DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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OFFICE OF
CHIEF COUNSEL

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MEMORANDUM FOR THEODORE R. LEIGHTON
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FROM: WILLIAM P. O'SHEA
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SUBJECT: § 6707 Questions

DATE: August 9, 2000

This memorandum responds to your request for technical assistance concerning the imposition of Tax Shelter Registration penalties under §§ 6707 and 6708 of the Internal Revenue Code.

Certain transactions have been identified that should have been registered under the tax shelter provisions as they existed prior to, and continue to exist after, the expansion of the tax shelter rules in 1997.[1]

ISSUES

1. Should the Service conduct separate §§ 6707/6708 penalty examinations for each individual shelter promoted, or an aggregate examination of all the tax shelter organizer's shelters, when an organizer failed to register more than one § 6111 shelter?

2. What are the organizer's administrative appeals rights?

3. Is a § 6707 exam part of an income tax exam? If the Service conducts a § 6707 concerning a particular deal, is it prohibited from conducting another

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[1]In 1997, Congress added confidential corporate tax shelters as shelters that may need to be registered under § 6111. See P.L. 105-34 § 1028, Taxpayers Relief Act of 1997, 1997-4 Vol. 1 C.B. 140. Some of the shelter transactions you have asked about occurred after the enactment of those provisions. However, those new rules are not addressed here because the shelters were required to register under the rules of § 301.6111-1T as they existed before, and continue to exist after, the 1997 Act changes.

similar exam concerning another shelter promoted by the same organizer during the same tax years?

CONCLUSIONS

1. The Service should conduct independent §§ 6707/6708 penalty examinations for each incomplete or unfiled tax shelter registration, if possible.

2. The shelter organizers subject to the §§ 6707/6708 penalties have appeal rights as described below. Shelter organizers should be informed of their appeal rights and we should help facilitate appeals.

3. Section § 7605(b) (prohibition against unnecessary examinations and more than one inspection of a taxpayer's books of account) should not prohibit the Service from conducting more than one examination of the same tax shelter organizer for the same tax year to determine penalties arising from different shelters. Moreover, a § 6707 exam does not need to be part of an income tax exam.

LEGAL BACKGROUND

Section 6111(a)(1) requires any tax shelter organizer to register the tax shelter with the Secretary (in such form and in such manner as the Secretary may prescribe) not later than the day on which the first offering for sale of interests in such tax shelter occurs. Section 6111(c) generally provides for the definition of a "tax shelter" for the purposes of § 6111.

Section 6111(a)(2) provides that any registration under § 6111(a)(1) must include (A) information identifying and describing the tax shelter, (B) information describing the tax benefits of the tax shelter represented (or to be represented) to investors, and (C) such other information as the Secretary may prescribe.

Section 6111(b)(1) provides that any person who sells (or otherwise transfers) an interest in a tax shelter shall (at such times and in such manner as the Secretary shall prescribe) furnish to each investor who purchases (or otherwise acquires) an interest in such tax shelter from such person the identification number assigned by the Secretary to such tax shelter.

Section 6111(b)(2) provides that any person claiming any deduction, credit, or other tax benefit by reason of a tax shelter shall include (in such manner as the Secretary may prescribe) on the return of tax on which such deduction, credit, or other benefit is claimed that identification number assigned by the Secretary to such tax shelter.

Section 6112(a) provides that any person who (1) organizes any potentially abusive tax shelter, or (2) sells any interest in such a shelter, shall maintain (in such manner as the Secretary may be regulations prescribe) a list identifying each person who was sold an interest in such shelter and containing such other information as the Secretary may by regulations require.

Section 6112(b) provides that for the purposes of § 6112, the term "potentially abusive tax shelter" means – (1) any tax shelter (as defined by § 6111) with respect to which registration is required under § 6111, and (2) any entity, investment plan or arrangement, or other plan or arrangement which is of a type which the Secretary determines by regulations as having a potential for tax avoidance or evasion.

Section 6112(c)(1) provides that any person who is required to maintain a list under § 6112(a) – (A) shall make such list available to the Secretary for inspection upon request by the Secretary, and (B) except as provided under regulations prescribed by the Secretary, shall retain any information which is required to be included on such list for seven years.

Section 6707(a) provides that if a person who is required to register a tax shelter under § 6111(a), (A) fails to register such tax shelter on or before the date described in § 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 § 6707(a)(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.

Section 6707(a)(2) provides that except as provided in § 6707(a)(3), the penalty imposed under § 6707(a)(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 a shelter, or (B) $500.

Section 6708(a) provides that any person who fails to meet any requirement imposed by § 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 § 6708(a) for any calendar year shall not exceed $100,000.

