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

OFFICE OF CHIEF COUNSEL
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DEPUTY AREA COUNSEL (TEGE)
PACIFIC COAST/CENTRAL MOUNTAIN AREA

FROM: ASSISTANT CHIEF COUNSEL
(ADMINISTRATIVE PROVISIONS & JUDICIAL PRACTICE)

SUBJECT: City of Imposition of I.R.C. § 6700 penalty
Your ref.: TL-N-4218-00

This Chief Counsel Advice responds to your memorandum dated December 18, 2000. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice is not to be used or cited as precedent.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

LEGEND

Bond Counsel =
City or Issuer =

ISSUE

Is the Internal Revenue Service precluded from asserting a penalty under I.R.C. § 6700 against an attorney (bond counsel) who rendered false or fraudulent advice with respect to government mortgage revenue bonds if the Service decided not to pursue an audit to determine whether the bonds satisfied the requirements of section 103(a)?

CONCLUSION

The Service need not open or pursue an audit on the bond issue under section 103 in order to assert the section 6700 penalty against bond counsel. However, the burden of proof with respect to each element of the section 6700 penalty is on the Service.

FACTS

The facts are fully set in the incoming memorandum. Briefly, however, the case before us involves a $ in mortgage revenue bonds (bonds) issued by the City on December 31, 1985, to finance the acquisition and construction of a housing project that was to provide a number of low to moderate housing units. The bonds were sold to the Underwriter on December 31, 1985. They were not offered to the public until . Furthermore, significant changes were made to the terms of the bonds in each of the years through . A portion of the bonds was also remarketed in , , and .

The Service audited the bonds and determined that the bonds did not meet the requirements of I.R.C. § 103 and, thus, that the interest earned on the bonds is not exempt from federal income tax. In April of 1999, the Service sent a preliminary adverse determination letter to the City advising the City of its proposed determination, the reasons therefor, and the City's right to an administrative appeal. See Rev. Proc. 99-35, 1999-2 C.B. 501. The City filed a timely protest. In its protest, the City advised the Service that it had redeemed all of the bonds before the adverse determination letter was sent. Because the bonds had been redeemed, the Service closed its audit of the bonds.

The Service is now considering asserting a section 6700 penalty against the various parties who participated in the marketing and sale of the bonds. Specifically, the Service would like to know whether it may assert the penalty against an attorney (bond counsel) who rendered opinions and statements regarding the excludability of interest earned on the bonds from gross income. The question presented is not whether the assertion of the penalty is appropriate in this case, but only whether the Service may assert the penalty when it did not pursue the audit of the bonds.

LAW AND ANALYSIS

Congress enacted section 6700 of the Internal Revenue Code to penalize promoters, organizers, sellers, and professional advisors of abusive tax shelters and other abusive tax avoidance schemes who make false statements concerning

the tax benefits of such schemes. Congress recognized that "[a]busive tax shelters must be attacked at their source." See S. Rep. No. 97-494, 97th Cong., 2d Sess., pt. 1, at 266 (1982). Thus, bond counsel, as a professional advisor, is within the category of persons potentially subject to the penalty. See also H.R. Rep. No. 101-247, 101st Cong., 1st Sess., at 1397-1398 (1989). In order to impose the penalty:

> there need not be reliance by the purchasing taxpayer [on the false or fraudulent statement] or actual underreporting of tax. These elements have not been included because they would substantially impair the effectiveness of this penalty. Thus, a penalty could be imposed based upon the offering materials of the arrangement without an audit of any purchaser of interests.

S. Rep. No. 97-494, supra, at 267.

The provision, as in effect at the time the bonds were first issued and offered to the public, 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 in the sale of any interest in an entity or plan or arrangement referred to in subparagraph (A), and
>
> (2) makes or furnishes (in connection with such organization or sale)--
>
> (A) a statement with respect to allowability of any deductions 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.

I.R.C. § 6700(a) (1984) (emphasis added). For activities after December 31, 1989, the statutory scheme is slightly different. 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). Although the amendment applies to activities after December 31, 1989, the OBRA legislative history suggests that these changes were made to clarify the pre-OBRA law. See H.R. Rep. No. 101-247, supra, at 1397 (“The bill also clarifies that the penalty applies to direct and indirect actions.”). In addition, the OBRA amendment also changed the formula for computing the penalty. See I.R.C. § 6700(a) (1989).

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).

Section 6700 does not define the terms “investment plan or arrangement” or “any other plan or arrangement.” The terms, however, are meant to be defined broadly. See generally S. Rep. No. 97-494, supra, at 266-267 (1982). The legislative history of the OBRA amendment to section section 6700 provides as follows:

> The committee wishes to clarify that, under present law, “investment plan or arrangement” and “other plan or arrangement,” as those terms are used in section 6700 of the Code, include obligations issued by or on behalf of State or local governments which are represented to be described in section 103(a) of the Code (“bonds.”)

