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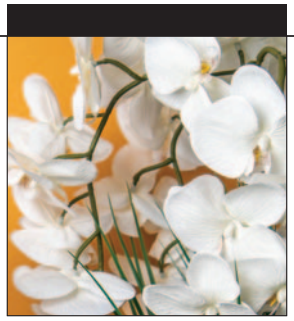

The Unavoidable Overlap of Promoter Investigations and Taxpayer Audits: Interactions and Insights

Important reminders for any advisor advocating for tax minimization planning.

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Enforcement actions by the Internal Revenue Service (IRS) against alleged promotors of abusive transactions and the taxpayers who participate in them are firmly linked. Therefore, effectively defending against IRS challenges requires an understanding of the overlapping rules, standards, and procedures. It calls for big-picture thinking, too, particularly when it comes to the order in which proceedings should occur and the resources that should be devoted to each. Many taxpayers are myopic, thinking solely about how certain events will affect them personally and immediately. Is this understandable? Sure. Does it achieve the best overall result when it comes to multi-faceted disputes with the IRS? No.

This article explains unique aspects of so-called promoter penalties, various actions the IRS takes in connection with alleged promoters, effects of such IRS measures on taxpayers who engaged in the transactions under scrutiny, recent events suggesting that promoter investigations might surge in the near future, and thoughts about the best path forward in the current environment.

Overview of Promoter Penalties

The IRS can assess sizable promoter penalties under Section 6700 against persons in certain situations. An overview of the key issues follows.

Origins. Records show that there was a high incidence of aggressive tax avoidance in the early 1980's, with the figures on a rapid ascent. Congress was determined to halt this trend in the most efficient manner possible. Its thoughts about the problem and solution were as follows:

> Congress believed that widespread marketing and use of tax shelters was undermining public confidence in the fairness of the tax system and in the effectiveness of enforcement provisions and that these tax schemes place a disproportionate burden on the resources of the [IRS]. Congress concluded that the penalty provisions of prior law were ineffective to deal with the growing phenomenon of abusive tax shelters and that [they] must be attacked at their source: the organizer and salesman.[1]

Section 6700 was born in 1982 based on the preceding rationale.

Criteria for Sanctions. The IRS can assess penalties against persons meeting specific criteria.

They *either* organize, or assist in the organization of, a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement, *or* they participate (directly or indirectly) in the sale of ownership interests in such entity, plan, or arrangement.[2] Unsurprisingly, the IRS defines the preceding concepts broadly, to the detriment of alleged promoters.

From the IRS's perspective, the notion of "organizing" includes discovering, planning, investigating or initiating an investment, devising a business or

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financial plan for the investment, or carrying out such investment through negotiations or transactions with others.[3] The idea of "assisting in the organization" is expansive, too. The IRS takes the position that it entails (i) preparing any document establishing an entity used in an abusive transaction (*e.g.*, articles of incorporation, partnership agreement, trust instrument, etc.), (ii) registering the entity with any federal, state or local government, (iii) creating a prospectus, private placement memorandum, or other document describing the transaction, (iv) drafting a tax or legal opinion, (v) issuing an appraisal, and/or (vi) negotiating or otherwise acting in connection with the purchase of any property utilized in the transaction.[4]

When it comes to "participating in the sale" of a supposed tax shelter, the IRS believes that this phrase reaches *any* marketing activities. These include, but are not limited to, direct contact with a prospective investor or his representative, solicitation of investors by mail, phone, or advertisements, and instructing salespersons about the tax shelter or sales presentations thereof.[5] Put differently, participation in this context can include "cold calls, preparation of promotional material, targeted sales pitches, and the offering documents and reports that contain statements that are false or fraudulent as to any matter material about the availability of tax benefits from a transaction."[6]

In addition to organizing or participating in the sale of a tax shelter, persons must have done one of following two things in order to be punished. They personally make or furnish, or cause another person to make or furnish, a statement about the allowability of any tax deduction or credit, the excludability of any income, or the attainment of any other tax benefit by a taxpayer, *and* they actually know, or have reason to know, that such statement is materially false or fraudulent.[7]

