. With either method, the intent is the same. Provide liability protection and secure a tax advantage allowed under the legal "tax avoidance" structuring principles. From a tax standpoint, the goal is to start depreciation over from a new tax basis and/or provide a new basis that can defer or eliminate capital gain if the asset is sold by the Trust. APT Manual at 6-7.

[17] This representation is false under the statutes governing depreciation. Section 1015 governs the basis for property acquired by gifts and transfers in trust and provides in pertinent part as follows: If the property was acquired after December 31, 1920, by a transfer in trust . . ., the basis shall be the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor on such transfer under the law applicable to the year in which the transfer was made. Section 1015 (emphasis added).

[18] The foregoing statute clearly provides that the basis for property transferred in trust "shall be the same as it would be in the hands of the grantor." This section provides no authority for the proposition that a taxpayer can acquire a fair market value basis for property simply by transferring it to a trust. If the basis of the taxpayer making the transfer into trust is zero, the basis of the trust in the equipment is also going to be zero.

[19] Henkell's suggestion that the property was actually exchanged for Units of Beneficial Interest ("UBIs") does not alter the analysis. Section 1031, which governs like-kind exchanges, expressly excludes from its provisions property that is exchanged for "certificates of trust or beneficial interests." See section 1031(a)(2)(E). In this court's

opinion, the "UBIs" advocated by Henkell are materially indistinguishable from "certificates of beneficial interest" and therefore cannot qualify as a like-kind exchange under section 1031. Moreover, a review of the "certificate" which purported to grant these UBIs reveals that they do not have an identifiable value that can be either transferred or sold.

[20] Therefore, the representation that property transferred at no cost into trust can gain a fair market value basis is false.

b. UPSTREAMING INCOME.

[21] Second, the government contends that the APT Manual falsely represented that supplies and services can be purchased for a business through a trust at a significant mark-up, thereby transferring income from the business to the trust in order to avoid taxes. This technique, which Henkell calls "upstreaming," was described in the APT Manual as follows: Through simple "upstreaming" techniques (covered in a later paragraph) and other payments, APTs provide an effective method of income splitting. If a business is involved in the "upstreaming" process, business profit can be significantly reduced. This will reduce, or possibly eliminate, self- employment taxes. APT Manual at 9. In describing the upstreamiing process, the APT Manual further states as follows: Upstreaming APT's provide equipment, supplies, services, and/or accounts receivable factoring to the existing business at a significant increase in cost. For example, if the business used specific supplies costing $30,000 per year, this Trust could provide them to the business for $50,000 per year and make a $20,000 profit. This moves $20,000 out of the net business profit and could save as much as $3,060 in self-employment tax or FICA (15.3%). APT Manual at 12. The APT Manual provides several examples of upstreaming profits, including: Many businesses use outside contract labor or sub-contractors to accomplish some business activities. This might also include outside services such as bookkeeping, janitorial, security, sales and marketing, and public relations. Purchasing these services through an APT at a significant mark-up provides an excellent way to move additional business profit. See APT Manual at 13.

[22] The foregoing representations are not supportable under the Internal Revenue Code. Under section 162(a), all trade or business deductions must be "ordinary and necessary" expenses. Courts have construed section 162(a) so as to avoid collusive mark-ups designed solely to gain a tax advantage. Thus, if a transaction as a whole is intended only to divert income and reduce tax liability, it is not an allowable deduction under section 162(a). See Audano v. United States, 428 F.2d 251, 256-57 (5th Cir. 1970); B. Forman Co. v. Commissioner, 453 F.2d 1144, 1160 (2nd Cir. 1972).

[23] The court finds the clear import of the "upstreaming" technique as described in the APT Manual to be that money can be moved between related entities solely to gain a tax advantage. Because the camouflaged assignment of income does not qualify as an "ordinary and necessary" business expense within the meaning of section 162(a), this qualifies as a false statement.

c. DEDUCTIBILITY OF PERSONAL EXPENSES/DEPRECIATION OF OWNER-OCCUPIED
HOME.

[24] The government next challenges the representation that APTs could be used to deduct personal expenses and depreciate a home. The government specifically targets the following statement: Our first area of attention is the personal residence Asset Preservation Trust. This trust converts the current family home from a personal residence into an income producing property. . . . Moving the residence into an asset preservation trust can provide additional tax write-offs for utility and maintenance costs that are currently nondeductible expenses. Depreciation of the home and furnishings from their current fair market value also adds to the tax benefits. APT Manual at 14-15.

[25] The representation that a taxpayer can deduct utility and maintenance expenses associated with a personal residence is not supportable under the Internal Revenue Code. "It is fundamental to our income tax regime that personal consumption expenditures . . . do not generate income tax deductions unless they are somehow inextricably linked to the production of income." Schulz v. Commissioner, 686 F.2d 490, 492-493 (7th Cir. 1982). The clear implication from the APT Manual is that by simply placing a personal residence into a trust, the residence is transformed into an income producing property. However, placing a home into a trust does not make personal expenses, such as maintenance costs and living expenses, deductible. See Buttorff, 761 F.2d at 1060. The failure to explain that expenses must have a business nexus in order to be deductible is fraudulent. See id.

[26] Nor can a personal residence placed in trust be properly depreciated when the taxpayer is still living in the residence. Depreciation deductions are only available for property used in a business or used for the production of income. See section 167 (West Supp. 1998). See also Sacks v. Commissioner, 69 F.3d 982, 986 (9th Cir. 1995). Therefore, the representation that a taxpayer can depreciate an owner-occupied personal residence by simply placing it into a trust is fraudulent.

d. DONATIONS MADE TO CHARITABLE FOUNDATIONS.

[27] Finally, the government contends that defendants gave improper advice pertaining to the establishment of charitable foundations. Specifically, the government contends that defendants encouraged taxpayers to set up charities, called "donor-directed foundations," for their own personal benefit in order to amass assets tax free. As part of its effort to market these foundations, NDF produced written materials advising taxpayers how to create these foundations. Specifically, NDF produced a brochure entitled "Description & Operation of Your Own Foundation" ("NDF Brochure") and a manual entitled "Operation Manual for a Donor-Directed Foundation" ("NDF Manual"). The NDF Brochure provided as follows: Suppose a person wanted to build a large charitable foundation to provide continued income during retirement years. The foundation might pay a person for management and consulting services and/or for involvement in charitable endeavors. A foundation may also pay for all actual expenses related to a charitable endeavor or activity without generating any taxable income to the participants. Since a Donor may contribute up to 50% of his or her income to a public foundation, establishment of a donor-directed foundation with NDF could become a very large amount of foundation wealth at retirement, especially when you consider the tax free growth within the charity. NDF Brochure at 9.

[28] The government contends that the foregoing statement is false because it communicates that these foundations can be created solely for the private inurement of those donating the money.

[29] Charitable contributions are generally deductible under section 170 (West Supp. 1998). This section defines a charitable contribution, in pertinent part, as a contribution or gift to or for the use of: A corporation, trust, or community chest, fund or foundation -- (B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to animals; (C) no part of the net earnings of which inures to the benefit of any private shareholder or individual. Section 170(c)(2).

[30] The Supreme Court has held that "[a] payment of money generally cannot constitute a charitable contribution if the contributor expects a substantial benefit in return." United States v. American Bar Endowment, 477 U.S. 105, 116-17, 106 S.Ct. 2426, 91 L.Ed.2d 89 (1986) Furthermore, to qualify as a charitable contribution, the donor must have surrendered dominion and control over the funds. See Pollard v. Commissioner, 786 F.2d 1063, 1067 (11th Cir. 1986). Thus, statements that an individual can use a charitable foundation to disburse funds back to the donor or the donor's family are false.

e. CONCLUSION AS TO FALSE STATEMENTS.

[31] Accordingly, the court finds that the four different statements targeted by the government are not supportable under the Internal Revenue Code and are hence false within the meaning of section 6700(a)(2)(A). In an attempt to defeat the present request for injunctive relief, Henkell contends that the government must prove that the representations made were "clearly illegal under existing precedent." As support for this assertion, Henkell cites United States v. Dahlstrom, 713 F.2d 1423 (9th Cir. 1983), cert. denied, 466 U.S. 980, 104 S.Ct. 2363, 80 L.Ed.2d 835 (1984). In Dahlstrom, the defendants were criminally charged with, inter alia, violating section 7206(2) of the Internal Revenue Code for their role in promoting abusive tax shelters. In order to satisfy its burden of proof under section 7206(2), the government was required to prove that the defendants willfully aided in the presentation and preparation of false income tax returns. Courts have interpreted "willfully" to require proof of a specific intent to violate the law. Id. at 1427. Following their conviction by jury trial, the defendants appealed and argued that the government had not satisfied its burden of proving specific intent to violate the law because the validity of the particular tax shelters at issue had not yet been addressed by any clearly relevant precedent. Id. at 1428. The Ninth Circuit agreed and reversed the convictions.

[32] Relying upon Dahlstrom, Henkell contends that because the statements challenged by the government all implicate grey areas of tax law that lack clear precedent, the government cannot establish that any of these statements were clearly illegal. The court is not persuaded by this contention. Firstly, the court is not convinced that these areas of tax law are as ambiguous as Henkell suggests. To the contrary, it appears to the court that Henkell manipulated potential ambiguities of the tax laws in order to gain an advantage.

[33] In any event, the court is not persuaded that the rule articulated in Dahlstrom applies to the present case. This action involves a civil proceeding initiated by the government, while Dahlstrom involved a criminal prosecution. Moreover, the statute at issue in Dahlstrom required the government to prove specific intent as an element of the substantive offense, which is a more stringent burden than the "knew or had reason to know" standard imposed under section 6700. Therefore, defendants' reliance on Dahlstrom is misplaced.

3. WHETHER HENKELL OR EPS KNEW OR HAD REASON TO KNOW OF THE FALSITY
OF THE STATEMENTS.

[34] The government must also establish that Henkell and EPS knew or had reason to know of the falsity of the statements made. See section 6700(2)(A). When determining whether this element has been satisfied, the following factors are relevant: (1) a particular defendant's familiarity with tax matters; (2) his level of sophistication and education; and (3) whether he obtained the opinion of knowledgeable professionals. See, e.g., United States v. Kaun, 827 F.2d 1144, 1149 (7th Cir. 1987).

[35] After considering the relevant factors, the court finds that Henkell knew or had reason to know that the representations he was making were false. While not a licensed CPA, Henkell is an educated individual who has endeavored to gain knowledge of tax principles by taking courses at various institutions and by referencing resource materials. Throughout the course of his testimony, Henkell was able to quickly refer to various sections of the Internal Revenue Code and appeared to be fairly well-versed in tax matters.

[36] Although Henkell did apparently consult with professionals, including attorneys and certified public accountants, he acknowledged that some of these professionals disagreed with him as to the propriety of specific representations contained in the APT Manual. Because Henkell knew some of his representations were subject to scrutiny and because he actively sought to recruit new sales agents, Henkell had an obligation to further investigate the legitimacy of the representations made in the APT Manual and in the NDF materials. See United States v. Campbell, 897 F.2d 1317, 1321-22 (5th Cir. 1990). Henkell, however, chose to ignore the opinions of those who were skeptical as to the legality of his statements and instead associated with individuals who unquestioningly agreed to further his scheme. In fact, testimony elicited at the preliminary injunction hearing established that some of the professionals with whom Henkell claimed to have consulted actually relied on Henkell's "legal" advice.