Section 6708(b) provides that the penalty imposed by § 6708 shall be in addition to other penalties provided by law.

DISCUSSION

1. Should the Service conduct separate §§ 6707/6708 penalty examinations for each individual shelter promoted, or an aggregate examination of all

the tax shelter organizer's shelters, when an organizer failed to register more than one § 6111 shelter?

The Service should conduct separate and independent §§ 6707/6708 penalty examinations for each incomplete or unfiled shelter registration.

The tax shelter registration program is designed to 1) enable the Service to analyze general trends among current tax shelters; and 2) allow the Service to identify the organizers of and participants in potentially abusive tax shelters. To further these goals, §§ 6111 and 6112 impose an affirmative duty on tax shelter organizers to register with the Service each individual shelter that they promote or organize, and to maintain separate lists of the investors in them. Similarly, the penalties under §§ 6707 and 6708 are application specific, and not taxpayer specific.

IRM Part 120, the Penalty Handbook, sets forth guidance for all penalties imposed by the Internal Revenue Code, including the penalty imposed by §§ 6707/6808. IRM Part 120 replaced former IRM Part IV Section 42(17)(12), which governed the Service's application of §§ 6707/6708. Prior IRM 42(17)(12) contained more detailed provisions than current IRM Part 120. Under Prior IRM 42(17)(12), § 6707 penalty exams were initiated and conducted separately for each incomplete or unfiled shelter registration. Note that this rule applied to shelters that were required to be registered separately under § 6111. The Service may conduct a joint examination for separate shelters that the organizer was required or had an option to register jointly (e.g. separate but identical structures using different entities and assets).

Thus, because the affirmative duties and the penalties imposed for failure to comply with such duties were specific to each shelter, the Service treated each examination separately and directed any informal inquiry specifically to each shelter that was not registered. See Prior IRM 42(17)(12).7. IRM Part 120 does not contradict these former procedures and we recommend that you continue to follow their substance.

2. What are the organizer's administrative appeals rights?

Taxpayers may assert a defense of reasonable cause against a penalty imposed under § 6707(a). IRM 120.1.10.12.3 provides that the reasonable cause exception applies to the penalties under § 6707 except the penalty under § 6707(b)(1). IRM 120.1.10.12.3 references IRM 120.1.1.3, which provides the general rules for the reasonable cause defense. Generally, IRM 120.1.1.3 provides that reasonable cause is based on all the facts and circumstances in each situation, and allows the Service to provide relief from a penalty that would otherwise be assessed. Reasonable cause relief is generally granted when the taxpayer exercises ordinary business care and prudence in determining their tax obligations

but is unable to comply with those obligations. However, taxpayers should not be granted reasonable cause relief, unless they meet all of the other criteria outlined in that section.

In addition to IRM 120.1, the special post assessment penalty procedures provided in IRM 8.11.1.7 (02-26-1999) apply to penalties imposed under § 6707. IRM 8.11.1.7(1) provides, with a few enumerated exceptions[2], that the Post Assessment Penalty Appeal procedure applies to all assessed additions to tax, and additional amounts and penalties (commonly referred to as penalties) imposed by Chapter 68 of the Code. These special post-assessment penalty procedures conform with the procedures outlined in IRM 120.1. Specifically, the post assessment penalty procedures state that the penalties are to be assessed and collected like taxes and paid upon notice and demand. IRM 8.11.1.7. Although technical advice procedures are not available to taxpayers who submit penalty appeals, IRM 8.11.1.7, taxpayers may now appeal penalties to an Appeals Officer who will resolve the appeal. IRM 8.11.1.7.2.1.

Finally, a taxpayer that wishes to litigate the § 6707 penalty must first pay the full penalty because the Tax Court does not have jurisdiction over a § 6707 penalty and § 6703 does not apply to § 6707 penalties. Cf. Medeiros v. Comm., 77 T.C. 1255 (1981)(100 percent penalty assessment under § 6672 not subject to Tax Court jurisdiction); Robertson v. Comm., 45 TCM (CCH) 537 (1983)(Penalty imposed under § 6654(a) for underpayment of estimated tax attributable to tax shown on return not subject to Tax Court jurisdiction).

3. Is a § 6707 exam part of an income tax exam? If the Service conducts a § 6707 concerning a particular deal, is it prohibited from conducting another similar exam concerning another shelter promoted by the same organizer during the same tax years?

The answer to this question assumes that the question concerns the restrictions contained in § 7605(b) against unnecessary examinations and more than one inspection of a taxpayer's books of account. Based on this assumption, the Service has a strong argument that it is not prohibited from conducting more than one examination of the same shelter organizer for the same tax year to determine whether to impose the penalty under §§ 6707/6708.

