

Office of Chief Counsel  
Internal Revenue Service  
**Memorandum**

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to: Area Counsel (TEGE)  
Pacific Coast Area (SF)

from: Brinton T. Warren  
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(Procedure & Administration)

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subject: Application of Section 6700 Penalty With Respect to Various Participants in Tax-Exempt Bond Issuance

This Chief Counsel Advice responds to your assistance request dated November 4, 2005.. In accordance with I.R.C. § 6110(k)(3), Chief Counsel Advice may not be used or cited as precedent.

**ISSUE**

Whether the Service can impose the section 6700 penalty against an individual participating in a bond transaction when the individual gave information to another participant about a material matter, when the individual knows, or has reason to know that the information is false or fraudulent and the other participant, who also knows or has reason to know that the statement is false, will use such false information to make or furnish a subsequent false or fraudulent statement regarding the tax benefits of the transaction.

**CONCLUSION**

Yes. The Service can impose the penalty on a participant to a bond transaction that made or furnished, or caused to be made or furnished, a false or fraudulent statement regarding the tax benefit of the transaction. For purposes of section 6700, the

participant makes or furnishes, or causes another person to make or furnish, a false or fraudulent statement regarding the tax benefits of the transaction if the participant who provided false or fraudulent material information (or withheld information that necessitated a false conclusion) was sufficiently involved in the transaction and knew another participant would use the information (or its absence) to make or furnish a subsequent false or fraudulent statement regarding the tax benefits of the transaction.

### **FACTS**

The facts are fully set forth in the incoming memorandum. In summary, the matters involve the issue of obligations (bonds) issued on behalf of a political subdivision of a State. Various participants may be involved in such bond offerings. You have asked us to accept for purposes of this memorandum that some of the participants to the bond issue made false statements regarding the tax benefits of the transaction to other participants, who then used those statements to make false statements themselves regarding the tax benefits of the transaction. You have asked us to accept for purposes of this memorandum that these participants were 1) sufficiently involved in the transaction and 2) knew or had reason to know that their statements were false, and 3) in the case of some of the participants, knew another participant would use the information to make or furnish a subsequent false or fraudulent statement regarding the tax benefits of the transaction.

### **LAW AND ANALYSIS**

Section 6700 of the Internal Revenue Code imposes a penalty upon persons who promote abusive tax shelters. Section 6700(a) provides, in pertinent part, that the penalty applies to any person who

- (1)(A) organizes (or assists in the organization of) –
    - (i) a partnership or other entity,
    - (ii) any investment plan or arrangement, or
    - (iii) any other plan or arrangement, or
  - (B) participates (directly or indirectly) in the sale of any interest in an entity or plan or arrangement referred to in paragraph (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,....

Generally, the penalty is the lesser of \$1,000 or 100% of the gross income derived (or to be derived) from the activity by the person on which the penalty is imposed; however, if

the penalty is imposed with respect to an activity that involves a statement described in section 6700(a)(2)(A), then the penalty is 50% of the gross income derived (or to be derived) from the activity by the person on which the penalty is imposed. I.R.C. § 6700(a)(flush language). Courts have recognized that a separate section 6700 penalty applies to each separate legal entity that engages in the conduct section 6700 prohibits. See, e.g., In re Tax Refund Litigation v. United States, 766 F. Supp. 1248, 1257 (E.D.N.Y. 1991), aff'd in part and rev'd in part, 989 F.2d 1290 (2d Cir. 1993). Whether the penalty should be asserted in a particular case is a highly factual determination and can only be made on a case by case basis. The Service bears the burden of proof with respect to each element of section 6700. I.R.C. § 6702. The burden of proof must be met by the preponderance of evidence. See Barr v. United States, 67 F.3d 469 (2d Cir. 1995). There is no period of limitations for assessment of the penalty. See Cappozzi v. United States, 980 F.2d 872 (2d Cir. 1992); Lamb v. United States, 977 F.2d 1296 (8th Cir. 1992); Sage v. United States, 908 F.2d 18 (5th Cir. 1990).