[37] After listening to Henkell's testimony, and in light of his level of education and his familiarity with tax issues, this court concludes that he either knew or had reason to know of the falsity of the statements he was making.

4. WHETHER THESE STATEMENTS PERTAINED TO A MATERIAL MATTER.

[38] Lastly, the government must establish that the statements made pertained to a "material" matter. If a particular statement has a substantial impact on the decision-

making process or produces a substantial tax benefit to a taxpayer, the matter is properly regarded as "material" within the meaning of section 6700. See Buttorff, 761 F.2d at 1062. Here, all of the statements pertain to the availability of tax deductions, credits, or other mechanisms for reducing tax liability. As a result, the statements clearly qualify as "material" within the meaning of section 6700.

B. WHETHER AN INJUNCTION IS NECESSARY TO PREVENT RECURRENCE.

[39] Having determined that Henkell and EPS have engaged in conduct subject to penalty under section 6700, the court must now determine whether "injunctive relief is appropriate to prevent recurrence of such conduct." Section 7408(b)(2). This element has been found to be satisfied where there is a reasonable likelihood of continued fraudulent conduct. See Kaun, 827 F.2d at 1150. Various factors have been identified as relevant to this inquiry: (1) whether mechanisms are in place for continuing the business or scheme; (2) whether the defendant had a high degree of knowledge and level of intent; (3) whether the actionable conduct was an isolated occurrence; (4) whether the defendant insists on the legality of his actions; and (5) whether the defendant has provided assurances that he will change his behavior in the future. See, e.g., Kaun, 827 F.2d at 1150; United States v. United Energy Corp., No. C-85-3655 RFP(CW), 1987 WL 4787, at *13 (N.D.Cal. Feb. 25, 1987); United States v. Campbell, 704 F.Supp. 715, 728 (N.D.Tex.1988).

[40] After considering the relevant factors, the court finds that Henkell's conduct is likely to recur. Shortly after the government formally assessed penalties against Henkell and EPS, Henkell altered his strategy, began marketing "Estate Management Trusts" in lieu of "Asset Preservation Trusts," and distributed new marketing materials. He also formed NDF and began advocating the creation of charitable foundations as a mechanism for reducing tax liability. While the newly conceived Estate Management Trusts addressed some of the IRS's concerns, they still retained some of the fraudulent features of the APTs. As for the sale of charitable foundations through NDF, the court has already concluded that Henkell made false representations as to the tax-free status of these purported donor-directed foundations. Henkell's modification of schemes and his continued insistence on the legality of his representations certainly creates doubt as to whether he will refrain from promoting abusive tax shelter schemes in the future.

[41] Henkell's level of education and the nature of the enterprise he conducted also demonstrate that his conduct is likely to recur. As previously discussed, Henkell is highly educated and has familiarity with a wide range of tax issues. He marketed and sold APTs through a nationwide multi-level marketing network of financial planners. Given the number of APTs that were sold, it cannot be said that the objectionable conduct was merely an isolated occurrence. Henkell also created an exceedingly complex organizational structure of various entities to facilitate his business operations. To a large degree, this network and the mechanisms for continuing the business enterprise appear to still be in place.

[42] For all of the foregoing reasons, the court finds that the objectionable conduct is likely to recur absent the issuance of an injunction.

[43] The court is not persuaded by Henkell's contention that the granting of injunctive

relief impermissibly infringes on his First Amendment right to free speech. The United States Supreme Court has held that "the federal government [is] free to prevent the dissemination of commercial speech that is false, deceptive, or misleading." See Zauderer v. Office of Disciplinary Counsel, 471 U.S. 626, 638, 105 S.Ct. 2265, 85 L.Ed.2d 652 (1985). In the particular context of suits for injunctive relief under section 7408, federal courts have consistently rejected First Amendment challenges on the ground that representations concerning abusive tax shelters are untruthful and therefore fall within the permissible scope of regulation. See Buttorff, 761 F.2d at 1066.

[44] Here, Henkell promoted the use of a tax scheme that contradicted fundamental tax principles and specifically advocated the use of deductions not allowable under the Internal Revenue Code. Because the speech that the government seeks to enjoin qualifies as false or misleading commercial speech, Henkell's First Amendment challenge must fail.

[45] Based on the foregoing, the court finds that the government has satisfied its burden and thus is entitled to a preliminary injunction as against Henkell and EPS.

IV. WHETHER THE GOVERNMENT IS ENTITLED TO AN INJUNCTION AGAINST
DEFENDANT CHARLES SCOTT GRACE.

A. WHETHER GRACE HAS ENGAGED IN CONDUCT SUBJECT TO PENALTY UNDER
SECTION 6700.

1. WHETHER GRACE PARTICIPATED IN THE SALE OF AN ENTITY, PLAN, OR ARRANGEMENT.

[46] Defendant Grace is an attorney who was intimately involved in the sale of APTs. Specifically, Grace was responsible for reviewing trust applications, discussing the application with the purchaser, and answering any questions the purchaser had. In light of these facts, Grace clearly participated in the sale of APTs.

[47] In addition to his involvement with APTs, Grace also participated in the initial discussions which led to the formation of NDF. Additionally, after Henkell resigned from NDF as president and board member, Grace assumed the presidency and joined the board of directors. Given these facts, Grace clearly participated in the sale of an entity, plan, or arrangement within the meaning of section 6700(a)(1)(A).

2. WHETHER GRACE MADE FALSE STATEMENTS.

[48] According to Grace's testimony, he discussed the representations made in the APT Manual with clients. Specifically, Grace admitted telling clients that: (1) property could be transferred into a trust at its fair market value and depreciated; (2) supplies and services could be purchased for a business through a trust at a significant mark-up, thereby transferring income from the business to the trust; and (3) mortgage payments, insurance, and upkeep on a personal residence could be deducted. See 2-18-98 Tr. at 74:2-3, 81:23-82:17, 83:11-15, 93:13-25, 95:9-96:4. As discussed supra in section

III.A.2, these statements are false under the Internal Revenue Code. Thus, the court finds that Grace did make false statements regarding the tax benefits to be derived from APTs.

3. WHETHER GRACE KNEW OR HAD REASON TO KNOW OF THE FALSITY OF THE
STATEMENTS.

[49] The court is satisfied that Grace had reason to know that the statements challenged by the government were false. Grace is an attorney with an L.L.M. in tax law, and therefore possesses the knowledge and resources necessary to perform legal research. He also knew that several people, including other attorneys, questioned the legality of the statements contained in the APT Manual. Instead of independently investigating the legality of these statements, Grace chose to rely on the advice of others, including non-attorneys such as Henkell. Since basic legal research would have revealed the falsity of statements contained in the APT Manual, Grace cannot escape liability by purporting to rely on others he considered more knowledgeable. His complete failure to examine the legality of statements made in the APT Manual even in light of their questionable efficacy provides ample support for the conclusion that he had reason to know that these statements were false.

4. WHETHER THESE STATEMENTS PERTAINED TO A MATERIAL MATTER.

[50] As previously discussed, a statement pertains to a material matter if it would impact the decision-making process of a reasonably prudent investor. See Buttorff, 761 F.2d at 1062. Here, since the statements made pertain to the availability of tax deductions and credits, they are material.

B. WHETHER AN INJUNCTION IS NECESSARY TO PREVENT RECURRENCE.

[51] The court finds Grace's conduct is likely to recur. As an attorney who primarily practices in the area of trusts, it is likely that Grace will again confront this type of abusive tax shelter scheme. See Kaun, 827 F.2d at 1150. Furthermore, Grace has shown an exceptional lack of judgment in his dealings with Henkell and EPS. He claims to have relied on non-attorneys in arriving at his conclusions that the products he was selling were legal, and he has also failed to perform any independent legal research into the representations he was making. In fact, even throughout the course of these proceedings, Grace continued to insist on the legality of some of the representations the court has found to be false. See 2-18-98 Tr. at 173:4-22. Moreover, while claiming to represent the purchasers of trusts, he closely associated with the seller of those trusts and at times acted as Henkell's attorney. In the court's opinion, this raises some serious ethical concerns and also demonstrates a propensity to become involved in abusive schemes in the future.

[52] As with Henkell, the modifications in approach also support the issuance of an injunction. When the IRS attacked the APTs, Grace began marketing Estate Management Trusts and also became involved with NDF. Based on Grace's persistent involvement with the various organizations at issue here, the court finds a reasonable likelihood of continued fraudulent conduct. See Kaun, 827 F.2d at 1150.

[53] Grace's insistence that he will not participate in any further tax evasion schemes does not alter the court's analysis. The court need not accept such self-serving statements, and the cessation of wrongful activity does not alleviate the necessity for an injunction because the defendant is free to return to unlawful behavior. See United States v. W.T. Grant Co., 345 U.S. 629, 632, 73 S.Ct. 894, 97 L.Ed. 1303 (1953).

[54] In light of all of the circumstances, the court finds that an injunction is necessary to prevent recurrence of Grace's involvement in the organization and sale of abusive tax schemes.

V. WHETHER THE GOVERNMENT IS ENTITLED TO AN INJUNCTION AGAINST DEFENDANT WILLIAM L. SEFTON.

A. WHETHER SEFTON HAS ENGAGED IN CONDUCT SUBJECT TO PENALTY UNDER
SECTION 6700.

1. WHETHER SEFTON PARTICIPATED IN THE SALE OF AN ENTITY, PLAN, OR ARRANGEMENT.

[55] Although Sefton did not directly sell any APTs, he did act as a vice president of EPS and was active in soliciting new sales agents for EPS. Additionally, he received compensation in the form of overrides for the sale of APTs by those agents he recruited. Furthermore, Sefton assisted in the organization of NDF and was a member of the initial board of directors. In light of these facts, the court finds that Sefton participated in the sale of an entity, plan, or arrangement within the meaning of section 6700(a)(1)(A).

2. WHETHER SEFTON MADE FALSE STATEMENTS.

[56] The court also finds that Sefton made statements concerning tax benefits to be derived from APTs and from charitable foundations established under NDF. Facts elicited at the hearing demonstrate that Sefton was intimately involved in EPS and NDF, both of which published materials containing fraudulent information regarding tax benefits. In an attempt to defeat the government's request for injunctive relief against him, Sefton insists that he did not directly make any statements concerning the tax benefits to be derived from APTs. However, in addition to authorizing a penalty against those who make statements, section 6700 also authorizes a penalty against those who "cause another person to make or furnish statements regarding tax benefits." Section 6700(a)(2). As an executive vice president of EPS who actively recruited new sales agents and who received overrides from sales, Sefton did cause others to make statements regarding potential tax benefits to be derived from APTs. Additionally, as a board member of NDF, Sefton approved the use of the NDF Brochure which contained fraudulent representations regarding donor-directed foundations. As a result of the approval of these materials for distribution, sales agents furnished those fraudulent statements to taxpayers. Therefore, even absent proof that Sefton personally directly made statements regarding the tax benefits of APTs or charitable foundations, the court finds that he had sufficient involvement with these entities to support a finding that he caused statements to be made.

[57] This conclusion comports with the approach taken by other courts holding that individuals involved in abusive tax schemes cannot escape liability simply by employing others to actually make the false statements. See United Energy Corp., 1987 WL 4787, at *12; Agbanc, Ltd. v. United States, 707 F.Supp. 423, 427 (D.Ariz. 1988). Employing that principle here, Sefton cannot avoid liability simply by insisting that the statements were made by others. Sefton clearly acted in concert with others in attempting to promote these abusive tax shelter arrangements. Therefore, Sefton made fraudulent statements regarding the tax benefits of both APTs and charitable foundations.