Alternatively, the persons make or furnish, or they cause another to make or furnish, a "gross valuation overstatement" as to any material matter.[8] The term "gross valuation overstatement" threshold is relatively low for these purposes. It means any statement regarding the value of any property or service that exceeds 200% of the correct amount, and the value is directly related to the amount of an income tax deduction or credit for any participant.[9] Notably, when the legislation was first introduced, the penalty threshold was 400% of the correct value. Congress ultimately reduced this by half, to just 200%, before enactment.[10] Also noteworthy is that the IRS can impose promoter penalties for making a "gross valuation overstatement," regardless of whether the person knows or has reason to know he is doing so.[11]

Many taxpayers are myopic, thinking solely about how certain events will affect them personally and immediately.

In summary, persons might get hit with promoter penalties under Section 6700 if they organize, help with organizing, directly sell, and/or indirectly sell interests in an entity, plan or arrangement, *and* they either make or cause another person to make (i) a false or fraudulent statement about the tax benefits that a taxpayer will obtain from participating, *or* (ii) a "gross valuation understatement." Congress crafted this standard with hopes of broad applicability. It stated that "persons subject to the penalty may include not only the promoter of a classic tax shelter partnership or tax avoidance scheme, *but any other person* who organizes or sells a plan or arrangement with respect to which there are material inaccuracies affecting the tax benefits to be derived from participation."[12]

Penalty Amounts. The size of the penalty depends on the behavior. In situations involving false or fraudulent statements, the penalty equals 50% of the income that the promoter has already derived, or will derive, from the activity.[13] Where the income amount is speculative, the formula is based on the money that the promoter was reasonably expected to realize. This covers, for example, fees that the promoter was scheduled to earn for ongoing management of the tax shelter after its initial implementation, as well as fees paid by taxpayers who ultimately decided not to claim the tax benefits.[14] Below is a simple example offered by the IRS:

> A promoter's scheme used limited liability companies (LLCs) and trusts to divert income. The examiner can prove that the promoter created 40 LLCs, 25 of which were used by known participants in the scheme. The examiner can also prove that four of the 25 participants paid $1,000 each to the promoter. Gross income to be derived from the scheme is $40,000 (40 LLCs multiplied by $1,000 minimum), so the penalty is $20,000 (50% of the gross income).[15]

By contrast, when cases involve gross valuation overstatements, the penalty is $1,000 or 100% of the income that the promoter has derived or will derive, whichever amount is lower.[16] That penalty, which is charged on a per-activity basis, can be mitigated if the promoter can demonstrate that there was a "reasonable basis" for the valuation and it was made in "good faith."[17] Notably, the existence of an appraisal, alone, is insufficient to meet this standard. The IRS can scrutinize the valuation methodology and inputs, how it was obtained, and the relationship between the appraiser and the promoter, among other things.[18] Below is an illustration of how the IRS calculates this particular penalty:

> Promoter prepared false statements that grossly overstated the value of assets. Promoter knew these statements were false. A total of 30 statements were made to 30 different taxpayers. These false statements were used to reduce the tax due by the taxpayers. The total penalty is $30,000 (30 multiplied by $1,000).[19]

Congress clarified that the mere promotion of an abusive transaction suffices to trigger the penalty under Section 6700; it is *not* necessary that a taxpayer actually engage in the transaction or claim the tax benefits therefrom. Legislative history contains the following commentary on this point:

> There need not be reliance by the purchasing taxpayer or actual underreporting of tax. These elements were not included because they would substantially impair the effectiveness of this [promoter] penalty. Thus, a penalty can be imposed based upon the offering materials of the arrangement without an audit of any purchaser of interests.[20]