H.R. Rep. No. 101-247, at 1397 (1989) (emphasis added). Because this statement is a clarification of pre-OBRA law, it may be relied on in interpreting the provisions of section 6700 as in effect prior to OBRA. Estate of Ceppi v. Commissioner, 78 T.C. 320, 324, 325 (1982), aff’d, 698 F.2d 17 (1st Cir. 1983). The legislative history provides further clarification as follows:

> The penalty imposed by section 6700 may apply to bond counsel, investment bankers and their counsel, issuers (and beneficiaries of “conduit” bonds) and their counsel, financial advisors, feasibility consultants and engineers, and other persons, who (1) are involved in the organization or sale 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.
>
> * * *
>
> In addition, section 6700 applies even if the Service insulated bondholders from the effect of a declaration of taxability of a bond sold as tax-exempt by entering into a closing agreement with the issuer of the bonds. Furthermore, so long as there has been a determination that a false or fraudulent statement (which may include a conclusion of law based on a false or fraudulent statement) has been utilized, action under section 6700 is not precluded by failure of the Service to enter into a closing agreement, to declare taxability, or otherwise penalize the issuer or owners of the bond in question.

Id., at 1398 (emphasis added). Accordingly, assuming that the facts support the assertion of the penalty, the Service may proceed under section 6700 against bond counsel or any other person involved in the issuance and sale of the bonds in question.

As noted above, the determination of whether any person is liable for the section 6700 penalty is highly factual and can only be done on a case by case basis. Consequently, before the Service can assess the penalty against bond counsel in the present case, the Service must first establish that:

1. Bond counsel organized or participated in the sale of the bonds;

2. Bond counsel made or furnished a statement with respect to the allowability of deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the bonds;

3. The statement in 3 is false or fraudulent as to any material matter; and

4. Bond counsel knew or had reason to know that the statement in 3 is false or fraudulent.

With regard to the first element listed above, the Service should investigate bond counsel's activities to determine the scope and nature of bond counsel's involvement in the transaction.

With respect to the second and third elements, the Service should examine the offering documents to determine whether any false and fraudulent statements with respect to the excludability of any interest earned by the bondholders were made by, or in reliance on the opinion of, bond counsel. Merely establishing a violation with respect to sections 103 and 141 through 150 of the Code is not sufficient to trigger the application of section 6700. Instead, the Service must establish, among other factors, that a false or fraudulent statement was made or furnished with respect of the tax exempt status of the bonds.

As indicated above, imposition of the penalty does not require reliance by an investor on bond counsel's false or fraudulent statements or underreporting of a tax liability as a result of bond counsel's statements. The statutory requirement is satisfied as long as the bond counsel's false or fraudulent statements would have "substantial impact on the decision-making process of a reasonably prudent investor." S. Rep. No. 97-494, supra, at 267. See also United States v. Buttorff, 761 F.2d 1056 (5th Cir. 1985); United States v. Petrelli, 704 F. Supp. 122 (N.D. Ohio 1986).

Lastly, the Service will need to determine whether bond counsel knew or had reason to know that the statements bond counsel made or furnished regarding the excludability of interest earned on the bonds were false or fraudulent. I.R.C. § 6700(a)(2)(A). The Service is not required to prove actual knowledge. Rather, the Service may rely on objective evidence of the bond counsel's knowledge of the transaction. S. Rep. No. 97-530, 97th Cong., 2d Sess., at 572 (1982). See also United States v. Campbell, 897 F.2d 1317, 1321-22 (5th Cir. 1990). The Service may not, however, impute knowledge to bond counsel beyond the level of comprehension required by bond counsel's role in the transaction. S. Rep. No. 97-530, supra, at 572. Thus, for example, bond counsel "would be able to rely, as to matters of fact or expectation relevant to his or her opinion, on information provided by other parties (including the issuer) absent actual knowledge or a reason to know of its inaccuracy or the use of statements not credible or reasonable on their face. On the other hand, bond counsel must draw [his or her] own legal conclusions from that information." H.R. Rep. No. 101-247, supra, at 1398 (1989). Consequently, whether bond counsel in the present case knew or had reason to know that statements contained in the bond documents were false or fraudulent depends upon bond counsel's role. The greater bond counsel's knowledge of the bond-financed project and involvement in the issuance, marketing, and sale of the bonds, the more likely it is that bond counsel knew or should have known that the bonds would not meet the requirements of section 103(a) of the Code.

In summary, the Service is not precluded from proceeding under section 6700 against bond counsel even if it does not enter into a closing agreement with the

issuer, declare interest on the bonds taxable, or otherwise penalize the issuer or owners of the bonds. The burden of proof, however, is on the Service. It is imperative, therefore, that the Service gather enough evidence to satisfy each element of section 6700 before asserting the penalty. We recommend that the Service work closely with area counsel when developing its case. We also recommend that in addition to investigating bond counsel's participation in the issuance and initial sale of the bonds, the Service also investigates bond counsel's activities, if any, with respect to the amendments to and subsequent remarketing of the original bonds.

HAZARDS, CASE DEVELOPMENT AND OTHER CONSIDERATIONS

As stated above, we believe that to the extent the OBRA legislative history merely clarifies Congress's original intent in enacting section 6700, the statements in the legislative history are useful in interpreting the pre-OBRA statute. [redacted] However, we have not had an opportunity to research this issue. Naturally, we would be pleased to provide additional field service advice on this and other issues that may arise in connection with the section 6700 examination of the law firm, its members, or other parties.

As always, we hope the advice provide herein is helpful. Please contact us at 202-622-4940 if you have any further questions.

CURTIS G. WILSON

By: _____

Michael Gompertz
Assistant to the Branch Chief,
Branch 2