3. WHETHER SEFTON KNEW OR HAD REASON TO KNOW OF THE FALSITY OF THE
STATEMENTS. /3/

[58] The court also concludes that Sefton knew or had reason to know that the statements were false or fraudulent. Sefton is a licensed CPA with a master's degree in accounting from the University of Southern California. By his own description, he practices primarily in the area of personal tax returns and audits, and clearly possesses sophisticated knowledge regarding the income tax system. He also has the skills and resources necessary to perform highly competent research regarding the availability of potential tax benefits. Sefton's reliance on "expert" advice regarding the validity of NDF practices does not overcome his experience and ability to personally investigate these practices. In an effort to distance himself from the fraudulent schemes at issue and demonstrate that he had no knowledge as to the propriety of particular statements made, Sefton repeatedly insisted that he never investigated the claims made regarding the APTs because they were not relevant to his clients. After listening to Sefton's testimony, evaluating his level of involvement with APTs and with NDF, and considering his education and professional background, the court finds that Sefton had reason to know of the falsity of the representations. Moreover, his efforts to distance himself from the APTs implies that he may have been aware of the questionable legality of the representations being challenged by the government.

4. WHETHER THESE STATEMENTS PERTAINED TO A MATERIAL MATTER.

[59] For reasons articulated supra with respect to defendants Henkell, EPS, and Grace, the representations made by Sefton did pertain to a "material" matter.

B. WHETHER AN INJUNCTION IS NECESSARY TO PREVENT RECURRENCE.

[60] Sefton's practice as a CPA focusing on individual tax returns and audits makes it likely that he will come into contact with other abusive tax schemes in the future. See Kaun, 827 F.2d at 1150. Moreover, Sefton has refused to take any responsibility for his involvement in either EPS or NDF, and has repeatedly insisted that he has no opinion on the fraudulent statements at issue. As with Grace, the court is not persuaded by his self-serving assertions that he will refrain from engaging in fraudulent conduct in the future. Therefore, the court finds that an injunction against Sefton is appropriate to prevent future wrongful conduct with respect to abusive tax schemes.

VI. CONCLUSION.

[61] 1. The court has subject matter jurisdiction over this action pursuant to 28 U.S.C. sections 1340 and 1345 and 26 U.S.C. sections 7402(a) and 7408.

[62] 2. Plaintiff is entitled to a preliminary injunction, pending trial and judgment in this court or further orders herein, enjoining and restraining defendants (1) Estate Preservation Services, a trust, (2) Estate Preservation Services, Inc. (3) Robert L. Henkell, (4) Charles Scott Grace, and (5) William L. Sefton, and their respective officers, directors, employees, attorneys, and agents from: a. organizing, promoting, marketing, or selling "Asset Preservation Trusts," "Estate Management Trusts," and any other abusive tax shelter, plan, or arrangement which advises or encourages taxpayers to attempt to violate internal revenue laws or unlawfully evade the assessment or collection of their federal tax liabilities; and b. organizing, selling, or assisting in the organization of an entity or otherwise promoting any plan or arrangement based upon: (1) the representation that property can be transferred into a trust by a taxpayer at no cost to the trust, for "units of beneficial interest" or otherwise, giving the trust a higher basis in the equipment than available to the taxpayer; (2) the representation that equipment transferred to a trust by a business can be leased back to the business at inflated rates thereby transferring income from the business to the trust for purposes of avoiding taxes; (3) the representation that personal expenses can be paid by a trust in order to obtain tax benefits not available to individuals; (4) the representation that owner-occupied personal residences of taxpayers can be transferred to a trust and then depreciated as a business asset; and (5) the representation that individual taxpayers can deduct contributions made to their own charities and later disburse the funds back to themselves or their families.

[63] 3. Because the court finds that the government is entitled to injunctive relief under section 7408(a), the court need not address the government's alternative contention that it is entitled to injunctive relief under section 7402(a).

[64] IT IS SO ORDERED.

Milton L. Schwartz
U.S. District Judge

FOOTNOTES

/1/ Estate Preservation Services, a Trust, and Estate Preservation Services, Inc., are separately named as defendants in this action. For ease of reference, they are collectively referred to hereinafter simply as "EPS."

/2/ Unless otherwise specified, all further statutory references are to the Internal Revenue Code, 26 U.S.C.

/3/ Sefton's attempt to elevate this element to a requirement of willfulness fails. United States v. Nordbrock, 828 F.2d 1401 (9th Cir. 1987), cited by Sefton in support of this proposition, indicates that the "knew or had reason to know" standard is applicable to cases decided under sections 6700 and 7408, and cannot be read to require a finding of willfulness in this action. See id. at 1403-04.

Code Section: SECTION 7408 -- ABUSIVE TAX SHELTER INJUNCTIONS
Author: Sneed, Joseph T.
Institutional Author: United States Court of Appeals for the Ninth Circuit
Citations: United States v. Estate Preservation Services, et al.; 85 AFTR2d Par. 2000-378; No. 98-17220; No. 98-17297 (January 25, 2000)
Tax Analysts Reference: 2000 TNT 19-7

Ninth Circuit Upholds Injunction Against Shelter Promoters, Marketers

The Ninth Circuit has affirmed preliminary injunctions ordered by the district court against the promoter, attorney, and CPA who were involved in the marketing and sale of abusive tax shelters.

====== CASE NAME ======

UNITED STATES OF AMERICA,
Plaintiff-Appellee,
v.
ESTATE PRESERVATION SERVICES, A TRUST; ESTATE PRESERVATION SERVICES, INC.; ROBERT L. HENKELL,
Defendants-Appellants.

UNITED STATES OF AMERICA,
Plaintiff-Appellee,
v.
ESTATE PRESERVATION SERVICES, A TRUST,
Defendant,
and
WILLIAM F. SEFTON,
Defendant-Appellant.

====== SUMMARY ======

The Ninth Circuit has affirmed preliminary injunctions ordered by the district court against the promoter, attorney, and CPA who were involved in the marketing and sale of abusive tax shelters.

Robert Henkell organized Estate Preservation Services (EPS), which marketed trusts and asset protection devices. Through EPS, Henkell advised individuals on how to create and use Asset Preservation Trusts (APTs) to generate tax deductions and reduce tax liability. CPA William Sefton was an executive vice president of EPS.

The IRS began investigating EPS in 1995, concerned that APTs were abusive tax shelters. The IRS eventually assessed $1.25 million in penalties against Henkell and EPS under section 6700. Henkell then began marketing Estate Management Trusts, and he formed New Dynamics Foundation (NDF) to advocate private charitable foundations as

mechanisms for reducing tax liability.

In 1997 the government sued EPS, Henkell, and Sefton, seeking to reduce the penalties to judgment and to enjoin all the defendants under section 7408 from giving further advice about abusive tax shelters. The district court granted injunctive relief against all three defendants (and another individual who apparently did not join in this appeal). (For a summary of the lower court's opinion, see Tax Notes, May 17, 1999, p. 1002; for the full text, see Doc 1999-17019 (15 original pages) or 1999 TNT 90-13.)

Circuit Judge Joseph T. Sneed, writing first about Henkell and EPS, concluded that their promotional statements were false and that they uttered the statements with the knowledge necessary to violate section 6700. As to the first element, the Ninth Circuit agreed with the district court that the APT manual fraudulently stated that taxpayers could transfer equipment into an APT at no cost to the trust, thereby giving the trust a higher basis in the equipment than the equipment had in the taxpayer's hands.

Judge Sneed pointed out that section 1015 clearly "precludes a taxpayer from acquiring a fair market value basis for property by merely transferring it to a trust." And the court rejected Henkell and EPS's contention that section 644 supported the promotional statement. Judge Sneed said Henkell and EPS also falsely told APT users that section 1031 allowed a stepped-up basis for equipment transferred to an APT in exchange for units of beneficial interest, which is prohibited by section 1031(a)(2)(E).

Also false were EPS materials asserting that business income could be "upstreamed" by transferring supplies and services to an APT, which would sell those items back to the business at a significant mark-up. Henkell and EPS also falsely represented that taxpayers could deduct utility and maintenance expenses relating to their personal residences by transferring their home to an APT.

Henkell and EPS further recommended that taxpayers establish charities called "donor-directed foundations" to amass assets tax-free -- basically charitable foundations for the taxpayers' own benefit. The Ninth Circuit concluded that this was contrary to section 170, because the taxpayers would retain dominion and control over the assets.

The appeals court rejected Henkell and EPS's assertion that they relied on the advice of attorneys and accountants, finding insufficient evidence to support that claim and pointing out that Henkell is "well-educated and familiar with tax matters."

As to Sefton, who recruited agents for EPS, the appeals court rejected his assertion that he did not organize and participate in EPS, finding ample evidence that Sefton indirectly participated in the APT fraud. Judge Sneed pointed out that section 6700 expressly provides for penalties against those who participate indirectly.

Sefton next contended that his indirect participation, if any, did not cause others to make fraudulent statements. "Sefton is too modest," Judge Sneed wrote; the court apparently believed that Sefton gave legitimacy to EPS through his participation at company events. The appeals court also agreed with the lower court that Sefton knew or had reason to know of the statements' falsity.

The court then concluded that the injunction was not an abuse of discretion, finding no clear error in the lower court's determination that Sefton would likely violate section 6700 again. Finally, the Ninth Circuit rejected the defendants' contention that the injunction violates the First Amendment, reasoning that the injunction "proscribes only fraudulent conduct."

====== FULL TEXT ======

FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

D.C. No. CV-97-01166-MLS GGH

D.C. No. CV-97-01166-MLS GGH

APPEALS FROM THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF CALIFORNIA
Milton L. Schwartz, District Judge, Presiding

Argued and Submitted
October 7, 1999 -- San Francisco, California
Filed January 25, 2000

Before: Joseph T. Sneed and Harry Pregerson, Circuit Judges, and David O. Carter, /1/ District Judge.

COUNSEL

Joe Alfred Izen, Jr., Bellaire, Texas, for defendants-appellants Estate Preservation Services, A Trust; Estate Preservation Services, Inc.; and Robert J. Henkell.

John R. Vaught, Vaught & Boutris, Oakland, California, for defendant-appellant William L. Sefton.

Jonathan S. Cohen and Joan I. Oppenheimer, Tax Division, United States Department of Justice, Washington, D.C., for plaintiff-appellee.

OPINION

SNEED, CIRCUIT JUDGE:

[1] We must decide the appropriateness of a preliminary injunction entered against the promoters of certain tax shelters. The United States filed suit in 1997 against Estate Preservation Services, a Trust; Estate Preservation Services, Inc.; /2/ Robert L. Henkell;

and William L. Sefton ("Appellants"). Injunctive relief was sought under Title 26 United States Code Section 7408 to prevent Appellants from rendering abusive tax-shelter advice under Title 26 United States Code Section 6700. The district court granted a preliminary injunction in October 1998. /3/ Independent appeals were timely filed and subsequently consolidated sua sponte by this court. Jurisdiction exists under Title 28 United States Code Section 1292(a)(1).