Section 7605(b) provides as follows:

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[2]Note that although the penalties under § 6707 are not listed among the exceptions, the penalties under §§ 6700 and 6701, for promoting and aiding and abetting abusive tax shelters are.

> No taxpayer shall be subjected to unnecessary examination or investigation, 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.

Section 7605(b) imposes restrictions on two activities: (1) unnecessary investigations, and (2) more than one inspection of a taxpayer's books of account for a taxable year. In construing the language of this section, courts have held that the prohibition against a second "inspection" must be read in pari materia with the opening clause which states the purpose for which the section was enacted; i.e. that no taxpayer shall be subjected to unnecessary examinations or investigations. See, United States v. Schwartz, 518 F.2d 842 (7th Cir. 1975); United States v. Kendrick, 469 F.2d 977 (5th Cir. 1972). In applying the restrictions of § 7605(b), courts have been reluctant to restrict legitimate investigations by the Service.

Section 7605(b) first appeared as § 1309 of the Revenue Act of 1921, 42 Stat. 310. "The section was designed to protect the taxpayer from onerous and unnecessarily frequent examinations and investigations of revenue agents. . . . The purpose of the section was to free honest taxpayers from the petty annoyances of repeated examinations. . . . There is no indication anywhere in the legislative history that section 7605(b) [was] intended to restrict the scope of [the government's] legitimate power to protect the revenue." See, Ivan Grossman and Sherry Grossman v. Commissioner, 74 T.C. 1147 (1980). "The grants of power contained in section 7601 (power to canvass districts), and 7602 (power to examine books, records, etc.) are to be liberally construed in recognition of the vital public interest they serve. By the same token, the limitation in section 7605 (b) is not to be construed so as to defeat that legitimate purpose." DeMasters v. Arend, 313 F.2d 79, 87 (9th Cir. 1963).

The Service treats the restrictions contained in § 7605(b) as applying to a case that has been closed but for which there are grounds to reopen. IRM section 4023, titled "Reopening of Closed Cases, restates the language of § 7605(b), and directs that when a "reexamination" of a taxpayer's books and records is necessary, a notice signed by the appropriate official be delivered to the taxpayer. In addition, Rev. Proc. 94-68, 1994-2 C.B. 803 (which amplifies and updates Rev. Proc. 85-13, 1985 C.B. 514) defines a closed case and lists specific examples, not intended to be all-inclusive, of contacts that are not examinations, inspections, or reopenings. This revenue procedure also explains the Service's policy against reopening any case closed after examination by a district office or service center to make an adjustment unfavorable to the taxpayer, except in certain specified conditions. This revenue procedure is often cited by the courts when addressing the restrictions contained in § 7605(b). For instance, in Schwartz, the court stated that:

> It is significant that the Internal Revenue Service does not treat the giving of a notice required under Section 7605(b) as a perfunctory matter, it deals with the matter of a second inspection on the assumption that it relates to an inspection following the closing of an examination by the agents.

469 F.2d at 984.

Based on this precedent the Service has a strong argument that it is not prohibited from conducting more than one examination of the same shelter organizer for the same tax year to determine whether to impose the penalty under §§ 6707/6708. The Service can conduct additional examinations or investigations of the same taxpayer for the same year as long as there exists a legitimate purpose for the examination and the Service does not harass the taxpayer. The penalties imposed by §§ 6707/6708 are based on individual tax shelters. Therefore, the Service could conduct an examination of a taxpayer with respect to one tax shelter, and could conduct a second or third, or several subsequent examinations with respect to different tax shelters. Each subsequent examination would be for a legitimate purpose, assuming multiple penalty investigations are not conducted to harass the taxpayer. Therefore, the restrictions contained in § 7605(b) would not apply.

The first part of question number 3 asks whether a penalty examination is part of an income tax examination. We are not sure what that question means. If the Service is not conducting an income tax examination at the time that it is conducting the penalty examination, the Service would not be prohibited from conducting an income tax examination of the same taxpayer for the same year. On the other hand, if the Service conducted an income tax examination at the same time that it conducted a penalty examination, the Service could not conduct another income tax examination of the same taxpayer for the same year without giving the taxpayer notice, or unless the taxpayer requests another income tax examination. If the Service conducts an income tax examination for a particular tax year, the Service could conduct a subsequent penalty examination of the same taxpayer for the same year with respect to a penalty under §§6707/6708. See, Kendrick, supra (a subsequent inspection of taxpayers' books and records to determine excise tax liability following a complete income tax audit did not require notice under § 7605(b)).

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