The courts have widely interpreted the type of behavior warranting sanctions. Promoters must pay a penalty "with respect to each activity" described in Section 6700(a)(1). That provision refers to organizing, or assisting in the organization of, a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement, *or* participating (directly or indirectly) in the sale of ownership interests in such entity, plan, or arrangement.[21] Promoters have tried to narrow the scope of punishable activities, of course, arguing that it only applies to the appraisal or appraisals leading to the gross valuation overstatement. Courts have rejected this position, concluding that (i) the "activity" giving rise to the promoter penalty "encompasses the entire arrangement facilitated and organized by [the promoter] to solicit timeshare donations, appraise the timeshares, and direct profits to his other organizations," (ii) the "activity" includes "the organization and sale of a tax scheme and not simply the making of false statements of that scheme," and (iii) the promoter's "entire timeshare donation scheme, including the related for-profit entities, [constitute] a particular, well-defined activity for purposes of calculating the penalty under Section 6700."[22]

Endless Assessment Period. Importantly, there is no statute of limitations on assessment of promoter penalties. The IRS, in other words, is under no time pressure to identify potential wrongdoers, audit them, and impose sanctions.[23] The IRS explains to its personnel that the penalty "can be assessed *at any time* for each specific act of organizing or selling interests in a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement [and] once an assessment is made, the 10-year statute of limitation on collection applies."[24]

The endless assessment period has led to cases in which a taxpayer promoted a tax shelter from 1999 to 2003, he was criminally convicted, the IRS assessed promoter penalties in 2010 while he was still incarcerated, and the IRS initiated collection actions when he was released from prison in 2014.[25] The endless assessment period has also triggered cases where the IRS assessed penalties against a promoter *after* he died and then proceeded to collect them from his estate.[26]

Significance of Assessable Penalty Status. Promoter penalties are "assessable penalties." This essentially means that alleged promotors have no right to seek administrative or judicial review *before* the IRS assesses penalties, they cannot utilize the normal deficiency procedures applicable to income taxes and other items, and they must pay a portion of the disputed penalties first and then try to recoup it through a specialized, two-step refund process.[27] They begin by paying at least 15% of the penalties and filing a timely Form 6118 (Claim for Refund of Tax Return

Preparer and Promoter Penalties). If the IRS either issues a Notice of Disallowance or simply ignores it for more than six months, then the alleged promoter can start a suit for refund in District Court.[28]

1 U.S. Joint Committee on Taxation. General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982. JCS-38-82 (Dec. 31, 1982), pg. 210.

2 I.R.C. Section 6700(a)(1)(A) and (B).

3 Chief Counsel Advisory 200402008.

4 Chief Counsel Advisory 200402008.

5 Chief Counsel Advisory 200402008.

6 Chief Counsel Advisory 200402008.

7 I.R.C. Section 6700(a)(2)(A).

8 I.R.C. Section 6700(a)(2)(B).

9 I.R.C. Section 6700(b)(1).

10 U.S. House of Representatives. Conference Report. 97th Congress, 2nd Session. Report No. 97-760 (Aug. 17, 1982), pg. 185.

11 *H&L Schwartz, Inc.*, 60 AFTR 2d 87-6031 (Dist. Court of CA 1987); *Humphrey*, 113 AFTR 2d 2014-515 (Dist. Court GA 2013).

12 U.S. Joint Committee on Taxation. General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982. JCS-38-82 (Dec. 31, 1982), pg. 211 (emphasis added).

13 I.R.C. Section 6700(a) (Flush Language).

14 Chief Counsel Advisory 202125008; Chief Counsel Advisory 202125009; U.S. Joint Committee on Taxation. General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982. JCS-38-82 (Dec. 31, 1982), pg. 212.

15 Internal Revenue Service. Tax Shelter Promoter Investigations under IRC 6700. LB&I Process Unit, Document Control Number PEN-P-005 (2021), pg. 40; Internal Revenue Manual section 4.32.2.12.5.2 (06-04-2018).

16 I.R.C. Section 6700(a) (Flush Language).

17 I.R.C. Section 6700(b)(2).

18 U.S. Joint Committee on Taxation. General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982. JCS-38-82 (Dec. 31, 1982), pg. 212.

19 Internal Revenue Service. Tax Shelter Promoter Investigations under IRC 6700. LB&I Process Unit, Document Control Number PEN-P-005 (2021), pg. 41.