[2] A district court's grant of a preliminary injunction is subject to "'limited review.'" FTC v. Affordable Media, LLC, 179 F.3d 1228, 1233 (9th Cir. 1999) (quoting Does 1-5 v. Chandler, 83 F.3d 1150, 1152 (9th Cir. 1996)). This court will therefore reverse a district court only when the lower court has committed an abuse of discretion. Id. An abuse of discretion occurs when a court bases its decision on an erroneous legal standard or on clearly erroneous factual findings. Id.

[3] The record on appeal indicates that the district court did not abuse its discretion by issuing the preliminary injunction against Appellants. We therefore affirm.

I.

[4] Appellant Estate Preservation Services ("EPS") was in the business of marketing trusts and other asset protection devices. In 1992 EPS began vending irrevocable non-grantor trusts which it called "Asset Preservation Trusts" ("APTs"). EPS sold these APTs through a nationwide, multi-level marketing network of financial planners.

[5] Appellant Robert L. Henkell was the central figure in promoting and organizing the activities of EPS. In this capacity, Henkell spawned a variety of trust entities, including the APT. He published a training manual entitled "Asset Preservation Trusts (APT) -- Description, Use & Benefits" ("APT Manual") to market the APT. The APT Manual made numerous representations about the permissibility of tax deductions and credits purportedly available to APTs. Henkell also conducted seminars during which he advised individuals on how to create and use APTs to generate tax deductions and reduce tax liability.

[6] Appellant William L. Sefton is a Certified Public Accountant who was held out as an "executive vice president" of EPS. Sefton received his Masters in Accounting from the University of Southern California in 1966 and was licenced as a Certified Public Accountant for nearly 30 years before the government filed this action. Sefton has described his practice as "primarily that of preparing income tax returns for individuals." He has claimed throughout this case to have had no expertise in the field of trust taxation. Nonetheless, Sefton spoke at EPS programs about living trusts and recruited to EPS thirty sales agents, some of whom sold APTs. EPS compensated Sefton in the form of a "sales override" on each of the three occasions that his recruits sold an APT.

[7] The Internal Revenue Service ("IRS") learned of APTs while auditing individual taxpayers in 1995. The IRS determined that APTs were tax shelters designed to claim excessive and/or improper deductions. It formally assessed penalties of $1.254 million each against Henkell and EPS pursuant to Section 6700 /4/ of the Internal Revenue Code. /5/

[8] Shortly after these penalties were levied, Henkell began marketing "Estate Management Trusts" ("EMTs") in lieu of "Asset Preservation Trusts." He modified the APT Manual to conform to this new EMT program. Henkell also formed the New Dynamics Foundation ("NDF"). NDF materials stated that a taxpayer could reduce his or her tax burden through forming private charitable foundations. The government alleged in its complaint that Henkell created the EMTs and NDF to mask illegalities and to further evade the properly applicable tax law. It was also averred that Sefton facilitated tax shelter abuses associated with NDF, which he helped Henkell to found.

II.

[9] Congress added the statutory provisions that apply to this litigation, I.R.C. Sections 6700 and 7408, as part of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Pub. L. No. 97-248, 96 Stat. 324. The government must prove five elements to obtain an injunction under these statutes: (1) the defendants organized or sold, or participated in the organization or sale of, an entity, plan, or arrangement; (2) they made or caused to be made, false or fraudulent statements concerning the tax benefits to be derived from the entity, plan, or arrangement; (3) they knew or had reason to know that the statements were false or fraudulent; (4) the false or fraudulent statements pertained to a material matter; and (5) an injunction is necessary to prevent recurrence of this conduct. I.R.C. SS 6700(a), 7408(b). The government bears the burden of proving each element by a preponderance of the evidence. United States v. H&L Schwartz, 1987 WL 45223, at *6 (C.D.Cal. 1987), aff'd sub nom, Bond v. United States, 872 F.2d 898 (9th Cir. 1989). The traditional requirements for equitable relief need not be satisfied since Section 7408 expressly authorizes the issuance of an injunction. Trailer Train Co. v. State Bd. of Equalization, 697 F.2d 860, 869 (9th Cir.), cert. denied, 464 U.S. 846 (1983); United States v. Buttorff, 761 F.2d 1056, 1059 (5th Cir. 1985).

[10] Each Appellant claims that the government failed to prove the above elements. We will consider their arguments separately since Henkell and EPS take somewhat different approaches in their briefs than does Sefton. Finally, we will address whether the preliminary injunction to any extent is in conflict with the First Amendment.

A. HENKELL AND EPS

[11] Henkell and EPS do not deny organizing or selling, or participating in the organization or sale of, an entity, plan, or arrangement. They do not deny that their words would have been materially fraudulent if they misrepresented the tax consequences of these devices. Further, they do not deny that their conduct, if prohibited by Section 6700, would likely recur and that injunctive relief would be a necessary precaution.

[12] Henkell and EPS do contend, however, that: (1) they did not promote any abusive tax shelters by making false statements about United States tax law; and (2) even if they did make false statements, they never knew or had reason to know that those statements were untrue, i.e., they did not act with the requisite scienter under Section 6700.

[13] We conclude in section 1 infra that the promotion statements were false, and in section 2 infra that Henkell and EPS uttered the statements with the scienter necessary to

violate Section 6700.

1. THE FALSE TAX ADVICE

[14] The district court determined that Henkell and EPS made at least four misrepresentations about the purported tax benefits of APTs, EMTs, and donor-directed foundations. These misrepresentations concerned: (1) the basis of property placed in trust; (2) the strategy of "upstreaming" income; (3) the deductibility of personal expenses and the depreciation of an owner-occupied home; and (4) the deductibility of certain donations to donor-directed charitable foundations.

[15] Henkell and EPS argue that no specific evidence of any EPS customers violating United States tax laws was ever adduced. They miss the point. Section 6700(a)(2)(A) penalizes promoters, like Henkell and EPS, who knowingly utter false statements with respect to certain tax matters. Whether EPS customers used that misinformation to violate the law is irrelevant. Congress intentionally omitted taxpayer reliance as an element of the offense. See S. Rep. NO. 97- 494, vol. 1 at 268 (1982), reprinted in 1982 U.S.C.C.A.N. 781, 1916.

[16] With this in mind, we turn to the four primary areas of Appellants' fraudulent conduct and to the conclusions reached by the district court.

(a) STEP-UP IN BASIS OF PROPERTY PLACED IN TRUST

[17] The APT manual represented that taxpayers could transfer equipment into an APT at no cost to the trust, and thereby give the trust a higher basis in the equipment than it had in the hands of the taxpayer. The district court did not commit clear error in holding these statements to be fraudulent.

[18] I.R.C. S 1015 governs the basis for property acquired by gifts and by transfers in trust. Section 1015(b) provides:

If the property was acquired after December 31, 1920, by a transfer in trust, the basis shall be the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor on such transfer under the law applicable to the year in which the transfer was made.

I.R.C. S 1015(b) (West 1999) (emphasis added). This section expressly precludes a taxpayer from acquiring a fair market value basis for property by merely transferring it to a trust. As the statute provides, the basis for property transferred in trust "shall be the same as it would be in the hands of the grantor." Id. Thus, an APT would not then be at liberty to, as the APT Manual represented, "start depreciation over" on property transferred to it by an EPS customer.

[19] Henkell and EPS argue that I.R.C. Section 644 (West 1986) (repealed by Pub. L. 105-34, Title V, S 507(b)(1), Aug. 5, 1997, 111 Stat. 857) /6/ should be read in conjunction with Section 1015 because Section 644 would have been "the law applicable to the year in which" the APT Manual urged transfers to APTs. However, Section 644 did not create a structure consistent with the representations of Henkell and EPS. Instead,

it related to taxing the trust on the gain from its sale of property that had been transferred to it at less than fair market value. Congress designed Section 644 "to cover the possible abuse where the grantor places in trust property which has unrealized appreciation in order to shift the payment of tax [on sale] to the trust at its lower progressive rate structure." STAFF OF JOINT COMM. ON TAXATION, 94TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 (Comm. Print 1976) at 162, reprinted in 1976-3 C.B. (col. 2) 1, 174. Section 644 is not applicable when the basis of such trust property was its fair market value at the time of transfer. The basis of property transferred to an APT must be determined without regard to Section 644. /7/

[20] Henkell and EPS also informed APT users that I.R.C. Section 1031 would likely allow a "stepped up" basis in equipment that was transferred to an APT in exchange for so-called "Units of Beneficial Interest" ("UBIs"). This was false. It is true that Section 1031(d) provides that the basis of property acquired in a like-kind exchange under Section 1031(a)(1) "shall be the same as that of the property exchanged." However, Section 1031 expressly excludes from this provision property that is exchanged for "certificates of trust or beneficial interests." I.R.C. S 1031(a)(2)(E). The district court found the UBIs to be "materially indistinguishable from 'certificates of beneficial interest.'" Consequently, an exchange of UBIs for property that has a basis less than its fair market value does not cause that property to acquire a new basis equal to its fair market value. The district court did not err in finding Henkell and EPS's representations about the impact of Section 1031 to be false.

(b) "UPSTREAMING" INCOME BY MEANS OF "CREATED COST" OF EARNING SUCH INCOME

[21] EPS materials also asserted that business income could be "upstreamed" by transferring business supplies and services to an APT which would then sell them back to the business at a significant mark-up. Presumably, this increased the "cost" of those supplies and services. It does not work. All trade or business deductions must be "ordinary and necessary" and reasonable in amount under I.R.C. Section 162(a). United States v. Haskel Engineering & Supply Co., 380 F.2d 786, 788-89 (9th Cir. 1967) (noting that ordinary and necessary expenditures are not deductible to extent they are unreasonable in amount). Courts have construed Section 162(a) to frustrate collusive mark-ups designed solely to gain a tax advantage. See, e.g., Audano v. United States, 428 F.2d 251, 256-57 (5th Cir. 1970) (trusts to which doctor transferred for the benefit of his children his undivided interest in supplies and in medical and surgical equipment, and to which his medical partnership thereafter paid rent for use of this property, were "nullities" for tax purposes); B. Forman Co. v. Commissioner, 453 F.2d 1144, 1160 (2nd Cir.), cert. denied, 407 U.S. 934 (1972) ("The test for determining deductibility is whether a hard-headed businessman, under the circumstances, would have incurred the expense").

[22] Henkell and EPS note correctly that no section of the Code expressly prohibits a person from forming a trust, transferring business assets to it, and then renting back those assets. It is the "mark up" that creates the problem. The law forbids deductions for payments where the obligation to pay "resulted not as an ordinary, necessary incident in the conduct of the taxpayer's business, but instead was created solely for the purpose of effectuating a camouflaged assignment of income." Audano, 428 F.2d at 256-57; see also

B. Forman, 453 F.2d at 1160 (citing Audano).

[23] Efforts to divest income from its proper source are not uncommon. The district court properly observed that "the clear import of the 'upstreaming' technique as described in the APT Manual to be that money can be moved between related entities solely to gain a tax advantage." Unpublished Memorandum of Decision and Order (Oct. 5, 1998), 11. The effort, however, does not generate "ordinary and necessary" business expenses within the meaning of Section 162(a). It follows that the district court did not err when it determined that the EPS materials made false statements advocating the deduction of non-ordinary, unnecessary, and unreasonable expenses.