At issue, here, are bond offerings where participants to the bond offering either conveyed facts that were necessary for another to represent, or represented themselves, that interest income earned with respect to the bonds may be excluded from the investors' gross income pursuant to section 103. Congress has stated that the terms "investment plan or arrangement" and "other plan or arrangement" include "obligations issued by or on behalf of State or local governments that are represented as those described in section 103." H.R. Rep. No. 101-247, 101st Cong., 1st Sess., at 1397 (1989). Therefore, the Bonds are an arrangement with respect to which the Service may impose a penalty under section 6700 against any person who, directly or indirectly, organized or assisted in the organization of the Bonds or participated in the sale of the Bonds.

Section 7701(a)(1) defines person as an individual, a trust, estate partnership, association, company, or corporation. In the context of a bond offering, the term person, includes, but is not limited to, bond counsel, investment bankers, issuers, conduit borrowers, financial advisors, feasibility consultants, engineers, and counsel to any of those participants. H.R. Rep. No. 101-247, at 1397. In addition, Congress clarified that the section 6700 penalty could apply to:

"other persons, who (1) are involved in the organization or sale of such State or local government bonds and (2) know or have reason to know that their opinions, offering documents, reports, or other statements (or materials on which they relied in making such statements) are false or fraudulent as to any matter material to the tax exemption of the interest on the bonds." A person who makes a statement facilitating the issuance or sale of State or local government bonds (including a sale occurring subsequent to the issuance of the bonds) is involved in the organization or sale of such bonds.

H.R. Rep. No. 101-247, at 1397-98.

Thus, it appears Congress specifically intended that all the various participants in a bond offering be within the definition of person for purposes of section 6700, provided they were involved in the organization or sale of the bonds and they knew or should have known the information was false or fraudulent as to any matter material to the tax exemption of the interest on the bonds. Organization or sale of the bonds would occur if a participant made a statement that facilitated the issuance of the bonds. If participants knew their opinion, offering document, report, or statement was false with respect to a material matter, then the Service could potentially impose a penalty under section 6700 against those participants, so long as the other requirements of section 6700 were met.

A statement can be either written or oral. United States v. Buttorff, 761 F.2d 1056 (5th Cir. 1985). There are two types of statements that fall within the statutory bar of section 6700: 1) statements directly addressing the availability of tax benefits, and 2) those concerning factual matters that are relevant to the availability of tax benefits. See Buttorff, *supra*; Unites States v. Petrelli, 704 F. Supp. 122 (N.D. Ohio 1986). Statements in the tax-exempt bond area include “opinions, offering documents, reports, or other statements (*or materials on which they relied in making such statements*)” that are false or fraudulent as to any matter material to the tax exemption of the interest on the bonds. H.R. Rep. No. 101-247, at 1398 (emphasis added). Thus, the term statement includes information that is false or fraudulent as to any matter material to the tax exemption of the interest on the bonds that other participants, such as special tax counsel and private placement agents, use to make statements. Such information is considered a statement, and the Service can impose the section 6700 penalty against the person who made or furnished, or caused another to make or furnish, the statement if the statement was false or fraudulent with respect to a material matter.

A matter is material if it has a substantial impact on the decision making process of a reasonably prudent investor. Buttorff, 761 F.2d at 1061. The Service does not need to prove actual reliance by the investor. Id. In bond offerings, statements concerning the exemption of interest on the bonds or facts relevant to that issue are clearly material, as a key factor for investors is whether the interest will be exempt from taxation.

In addition to actually making statements regarding the tax benefits of a transaction or facts necessary to determine the tax benefits, a person may be liable for the penalty if they furnished such statements. Thus, the Service might be able to impose the penalty against participants who provided such statements to the investors. For example, participants who disseminate false statements, and knew they were false, as part of their activities in organizing and promoting the bond offering, such as a program advisor, may have furnished false statements. See United States v. Raymond, 78 F.Supp.2d 856, 881 (E.D. Wis. 1999), aff'd, 228 F.3d 804 (7th Cir. 2000), cert. denied, 533 U.S. 902, 121 S.Ct. 2242 (2001) (promoters who sold an informational program, which contained false statements concerning tax benefits that provided instructions for

avoiding federal income taxation, were considered to have “furnished” false statements to the purchasers of the program by the very act of selling them the program).