20 U.S. Joint Committee on Taxation. General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982. JCS-38-82 (Dec. 31, 1982), pg. 212; See also *Gardner*, 145 TC 161 (2015), *aff'd* 120 AFTR 2d 2017-6699 (9th Cir. 2017).

21 I.R.C. Section 6700(a)(1)(A) and (B).

22 *Tarpey*, 124 AFTR 2d 2019-6574 (Dist. Ct. MT 2019).

23 Internal Revenue Manual section 20.1.6.13 (08-25-2020); *In re Tax Refund Litigation*, 766 F. Supp. 1248 (E.D. N.Y. 1991); *Capozzi*, 980 F.2d 872 (2nd Cir. 1992).

24 Internal Revenue Service. Tax Shelter Promoter Investigations under IRC 6700. LB&I Process Unit, Document Control Number PEN-P-005 (2021), pg. 5 (emphasis added); see also Internal Revenue Manual section 4.32.2.12.5.1 (06-08-2012).

25 *Crim*, TC Memo 2021-117; *Crim*, 131 AFTR 2d 2023 (Court of Appeals for the District of Columbia May 2, 2023).

26 Chief Counsel Advisory 201235017; *Reiserer*, 479 F.3d 1160 (9th Cir. 2007).

27 Internal Revenue Service. Tax Shelter Promoter Investigations under IRC 6700. LB&I Process Unit, Document Control Number PEN-P-005 (2021), pg. 5; I.R.C. Section 6703(b); I.R.C. Section 6703(c).

28 I.R.C. Section 6703(c).

Surreptitious Start. The Internal Revenue Code does not require the IRS to send an initial notice to the alleged promoter. Accordingly, Revenue Agents "may proceed with the development of a civil [promoter penalty] investigation *without* contacting the promoter."[29] Revenue Agents often decide to contact them, though, so that they can seek an interview, start issuing Information Document Requests, and otherwise advance the investigation.[30]

Potential Outcomes. The results of a promoter investigation vary. In theory, the IRS might conclude that nothing is awry, halt the procedure, and issue a so-called "Discontinuance Letter." This occurs in rare circumstances.[31] More often, the IRS decides to assess civil penalties, collaborate with the Department of Justice (DOJ) to seek an injunction from a federal court, refer the matter to the IRS's criminal division, or take other steps.[32] Possibilities are discussed later in the article.

Impact on Alleged Promoters

Promoter investigations can trigger several negative consequences for those in the proverbial crosshairs. Here is a partial list.

Promoter Penalties. For starters, promoters can be hit with penalties under the key provision, Section 6700. In cases involving false or fraudulent statements, the penalty equals 50% of the income that the promoter has already derived, or will derive, from the activity.[33] Where situations involve gross valuation overstatements, the penalty is $1,000 per activity or 100% of the income that the promoter has derived or will derive, whichever amount is lower.[34]

Aiding-and-Abetting Penalties. Other civil penalties might apply, too. For instance, the IRS can sanction a promoter under Section 6701 for aiding-and-abetting a tax understatement in certain instances. Penalties apply where a person assists in, procures, or advises with respect to the preparation of any portion of a return, affidavit, claim, or other document, *and* such person knows (or has reason to know) that such portion will be used in connection with a material tax matter, *and* knows that such portion will result in a tax understatement to the IRS.[35] The type of person on whom the IRS may impose this penalty is broad; it is not limited to traditional accountants, enrolled agents, and other return preparers.[36]

In terms of numbers, the aiding-and-abetting penalty generally equals $1,000 per person, per period, per taxpayer.[37] The courts have largely concluded that this penalty applies to cases characterized by false or fraudulent statements.[38] The courts have also confirmed that, like promoter penalties under Section 6700, there is no time limit on when the IRS may assess the aiding-and-abetting penalty.[39] On a positive note for alleged promoters, the IRS cannot double down, imposing both promoter penalties under Section 6700 and aiding-and-abetting penalties under Section 6701; it must select one or the other.[40]