(c) DEDUCTION OF PERSONAL EXPENSES; DEPRECIATION OF AN OWNER-OCCUPIED HOME

[24] Henkell and EPS also represented that a taxpayer could deduct utility and maintenance expenses associated with a personal residence, as well as claim depreciation deductions thereon, by transferring the property to an APT. Taxpayers frequently seek to convert non-deductible consumption expenditures into deductible expenses.

[25] Placing an owner-occupied home into an APT, however, does not transform the home into income generating property. All expenses related to the ownership of such a home remain personal expenses and are not deductible. /8/ Nor does placing a personal residence in trust make it depreciable for tax purposes while the owner lives there. The Code only allows depreciation of property used in business or for the production of income. See I.R.C. S 167 (West 1999); see also Sacks v. Commissioner, 69 F.3d 982, 986 (9th Cir. 1995) (finding sale-leaseback arrangement to be legitimate business activity and therefore allowing related depreciation deductions).

[26] To repeat, an owner-occupied home is not transformed into "property used in business or for the production of income" by virtue of its placement in an APT.

(d) DEDUCTIONS FOR DONATIONS TO DONOR-DIRECTED CHARITABLE FOUNDATIONS

[27] Efforts to shelter income from taxation while retaining control of the income-producing assets are commonplace. Appellants marketed such a device. Appellants encouraged taxpayers to establish charities called "donor-directed foundations" with the expectation that doing so would enable the taxpayers to amass assets tax-free. NDF produced a brochure entitled "Description & Operation of Your Own Foundation" ("NDF Brochure") and a manual entitled "Operation Manual for a Donor-Directed Foundation" ("NDF Manual") to market these foundations. The district court held that these materials fraudulently communicated to NDF customers that they could establish charitable foundations solely for their own benefit.

[28] The district court based its decision on I.R.C. Section 170, United States v. American Bar Endowment, 477 U.S. 105 (1986), and Pollard v. Commissioner, 786 F.2d 1063 (11th Cir. 1986). Section 170, which makes charitable contributions generally deductible, defines them as a contribution or a gift to or for the use of:

A corporation, trust, or community chest, fund, or foundation --

(B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for
the prevention of cruelty to children or animals;

(C) no part of the net earnings of which inures to the benefit of any private shareholder or individual . . . .

S 170(c)(2) (West 1999) (emphasis added). In American Bar Endowment, the Supreme Court held that "[a] payment of money generally cannot constitute a charitable contribution if the contributor expects a substantial benefit in return." 477 U.S. at 116-17. In Pollard, the Eleventh Circuit held that a donor must have surrendered dominion and control over the gift for it to qualify as a charitable contribution. 786 F.2d at 1067. See also Hernandez v. Commissioner, 490 U.S. 680, 690 (1989) (expectation of "quid pro quo" defeats deductibility of contribution).

[29] The evidence strongly suggests that the grantor of a donor-directed foundation could expect to retain significant dominion and control over the assets deposited therein. An EPS newsletter described the scheme as "the perfect way for your client to warehouse wealth" and as a "safety net" that could provide employment to donors and their families. Henkell marketed the foundations as a way for "donors" to avoid taxation, build a large portfolio, and still retain control of the "donor's" money. The NDF Brochure even advertised donor-directed foundations as a means to "continued income during the retirement years." All a donor had to do to access his or her "warehoused" wealth was to submit a so-called expenditure "request." The record suggests that only one of these "requests" was ever rejected and that the "charitable use" of disbursed funds was never verified.

[30] NDF and EPS literature improperly suggested that for tax purposes charity begins at home. Such motivated deductions for "donations" to these foundations would not yield the results claimed. Consequently, the district court did not abuse its discretion by enjoining Henkell and EPS from making such unsupportable claims.

(e) GOVERNMENT'S BURDEN OF PROOF

[31] Henkell and EPS argue that the district court: (1) impermissibly "rejected the teachings" of United States v. Dahlstrom, 713 F.2d 1423 (9th Cir. 1983) (criminally charging defendants with, inter alia, violating I.R.C. Section 7206(2) for their role in promoting abusive tax shelters), cert. denied, 466 U.S. 980 (1984); and (2) lacked "all authority for its interpretation" that proving the Section 6700(a)(2)(A) "knew or had reason to know" element would be less burdensome than proving the Section 7206(2) willfulness element. We reject the argument.

[32] The district court correctly distinguished the "knew or had reason to know" element of Section 6700(a)(2)(A), which is provable by a preponderance of the evidence, from

the willfulness element under Section 7206(2), which is provable beyond a reasonable doubt. Dahlstrom was a criminal case. This case is not. Therefore, the district court correctly applied the preponderance of the evidence standard.

2. SCIENTER

[33] In addition to challenging the district court's conclusion that they made false statements, Henkell and EPS insist that they never knew or had reason to know that the statements were false. We shall apply the following factors in determining whether a particular defendant had the requisite scienter to violate Section 6700: (1) the extent of the defendant's reliance upon knowledgeable professionals; (2) the defendant's level of sophistication and education; and (3) the defendant's familiarity with tax matters. See United States v. Kaun, 827 F.2d 1144, 1149 (7th Cir. 1987). The record in this appeal suggests that in the district court the government more than adequately established with respect to each defendant all three factors.

(a) NO RELIANCE ON "PROFESSIONALS"

[34] Both Henkell and EPS claim that Henkell relied upon "professionals including attorneys and certified public accountants" when he developed and marketed the APT concept. This defense is suspect. The one lawyer who discussed the APT concept with Henkell apparently disagreed with him, believing that property placed into an APT would assume the donor's basis. Further, the two professionals who allegedly advised Henkell regarding NDF and donor-directed foundations were neither deposed nor called as witnesses. Only Henkell testified to their qualifications and their advice. The district court determined that Henkell chose to ignore those who were "skeptical as to the legality of his statements" and to "associate" with those who "unquestioningly agreed to further his scheme."

(b) LEVEL OF SOPHISTICATION AND EDUCATION

[35] Henkell is well-educated and familiar with tax matters, including the law implicated in his APT and NDF schemes. He held an advanced degree in physics and had completed course work for an advanced degree in computer science. Henkell also received training at the University of Southern California Law School in the field of taxation. The record and Henkell's own testimony substantiate his facility with various elements of the Internal Revenue Code.

[36] The House Conference Report accompanying TEFRA indicates that the "reason to know" standard of Section 6700(a)(2)(A) "allow[s] imputation of knowledge so long as it is commensurate with the level of comprehension required by the speaker's role in the transaction." United States v. Campbell, 897 F.2d 1317, 1321-22 (5th Cir. 1990) (analyzing H.R. CONF. REP. NO. 97-760, at 572 (1982), reprinted in 1982 U.S.C.C.A.N. 1190, 1344). The "knew or had reason to know" standard therefore includes "'what a reasonable person in the [defendant's] . . . subjective position would have discovered.'" Id. (quoting Sanders v. United States, 509 F.2d 162, 166 (5th Cir. 1975)). This was clearly the standard the district court applied when it concluded: "After listening to Henkell's testimony, and in light of his level of education and his familiarity with tax issues, this court concludes that he either knew or had reason to know of the

falsity of the statements he was making." The district court did not clearly err in drawing this conclusion. /9/

B. SEFTON

[37] Sefton challenges the district court's findings that, as required by Section 6700: (1) he participated in the organization of a tax shelter; (2) he furnished the fraudulent statements; (3) he knew or had reason to know that the statements were false; and (4) his conduct is likely to recur. Sefton has adopted those portions of the Henkell and EPS brief which concern whether the representations of tax benefits were false and, if so, whether they were material.

1. PARTICIPATION IN ORGANIZATION

[38] Sefton completely denies organizing and participating in EPS. He makes a number of arguments to support this claim. First, he insists that he spoke at EPS's public events solely on the subject of revocable living trusts, his area of expertise. Second, he contends that his position as EPS "executive vice president" was only a "marketing title" and that he was an "independent contractor." Third, he claims that he intended for the thirty agents he recruited to EPS to sell only revocable living trusts. This was, Sefton urges, because he saw no market for APTs. Finally, Sefton argues that he did not know until this litigation that he received any benefit from the sale of APTs by the agents he recruited to EPS. The $1900 in APT sales overrides that he collected from these agents was spread throughout a three year period.

[39] We are not convinced. Section 6700 states explicitly that whoever "participates (directly or indirectly)" in promoting an abusive tax shelter is subject to potential penalties. I.R.C. S 6700(a)(1)(B) (emphasis added). Congress added this language as part of the Omnibus Budget Reconciliation Act of 1989. Pub. L. 101-239, S 7734(a)(1)(B) (inserting "(directly or indirectly)" following "participates" in Section 6700(a)(1)(B)). While no prior case appears to have addressed the import of these added words, their plain meaning indicates that even one who "indirectly" participates by recruiting agents who market an abusive tax shelter may be liable under Section 6700.

[40] Before Congress added this language, several courts had determined that tax shelter representatives could violate Section 6700 where they recruited salespersons and received commissions as a result of such persons' sales. See Gates v. United States, 874 F.2d 584, 585-86 (8th Cir. 1989) (upholding liability of promoter who recruited others to market abusive tax shelters); Reno v. United States, 717 F. Supp. 1198 (S.D. Miss. 1989) (finding that defendant "unequivocally participated" in sales of abusive tax shelters when he "recruited salesmen . . . and provided promotional and tax information to salesmen and tax preparers who, as conduits, passed that information along to [purchasers]"); Agbanc, Ltd. v. United States, 707 F. Supp. 423, 427 (D. Ariz. 1988) (stating that "a person or entity cannot insulate itself from Section 6700 liability merely by employing salespeople who actually made the false statements"); United States v. United Energy Corp., 1987 WL 4787 (N.D. Cal. 1987) (stating that "[i]t would frustrate the congressional purpose if a person who funded an enterprise, acted as one of its officers and directors, and profited from it, could insulate him or herself merely by employing salespeople who actually made the false statements").

[41] These cases and Congress's more recent addition of the "indirectly" language amply support the injunction against Appellants. The district court did not, given the record on appeal, clearly err in finding that Sefton indirectly participated in the APT fraud.

2. CAUSATION

[42] Sefton insists that his "indirect participation, if any, neither made nor "caused others to make," fraudulent statements with regard to the tax benefits of APTs or of charitable foundations. He argues that lending legitimacy to the company through his participation in EPS events could not establish causation under Section 6700(a)(2). He also insists that his participation in NDF was too tangential to support the district court's judgment.

[43] We reject this contention. Sefton is too modest. The level of Sefton's involvement in EPS as an "executive vice president," a recruiter of sales agents, and a recipient of sales overrides supports the determination that he, at minimum, "caused others to make" fraudulent statements. Both EPS and NDF published materials containing fraudulent information regarding tax benefits while Sefton was deeply involved. These materials were then given to sales agents for transmission to taxpayers. Sefton, as an NDF director, voted his approval of the NDF materials knowing that they would be distributed to donors. The district court on the basis of these facts did not abuse its discretion. See United Energy, 1987 WL 4787, at *12; Agbanc, 707 F. Supp. 423, 427 (D.Ariz. 1988).

3. SCIENTER

[44] The district court concluded that Sefton "knew or had reason to know" of the falsity of the statements made, per Section 6700(a)(1)(A). In doing this the court: (1) considered Sefton's testimony, which included a claim of justifiable reliance upon knowledgeable professionals; (2) evaluated his level of involvement with the APT scheme and NDF; and (3) weighed his level of education and professional background. The court did not commit error because there was ample evidence to support its conclusion and because it correctly applied the relevant law. See Kaun, 827 F.2d at 1149; Campbell, 897 F.2d at 1321-22.