Whether a person knows or has reason to know that such person's statement is false or fraudulent as to any material matter depends upon that person's role in the organization or sale. H.R. Rep. No. 101-247, at 1397-98. In addition, the courts often look to three factors to determine whether a person had the requisite knowledge to violate section 6700: 1) the extent of the person's reliance on knowledgeable professionals; 2) the person's level of sophistication and education; 3) the person's familiarity with tax matters. See, e.g., United States v. Estate Pres. Servs., 202 F.3d 1093, 1103 (9th Cir. 2000). Participants can rely on matters of fact or material provided by other participants necessary to make their own statements or draw their own conclusions, unless they have actual knowledge or a reason to know of its inaccuracy or the statement is not credible or reasonable on its face. H.R. Rep. No. 101-247, at 1398. In the facts as presented, the participants identified appear involved enough that the transaction would not have happened without their involvement. In addition, these participants helped prepare, or supervise the preparation of, statements or documents concerning the transaction and the tax benefits of the transaction that were provided to investors. These participants knew their statements were false and that the other participants using those statements knew, or had reason to know, they were false.

If the participant who provided the false or fraudulent material information (or withheld information that necessitated a false conclusion) was extensively involved in the transaction and knew another participant would use the information (or its absence) to make or furnish a statement regarding the tax benefits of the transaction, then that participant made or furnished a statement with respect to the tax benefits of the transaction that was false with respect to a material matter. Consequently, the Service could impose the section 6700 penalty against that participant. In addition, as the participants who used the information (or its absence) to make or furnish their own subsequent statements regarding the tax benefits of the transaction knew the information (or its absence) was false (or necessitated a false conclusion), the Service also could impose the section 6700 penalty against those participants.

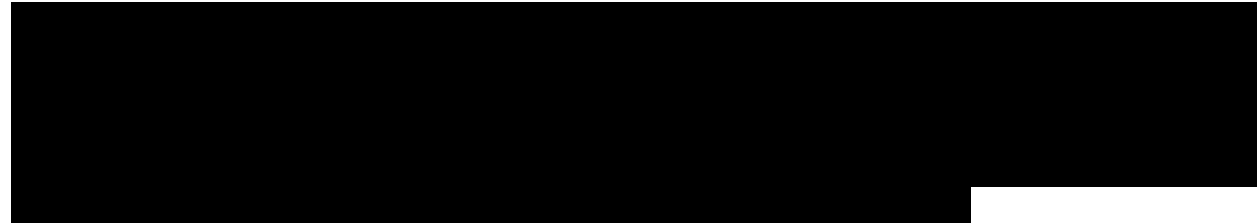
As discussed above, the Service may impose the section 6700 penalty on the person who actually made or furnished a false or fraudulent statement concerning the tax benefits of the transaction or against a person who caused such statement to be made. Section 6700 does not limit by its terms the particular means by which a person may cause another person to make or furnish a false statement, nor the degree of attenuation between these two people's actions. Section 7734(a) of the Omnibus Budget Reconciliation Act (OBRA) of 1989, Pub. L. No. 101-239, amended section 6700(a) by inserting "(directly or indirectly)" after "participates" in paragraph (1)(B) and by inserting "or causes another person to make or furnish" after "makes or furnishes" in paragraph (2). The legislative history states that the amendments made in 1989 were made to clarify that the penalty applies to direct and indirect actions. H.R. Rep. No. 101-247, at 1397. As even the indirect actions of participants may subject them to the

section 6700 penalty, participants cannot try to avoid the penalty by using other participants to make false statements regarding the tax benefits of the transaction.

For example, an individual was considered to have caused others to make fraudulent statements due to the individual's high level of involvement in the transaction where the individual was involved in the management of an entity that participated in a plan or arrangement subject to the section 6700 penalty. Estate Pres. Servs., 202 F.3d at 1104-05. The court also considered the fact that the individual voted to approve the materials distributed to investors, which contained false statements concerning the tax benefits of the transaction. Id. In the facts presented, the participants were all sufficiently involved in making the bond offering and the preparation or supervision of documents necessary for the bond offering. Participants who made or furnished statements regarding the tax benefits of the transaction or facts necessary to determine the tax benefits of the transaction may have caused other participants to make such statements by providing them with, or withholding, information they knew the other participants needed and would use to make their statements regarding the transaction.

While whether the Service may assert the section 6700 penalty against participants in the bond offering depends on their role in a bond offering, the Service should conduct thorough examinations of the activities of the participants in question in order to determine whether the penalty should be asserted. The question of whether the penalty should be asserted is a highly factual determination that will vary from case to case. We will be pleased to continue to work closely with you when developing these cases.

#### **CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS**



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If you have any further questions, please call us at (202) 622-4940.