[45] Sefton cites Weir v. United States, 716 F. Supp. 574 (N.D. Ala. 1989), in which a tax shelter promoter was found not to have violated Section 6700. The case is easily distinguishable. The Weir promoter possessed no significant tax law experience. 716 F. Supp. at 580. He appears to have relied upon a "lengthy and weighty" legal opinion by established experts in the field. Id. Given these facts, the Weir court concluded that the promoter could not have known the law of charitable deductions, as was alleged. Id. Sefton, in contrast, was an experienced C.P.A. who had specialized in preparing individual tax returns for sixteen years before he helped to form NDF and voted his approval of the fraudulent NDF documents. Sefton could not help but be aware of Section 170, given his advanced training. Finally, unlike the defendant in Weir, Sefton never presented the corroborating evidence from the experts upon which he claims to have justifiably relied.

[46] There was therefore no abuse of discretion. /10/

4. LIKELIHOOD OF FUTURE SECTION 6700 VIOLATIONS

[47] Factors that a court may consider in determining the likelihood of future Section 6700 violations and, thus, the need for an injunction include: (1) the gravity of the harm caused by the offense; (2) the extent of the defendant's participation; (3) the defendant's degree of scienter; (4) the isolated or recurrent nature of the infraction; (5) the defendant's recognition (or non- recognition) of his own culpability; and (6) the likelihood that defendant's occupation would place him in a position where future violations could be anticipated. See Kaun, 827 F.2d at 1144-45; Buttorff, 761 F.2d at 1062; SEC v. Holschuh, 694 F.2d 130, 144 (7th Cir. 1982).

[48] The district court determined that the injunction was necessary for three primary reasons. First, Sefton's practice as a C.P.A. focusing on individual tax returns and audits made it likely that he would come into contact with other similarly abusive tax schemes. Second, Sefton had not taken any responsibility for his actions with NDF or EPS, and he repeatedly insisted he had no opinion as to the truth or falsity of the statements at issue. Third, the court was not persuaded by Sefton's "self-serving" statements that he would refrain from future fraudulent conduct. The court's findings were not clearly erroneous.

[49] The record indicates that when Sefton chose to become involved with Henkell in NDF he possibly knew that the IRS was conducting an examination of EPS. He also very likely knew that Henkell had entirely rewritten the APT Manual and had discontinued selling APTs following the IRS audit notification. Sefton's participating in Henkell's NDF scheme under these circumstances indicates that he chose to ignore any of his own doubts about Henkell's questionable behavior. Considering the record on appeal, the district court did not clearly err when it determined that Sefton would likely violate Section 6700 again if unchecked. The preliminary injunction was therefore not an abuse of discretion.

C. FIRST AMENDMENT

[50] Finally, the injunction does not violate the First Amendment to the United States Constitution. It proscribes only fraudulent conduct. Other courts have upheld similar Section 7408 injunctions in spite of First Amendment challenges. See, e.g., Buttorff, 761 F.2d at 1066; Kaun, 827 F.2d at 1150-52; United States v. White, 769 F.2d 511, 516-517 (8th Cir. 1985). The Fifth Circuit has declared:

[W]here it has been determined that [a promoter's] statements regarding the tax benefits of his trust, which constitute commercial speech, are misleading in the context contemplated by
Congress in enacting the statute, and the injunction prohibiting such statements is adequately tailored and construed to enjoin only such commercial speech which has been shown to be both misleading and likely to promote illegal activity, such representations are not protected by the First Amendment . . . .

Buttorff, 761 F.2d at 1066.

[51] The preliminary injunction in this case does not exceed the scope of what is

necessary to forestall Appellants from further misrepresentations. Appellants may continue to publish legitimate tax planning advice, even regarding trusts. They are simply prohibited from advocating shelters that provide no legitimate shelter from lawful taxation. Every honest and qualified tax consultant knows the difference between legitimate and plainly illegitimate tax shelters. Appellants crossed the line into the "plainly illegitimate."

[52] AFFIRMED.

FOOTNOTES

/1/ The Honorable David O. Carter, United States District Judge for the Central District of California, sitting by designation.

/2/ For ease of reference, we will refer to Estate Preservation Services, a Trust, and Estate Preservation Services, Inc., as "Estate Preservation Services."

/3/ The preliminary injunction states:

[Appellants] and their respective officers, directors, employees, attorneys, and agents are hereby enjoined and restrained, pending trial and judgment in this court or further orders herein, from:

1. organizing, promoting, marketing, or selling "Asset Preservation Trusts," "Estate Management Trusts," and any other abusive tax shelter, plan, or arrangement which advises or encourages taxpayers to attempt to violate internal revenue laws or unlawfully evade the assessment or collection of their federal tax liabilities; and

2. organizing, selling, or assisting in the organization of an entity or otherwise promoting any plan or arrangement based upon:

A. the representation that property can be transferred into a trust by a taxpayer at no cost to the trust, for "units of beneficial interest" or otherwise, giving the trust a higher basis in the equipment than available to the taxpayer;

B. the representation that equipment transferred to a trust by a business can be leased back to the business at inflated rates thereby transferring income from the business to the trust for purposes of avoiding taxes;

C. the representation that personal expenses can be paid by a trust in order to obtain tax benefits not available to individuals;

D. the representation that owner-occupied personal residences of taxpayers can be transferred to a trust and then depreciated as a business asset; and

E. the representation that individual taxpayers can deduct contributions made to their own charities and later disburse the funds back to themselves or their families.

/4/ Section 6700, which proscribes abusive tax shelters, states in relevant part:

(a) Imposition of penalty. -- Any person who --

(1)(A) organizes (or assists in the organization of) --

(ii) any investment plan or arrangement, or. . .

(B) participates (directly or indirectly) in the sale of any interest in an entity or plan or arrangement referred to in subparagraph (A), 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,

. . .

shall pay, with respect to each activity described in paragraph (1), a penalty equal to . . . .

26 U.S.C. S 6700 (West 1999).

/5/ Unless otherwise indicated, all statutory references are to the Internal Revenue Code, codified at Title 26 of the United States Code ("I.R.C."). This appeal does not involve the penalties imposed against Henkell and EPS.

/6/ This statute stated in relevant part:

S 644. Special rule for gain on property transferred to trust at
less than fair market value

(a) Imposition of tax. –

(1) In general. -- If --

(A) a trust (or another trust to which the property is distributed) sells or exchanges property at a gain not more than 2 years after the date of the initial transfer of the property
in trust by the transferor, and

(B) the fair market value of such property at the time of the initial transfer in trust by the transferor exceeds the adjusted basis of such property immediately after such transfer,

there is hereby imposed a tax determined in accordance with paragraph (2) on the

includible gain recognized on such sale or exchange.

(2) Amount of tax. -- The amount of tax imposed by paragraph (1) on any includible gain recognized on the sale or exchange of any property shall be [calculated at the contributor's marginal rates] . . . .

/7/ Section 644(a) was repealed in 1997. Pub. L. 105-34, Title V, S 507(b)(1), Aug. 5, 1997, 111 Stat. 857. At that time other provisions had slowed substantially the potential tax reduction arising from taxation at the trust level rather than the beneficiary or contributor level. See Tax Reform Act of 1986, Pub. L. 99-514, Title I, Subtitle A,S 101 (a), Oct. 22, 1986, 100 Stat. 2085 (reducing maximum tax benefit of graduated rate structure applicable to trusts); Tax Reform Act of 1984, Pub. L. 98-369, Div. A, Title I, Subtitle F, S 82, Jul. 18, 1984, 99 Stat. 494 (curtailing tax avoidance use of multiple trusts).

/8/ See I.R.C. S 262(a) ("Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses."); United States v. Buttorff, 761 F.2d 1056 (5th Cir. 1985) (holding trust which lacked the tax benefits marketed by its promoter, including the deductibility of personal consumption expenses associated with home ownership, to be a sham under Section 6700); see also Grimes v. United States, 806 F.2d 1451, 1453 (9th Cir. 1986) (noting nondeductibility of personal expenses and describing necessity of specific legislation authorizing deductions); Neal v. Commissioner, 681 F.2d 1157, 1158 (9th Cir. 1982) (emphasizing nondeductibility of personal expenses).

/9/ The district court incorrectly mentioned that Henkell had an "obligation to further investigate the legitimacy of the representations made in the APT Manual and in the NDF materials." The House Conference Report makes it clear that the "knew or had reason to know standard" does not include a duty of inquiry. H.R. CONF. REP. NO. 97-760, at 572 (1982), reprinted in 1982 U.S.C.C.A.N. 1190, 1344. However, the district court ultimately applied the correct legal standard, see Campbell, 897 F.2d at 1321-22, when it determined that Henkell and EPS "knew or had reason to know" that their statements were fraudulent.

/10/ The district court should not have verbalized Sefton's failure to investigate the claims about APTs. See H.R. CONF. REP. NO. 97-760, at 572 (1982), reprinted in 1982 U.S.C.C.A.N. 1190, 1344 (noting that Section 6700 does not establish a "duty of inquiry"). However, based on the evidence in the record, the district court did not abuse its discretion in determining that Sefton "knew or had reason to know" of the falsity of the statements. A reasonable person in Sefton's subjective situation would have known or have had reason to know that the statements were false. See Campbell, 897 F.2d at 1321-22; see also n. 7, supra (reaching similar conclusion with regard to Henkell and the "duty of inquiry").

JOINT REPORT ON CIVIL AND CRIMINAL ISSUES IN ABUSIVE TRUST AND UNSCRUPULOUS RETURN PREPARER CASES

October 1, 1999

Task Force Members:

Steven Pregozen, CI
Thomas McMahon, CI
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The purpose of this report is to provide interim guidance to Criminal Investigation (CI), Examination (Exam), Office of Chief Counsel (Counsel), Department of Justice, Tax Division (Tax Division), and US Attorney Offices (USAO) until the Internal Revenue Manual (IRM), Chief Counsel Directives Manual (CCDM), and Department of Justice Criminal Tax Manual (CTM) can be revised concerning the investigation of cases involving promoters and preparers of abusive foreign and domestic trust and unscrupulous return preparers. These guidelines can also be applied to abusive tax shelter schemes. In order to enhance compliance in these investigations, it is critical that both civil and criminal remedies be fully pursued. This includes the examination of clients as well as criminal prosecution recommendations against promoters, preparers, and clients when warranted.

Due to the proliferation of abusive trust cases, a trust task force was impaneled in March, 1999, to deal with civil and criminal issues in abusive trust cases. This task force includes members of CI, Exam, Counsel, and Tax Division. The task force was initiated due to perceived coordination difficulties between CI and Exam in abusive trust cases. It became clear to this task force that the issues in abusive trust investigations were also relevant to return preparer cases. Therefore, the topics of discussion listed below apply not only to abusive trust investigations, but also to return preparer investigations. As stated earlier, this report provides interim guidance until the aforementioned manuals can be revised. The topics of discussion in this report are as follows:

- Examination of clients after promoters and preparers have been referred to CI;
- Sharing of non-grand jury information between CI and Exam;
- Selection of method of investigation – administrative vs. grand jury;
- Prevention of improper criminal influence in civil examinations;
- Prohibiting the presence of special agents at examinations of promoters' and return preparers' clients;
- Preventing CI and AUSA's from having roles in determining what civil penalties Exam asserts against abusive trust promoters or their investors and return preparers and their clients;
- Providing general guidance on criminal cases involving promoters, preparers, and their clients;
- Selection of Witnesses in abusive trust and unscrupulous return preparer cases.

Examination of Clients After Promoters and Preparers have been Referred to CI

In abusive trust or unscrupulous preparer cases, Exam must refer a case against a promoter or return preparer to CI after it has examined enough client returns to determine that there are firm indications of fraud by the to a promoter or preparer. IRM § 4565.21(1) dictates that once a revenue agent discovers firm indications of fraud, he or she must suspend all examination activity and refer the case to CI. If CI determines that the clients whose returns were the subject of the referral did not commit fraud, IRM § 4565.21(5) allows Exam to close out the civil cases against those clients. In those cases that may involve a large client base, there may be hundreds of returns that were not examined by Exam before the fraud referral. While the IRM permits Exam to close out civil cases against taxpayers who were part of the original referral once it is clear that those clients did not commit fraud, the IRM does not clearly state that Exam may examine additional clients outside of the scope of the referral. Revenue agents should be permitted to examine additional clients beyond the scope of the original referral after a promoter or preparer becomes a target of a criminal investigation where the underlying factor is the collection of civil tax dollars. In these instances, close coordination is essential between CI and Exam, but under no circumstances should CI direct the examinations or should Exam receive grand jury information from CI. In fact, if the investigation of the promoter or preparer is being conducted by a grand jury, the only communication permitted is from Exam to CI.

Sharing of Non-Grand Jury Information Between CI and Exam

It is permissible, in fact desirable, for Exam to share return information and completed revenue agent's reports with special agents conducting both administrative and grand jury investigations. If revenue agents conduct civil examinations of additional clients of a promoter or preparer, they may be able to identify additional taxpayers who could become witnesses or targets. The identification of these taxpayers may be legally shared with special agents by Exam; however, it is best to limit the information to the years under criminal investigation. In addition, Exam should only turn over reports once a civil examination is completed. This will avoid the appearance that the special agent is either interfering with or directing the particular civil examination. It is foreseeable that CI could discover a taxpayer who participated in a trust scheme promoted by the target or whose tax return was falsely prepared by the target during the course of a grand jury investigation **before** Exam has examined the client's returns. In this instance, Rule 6(e) of the Federal Rules of Criminal Procedure prohibits CI from forwarding the taxpayer's name to Exam until after the promoter or return preparer is indicted and the client's return is included in the indictment or otherwise made public or included in a Rule 6 (e) order. Once a case is being handled civilly, it is imperative that prosecutors and special agents be prohibited from trying to influence or appear to be influencing Exam with respect to civil examinations or decisions of any kind.

It cannot be stressed enough that in the case of a grand jury investigation Rule 6(e) of the Federal Rules of Criminal Procedure severely limits the exchange of information derived from the grand jury investigation. It would be best to take the cautious view that the information exchange with evidence derived through the grand jury process is for all practical purposes a one-way transfer and cannot be shared with Exam.

Selection of Method of Investigation – Administrative vs. Grand Jury

An issue flowing from the above discussion is whether to investigate a promoter/preparer through the use of an administrative investigation or a grand jury investigation. In making this decision a number

of factors must be balanced.

IRM § 9.5.2.2 and CCDM Part (31) 550(1)(a) and 560(1)(a)(3) set forth a list of the relevant factors for Service initiated grand jury requests. Several factors are of particular importance in the promoter/preparer area. First, are there in existence both administrative and grand jury investigations related to the same abusive trust promotion? A mix of grand jury and administrative investigations makes coordination very difficult. Thus, once one or more grand jury investigations are in progress, future investigations of related or similar parties may be investigated more easily through another grand jury. Second, will the administrative process be able to develop the relevant facts within a reasonable period of time? A grand jury subpoena may be appropriate when a summons would be ineffective due to promoters' common practice of instructing clients to disregard Service requests for information. In such a case, when the delay caused by a summons enforcement action would be detrimental to the case, a grand jury investigation may be more appropriate. Third, does the investigation require the secrecy of the grand jury process? This factor can equally apply to abusive trust and return preparer investigations.

These perceived benefits resulting from the use of a grand jury investigation must be balanced with the negative impact on the civil collection process. It is foreseeable that numerous clients will be identified through the investigation of promoters or preparers. While all of these clients may not be good criminal targets, the civil figures involved could be substantial. A grand jury investigation could impede or preclude the development of civil cases against these clients. Additionally, by proceeding through a grand jury investigation, the Service abdicates control of the case, giving up authority to issue summons under I.R.C. § 7602 as well as settlement authority under I.R.C. § 7121 in regard to any referred case. All of these factors must be carefully weighed before making the decision whether to proceed with an administrative or grand jury investigation.

Prevention of Improper Criminal Influence in Civil Examinations

Currently, IRM § 4565.21 prohibits CI from giving advice or direction to Exam regarding a specific case under examination. It is imperative that special agents not specifically direct Exam concerning the selection of taxpayers for civil examination or the degree of substantiation to be required from these taxpayers. Any such actions could be regarded as overreaching and manipulative and could potentially jeopardize the success of the investigation. Likewise, Assistant United States Attorneys (AUSA's) should not attempt to influence Exam regarding any aspect of a taxpayer's examination. These restrictions, however, do not constrain special agents or AUSA's from sharing relevant **non-grand jury** information with Exam. Further, these restrictions do not preclude CI from providing Exam with general (non-case specific) criteria for determining which examinations might be criminally referred as long as the purpose is not to influence the civil examination.

Prohibiting the Presence of Special Agents at Examinations of Promoters' and Return Preparers' Clients

A special agent's presence during a civil examination of clients of promoters and return preparers could create the impression that CI is exercising improper influence over the course of an examination. Special agents, therefore, should be prohibited from being present at a civil examination. Clients may believe, because of the ongoing criminal investigation of a promoter or preparer, they must accept all of the adjustments recommended by the revenue agent without

questioning them. Moreover, with the special agent present at an examination, a client may be more inclined to falsely incriminate the promoter or preparer rather than accept responsibility for the false items on the return. It could be further argued the Service acted arbitrarily against these clients for the sole purpose of exaggerating the preparer's alleged criminal conduct for the purpose of establishing the tax loss for sentencing purposes.

Preventing CI and AUSA's From Having Roles in Determining What Civil Penalties Exam Asserts Against Abusive Trust Promoters, Investors or Return Preparers or Their Clients

Special agents and AUSA's should be prohibited from having any role in determining what civil penalties, if any, Exam will assert against clients of an abusive trust promoter or return preparer under investigation. The IRM currently requires Exam to "coordinate" the imposition of negligence penalties against clients of a return preparer under criminal investigation. IRM § 4565.22 states "when a return preparer is being considered for criminal prosecution, the Service should refrain from asserting negligence penalties against those taxpayers whose returns may be the basis for the criminal prosecution until after the matter has been completely coordinated with the office having jurisdiction over the criminal aspects of the case." IRM § 9526.3 states that in grand jury investigations, if CI believes the proposed civil activity by Exam or the Collection Division will adversely affect the criminal investigation, the civil activity must be suspended until the criminal aspects are completed.

These existing IRM provisions cloud the boundary between the criminal and civil divisions and restrict the independence that Exam should be exercising during a civil examination. The IRM should state, when revenue agents examine clients of a promoter or preparer under criminal investigation, they should assert the appropriate penalties against the clients based on the facts in each case, regardless of whether the clients may testify for the government against the preparer or become a defendant.

The government's criminal case against the promoter or return preparer will always be stronger if the clients who filed false returns can testify they neither provided false information to the promoter or preparer nor knew the return was false when they filed it. However, if the Service refrains from asserting a civil penalty against clients only because they are witnesses for the government in the criminal case against the promoter or preparer, such inaction could give rise to the allegation the government is conferring a benefit on witnesses in order to secure their cooperation or encourage them to testify they did not know the returns were false when they filed them. Such a perception could greatly diminish the clients' credibility as witnesses. On the other hand, if Exam asserts the appropriate civil penalties against the clients, AUSA's prosecuting the promoters or preparers will be in a better position to assess the credibility of the potential witnesses.

If Exam completes its examination of a witness's returns and asserts penalties, it may be problematic for a prosecutor who later determines that the witness is criminally culpable and deserves to be prosecuted. For instance, if a revenue agent completes a civil case against a client and then CI recommends prosecution of the client, the client might allege the revenue agent mislead him or her as to the purpose of the civil examination and, therefore, statements he or she made should be suppressed pursuant to United States v. Tweel, 550 F.2d 297, 299-300 (5th Cir. 1977). However, if CI is not directing the civil examination or influencing the course of the examination, the prosecution should survive any motion to suppress based on an alleged Tweel violation.

Moreover, if Exam asserts the appropriate civil penalties based on the facts of each case, their

decisions should not pose a problem from a criminal perspective. A client of an alleged fraudulent promoter or return preparer is rarely prosecuted unless the tax loss is significant and there is overwhelming evidence of the clients' willfulness such as; but not limited to, the client's active involvement in the scheme, an admission the client lied to the examiner or submitted false documents in support of fraudulent deductions or exemptions. Nevertheless, Exam should continue to inform CI when civil penalties are asserted against clients by forwarding completed revenue agent's reports. Similarly, AUSA's should be prohibited from influencing the IRS with respect to what civil penalties are assessed against clients of an abusive trust promoter or return preparer who is the subject of a grand jury investigation.

Providing General Guidance on Criminal Cases Involving Promoters, Preparers, and their Clients

It is not improper to identify a certain type of client of promoters or preparers who should be referred to CI. The factors to consider include, but should not be limited to, the extent of the client's involvement in the criminal conduct, the level of education of the client, the client's profession, sophistication in tax matters, past history with the Service, attitude during any meetings with Exam, egregiousness of false items, and, in the case of trust clients, their level of control over the trust operation, and whether they deviated from the "Package" instructions. In dealing with clients who meet the above criteria, the preferred course of action should be to refer them to CI. CI can then determine whether to target the individual (triggering 914 controls) or return the case to Exam. Additionally, cases involving an offshore component should be a priority where there is no genuine business purpose supporting the international transfer of funds. A criminal case is further enhanced where foreign trust accounts are located in tax haven jurisdictions known for their financial secrecy laws. In such cases where a taxpayer derives his income from a locally based small business or professional practice, there is little business purpose behind setting up an offshore trust or management company to assign income.

An ancillary issue to the above situation is whether to pursue the matter criminally or civilly. The following factors should be weighed in determining whether the case should be pursued criminally over civilly, if they cannot proceed simultaneously: the amount of tax loss; the general sophistication of the scheme (i.e. does it involve multiple layers and nominees); the size of the scheme and how it is promoted; the type of taxpayers it attracts or seeks; the probability of a criminal conviction; an international component with no business purpose; and jury appeal.

Selection of Witnesses in Abusive Trust and Unscrupulous Return Preparer Cases

Witness selection is of paramount importance in both trust promoter and return preparer cases. Too often witness selection is driven primarily by sentencing guideline concerns and not the quality of the anticipated testimony from a witness. Presenting witnesses with severe credibility issues can, of course, cause a jury to return a verdict of not guilty. A concern of equal importance is the damage to the government's image with the judge, which could then result in "collateral" damage to the government's presentation, i.e. evidentiary rulings or Rule 29 determinations, etc.

In most cases, a client's credibility and culpability will lie between the two extremes of total ignorance of any problem, to that of a willing co-conspirator. Effective interviewing is essential to determining each client's degree of potential culpability. Finally, promoter/preparer cases that are often complex in nature should be clearly presented highlighting substance over form to the grand jury. Effective use of the grand jury will afford the opportunity to gauge both individual and collective responses of the grand jurors to particular witnesses, serving as a "barometer" as to how their testimony might be received during the actual trial. While it may seem to be stating the obvious, only counts which involve a credible witness, should be charged in an indictment.

The above notwithstanding, the fact a witness may have a false item on his/her return, or utilize some form of abusive trust arrangement does not automatically preclude his/her use as a witness. What is important is the witness' knowledge about the scheme, truthfulness about what the witness understood, and his/her motivation. Someone who is in a state of denial over the obvious or is looking to rationalize his/her way out of their behavior would not be a good witness for the government.

The credibility of a witness should be judged using a "totality of the circumstances" test. The factors enumerated in the discussion of whether a case should be civil or criminal should be utilized again, i.e. level of education, profession, income level, type of falsity or trust used, blatancy of the falsity, involvement of the client (particularly in abusive trust cases), whether there is a multi-year pattern of conduct, the client's culpability after learning of the problems with the return, or the illegality of the trust.

/s/ Steven Pregozen /s/ John Buchanan

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DOJ -Tax Division DOJ-Tax Division

Criminal Section Civil Trial Section

CC:EL:CT-103861-00

CTMonica

MEMORANDUM FOR JOHN S. FOWLER

Chief, Office of Tax Crimes

(Criminal Investigation) OP:CI:O:T

FROM: Barry J. Finkelstein

Assistant Chief Counsel (Criminal Tax)

SUBJECT: Sharing of Client Lists and Other Pertinent Information in Abusive Trust Investigations

This responds to your memorandum dated February 15, 2000 in which you requested advice regarding the sharing of client lists and other pertinent information with the Examination Division ("Exam") and/or other civil functions, where such information was obtained through administrative or grand jury investigations of abusive trust schemes.

QUESTIONS PRESENTED

1. In the context of an administrative or grand jury investigation of abusive trust schemes, when is it appropriate for the Criminal Investigation Division ("CI") to share client lists or other pertinent information with Exam or other civil functions?

2. Is it permissible in a grand jury investigation of abusive trust schemes for CI to release information to Exam or other civil functions where the information was received outside of

the grand jury process, such as through a search warrant or confidential informant?

3. Is it permissible in a grand jury investigation of abusive trust schemes for CI to release information to Exam or other civil functions where the information was received prior to the commencement of the grand jury process?

In order to properly and thoroughly answer these questions, a detailed analysis of Federal Rule of Criminal Procedure 6(e) is required.[1] Therefore, we are attaching for your review Litigation Guideline Memorandum CT-3: "Grand Jury Evidence - Matters Occurring Before The Grand Jury" (the "LGM"). This document was originally prepared by our office in September, 1994, and remains today an accurate reflection of the state of the law concerning Rule 6(e) and its applicability. Initially designed to provide internal guidance to Counsel attorneys, the LGM has since been released in full to the public and our disclosure of it to you does not violate any internal Service confidentiality prohibitions. In the following discussion, we will attempt to provide brief, specific answers to your questions, accompanied with citations to the LGM, where a more in depth, detailed answer can be found.

DISCUSSION

Question 1:

A. In a purely administrative criminal investigation conducted by CI, information such as client lists may be shared with Exam and/or other civil functions.[2] Upon obtaining a client list, CI should review the list and determine if any of the individuals should be pursued criminally. The remaining names on the list may then be shared with Exam for civil purposes. If this occurs, CI must be extremely cautious to not use Exam, or agents thereof, as investigatory tools in any impending criminal investigation. See, United States v. Tweel, 550 F.2d 297 (5th Cir. 1977). Should Exam later determine there are firm indications of fraud with respect to any of the clients on the list, Exam should then refer those cases to CI.

Additionally, in the context of sharing information with Exam, CI must recognize that civil activities during a criminal investigation may not be viewed favorably by the Department of Justice. Thus, a careful balancing of the civil and criminal aspects should occur.

B. In the case of a grand jury investigation, Rule 6(e) severely limits the exchange or sharing of information derived from that grand jury investigation. Briefly stated, absent a court order, Rule 6(e) prohibits the disclosure of "matters occurring before the grand jury" and further provides that knowing violations are punishable as "contempt of court." When determining what constitutes "matters occurring before the grand jury" and, therefore, the implication of Rule 6(e), the standard to follow is whether the disclosure of the particular evidence would reveal the content of the grand jury proceedings, the strategy or direction of the grand jury, the identity of grand jury witnesses or the substance of their testimony. A positive answer with respect to any of these questions prohibits disclosure of the information. Because the proper determination of these issues will most likely depend on the facts of each individual case, we are unable to provide a blanket statement or definitive answer as to when client lists obtained in a grand jury investigation may be shared with Exam and/or other civil functions.

For a more detailed discussion of what constitutes "matters occurring before the grand jury," please see the LGM at pgs. 3-11; and pg. 17, "After A Grand Jury Convenes."

Question 2:

Generally speaking, evidence obtained by a truly independent source which does not reveal the inner workings of the grand jury may be used for civil purposes. Moreover, evidence obtained during the course of a grand jury investigation, without use of grand jury process, without any disclosure as to the existence of a grand jury, and which was not presented to the grand jury, does not invoke Rule 6(e). For example, the Fourth Circuit has held that grand jury secrecy requirements were not violated when an Internal Revenue Service special agent made available to IRS civil agents materials obtained from criminal investigation targets through search warrants, even though the warrants were obtained and executed during the pendency of a grand jury investigation. See, In re Grand Jury Subpoena, 920 F.2d 235 (4th Cir. 1990).[3]

For a more detailed discussion, please see the LGM at pg. 16, "Independently Obtained Evidence."

Question 3:

Evidence gathered prior to a grand jury referral, which has been clearly identified and segregated, is not Rule 6(e) matter, even if the evidence is eventually presented to a grand jury. For example, books, records, documents, witness statements, special agents' reports, Counsel reports, Service fact sheets, and similar items which were obtained or prepared prior to referral do not constitute "matters occurring before the grand jury." See, Lombardo v. Commissioner, 99 T.C. 342 (1992) (client lists of attorney under investigation for preparing false tax returns, obtained by CI prior to grand jury referral and shared with Exam, held not to be "grand jury matter"). Of vital importance in this area is assurance that evidence in existence and obtained prior to the grand jury referral is segregated and indexed in order to establish it is not Rule 6(e) material. See, I.R.M. 9.5.2.4.3(2).

For further explanation, please see the LGM at pg. 14, "Matters Obtained Prior To Referral."

CONCLUSION

We understand CI's desire to formulate a system to release client lists and other pertinent information on abusive trust schemes to Exam and other civil functions in order to enhance the overall compliance effect. Hopefully, the above discussion combined with that found in the LGM will serve as a foundation to create such a system of sharing information in the future. However, it is critical to keep in mind there is no definitive, concrete answer as to what constitutes "matters occurring before the grand jury." As the LGM cautions, this is an issue the Supreme Court has not expressly addressed and is the subject of numerous and often conflicting court opinions. Therefore, every decision to release or share evidence gathered from abusive trust investigations must be made on a case by case basis. Moreover, in designing a system to share such information as client lists, we strongly urge

that consultation with a Criminal Tax attorney become an integral part of the decision making process.

If you have any questions or comments, please feel free to contact Chris Monica of my staff on (202) 622-4470.

Attachment

DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

WASHINGTON, D.C. 20224

Chief, Office of Tax Crimes

(Criminal Investigation) March 23, 2000

MEMORANDUM FOR CRIMINAL INVESITGATION ALL CHIEFS

FROM: /S/ John S. Fowler

Chief, Office of Tax Crimes

(Criminal Investigation) OP:CI:O:T

SUBJECT: Sharing of Client Lists and Other Pertinent Information in

Abusive Trusts Investigations

Attached is a memorandum from the Office of Chief Counsel (Criminal Tax) that discusses situations where Criminal Investigation (CI) can share client lists and other pertinent information with the Examination Division (Exam) and other civil functions. The memorandum should be used as guidance on how information **can** be shared with other functions.

The attached Criminal Tax memorandum addresses three questions concerning the release of information to Exam and other civil functions. These questions are as follows:

1. In the context of an administrative or grand jury investigations of abusive trust schemes, when is it appropriate for CI to share client lists or other pertinent information with Exam or other civil functions?

2. Is it permissible in a grand jury investigation of abusive trust schemes for CI to release information to Exam or other civil functions where the information was received outside of the grand jury process, such as through a search warrant or confidential informant?
3. Is it permissible in a grand jury investigation of abusive trust schemes for CI to release information to Exam or other civil functions where the information was received prior to the commencement of the grand jury process?

Question 1

It is permissible and in fact encouraged to share information with Exam and other civil functions in an administrative abusive trust investigation.

In a grand jury investigation, CI cannot disclose "matters occurring before the grand jury." When determining what constitutes matters occurring before the grand jury, the standard to follow is whether the disclosure of the particular evidence would reveal the content of the grand jury proceedings, the strategy or direction of the grand jury, the identity of grand jury witnesses or the substance of their testimony. In these situations, it is critical that the advice of District Counsel (Counsel) and the US Attorney's Office (USAO) be sought before releasing information that may qualify as matters occurring before the grand jury. For reference, Chief Counsel's Litigation Guideline Memorandum, Grand Jury Evidence – Matters Occurring Before a Grand Jury is attached to this memorandum.

Question 2

Evidence obtained by a truly independent source which does not reveal the inner workings of the grand jury, or the existence of the grand jury, and which has not been presented to a grand jury may be used for civil purposes. Perhaps the best examples of this are client lists obtained via a search warrant or from a confidential informant. In this situation, it would be permissible to give the client lists to Exam or other civil functions.

Question 3

Evidence gathered prior to a grand jury request being submitted to the Department of Justice, such as books and records, tax return information, documents, witness statements, or other material, can be released to Exam or other civil functions even if the material is eventually presented to a grand jury. The key element is that the material must be clearly identified and segregated from grand jury material.

Due to the fact that abusive trust promotions are marketed towards higher income taxpayers and the resulting tax revenue losses could be massive, CI should be cognizant of the overall compliance effect when investigating these schemes. This includes criminal prosecution of promoters, their staffs, and selected clients, and the civil examination and collection activity against the remaining client base. CI should always decide which clients should be worked criminally prior to turning over client lists or other pertinent information to Exam or other civil functions. However, it is impractical for CI to attempt to work all clients criminally. The balance of the clients, per the guidelines pointed out in attached Chief Counsel's memorandum, should be forwarded to Exam or other civil functions. It is possible that many of names provided to Exam or other civil functions, with the proper level of coordination, may later be referred back to CI.

Although sharing information with Exam or other civil functions is highly encouraged under the circumstances listed above, extreme caution should be exercised prior to releasing any information in a grand jury setting and the advice of Counsel and the USAO should be sought before any disclosure.

If there are questions concerning this memorandum, please contact me at

(202) 622-4069 or Senior Analyst Steven Pregozen of my staff at (202) 622-5755.

Attachments

CC: Headquarters Senior Staff

Operations Senior Staff