Referrals to Office of Professional Responsibility. The IRS instructs its personnel to refer a potential promoter to the Office of Professional Responsibility (OPR) as soon as it appears that the individual has violated *any aspect* of the rules governing practice before the IRS (Circular 230).[41] Moreover, the IRS dictates that referrals to OPR are "mandatory," not discretionary, in cases where the IRS actually assesses promoter penalties. The IRS further clarifies that an OPR referral is not a substitute for sending a case to the DOJ for an injunction action, but rather a supplement thereto.[42]

The OPR has jurisdiction over attorneys, accountants, enrolled agents, actuaries, retirement plan agents, registered tax return preparers, and other professionals who "practice before the IRS."[43] That key phrase is expansive, encompassing all matters connected with a presentation to the IRS related to a taxpayer's rights, privileges, or liabilities. Likewise, the notion of a "presentation" broadly covers (i) preparing documents, filing documents, and/or communicating with the IRS, (ii) giving written advice with respect to any entity, transaction, plan or arrangement "having a potential for tax avoidance or evasion," and (iii) representing a client at conferences, hearings or meetings.[44]

The OPR has the power to punish any practitioner who is incompetent, disreputable, violates any part of Circular 230, or willfully and knowingly misleads (with intent to defraud) a person he is currently or potentially representing.[45] As one would expect, the rules broadly define the concept of in-

[29] Internal Revenue Manual section 4.32.2.7.6 (06-04-2018) (emphasis added).

[30] Internal Revenue Manual section 4.32.2.8.2.1 (06-04-2018); Internal Revenue Manual section 4.32.2.8.3 (06-04-2018).

[31] Internal Revenue Manual section 4.32.2.12.10.3.2.2 (06-04-2018). Discontinuation might be appropriate where the IRS concludes that the alleged promoter was not involved in the relevant activity, the activity was not abusive in nature, or the promoter died and the operation is defunct. See Internal Revenue Manual section 4.32.2.9.3 (06-04-2018).

[32] Internal Revenue Service. Tax Shelter Promoter Investigations under IRC 6700. LB&I Process Unit, Document Control Number PEN-P-005 (2021), pg. 4.

[33] I.R.C. Section 6700(a) (Flush Language).

[34] I.R.C. Section 6700(a) (Flush Language).

[35] I.R.C. Section 6701(a).

[36] *Nielsen*, 976 F.2d 951, 955 (5th Cir. 1992); IRS Technical Advice Memorandum 200243057.

[37] I.R.C. Section 6701(b)(1). The penalty increases to $10,000 when corporations are involved.

[38] *Sansom*, 703 F.Supp. 1505, 1509 (N.D. Fla. 1988).

[39] *Mullikin*, 952 F.2d 920, 928 (6th Cir. 1991); *Lamb*, 977 F.2d 1296, 1297 (8th Cir. 1992).

[40] I.R.C. Section 6701(f)(3).

[41] Treasury Department, Circular 230, Title 31 of Code of Federal Regulations, Subtitle A, Part 10 (2014).

[42] Internal Revenue Service. Tax Shelter Promoter Investigations under IRC 6700. LB&I Process Unit, Document Control Number PEN-P-005 (2021), pg. 39; Internal Revenue Manual section 4.32.2.13.2 (06-04-2018); Internal Revenue Manual section 4.32.2.13.2 (06-04-2018). IRS personnel make a referral by completing and submitting Form 8484 (Report of Suspected Practitioner Misconduct).

[43] 31 U.S.C. section 10.2(a)(5); 31 U.S.C. section 10.3.

[44] 31 U.S.C. section 10.2(a)(4).

[45] 31 U.S.C. section 330(b); 31 U.S.C. section 10.50.

[46] 31 U.S.C. section 10.51(a)(7).

[47] 31 U.S.C. section 330(b); 31 U.S.C. section 10.50.

[48] 31 U.S.C. section 330(b); 31 U.S.C. section 10.50; No-

competent and disreputable conduct to cover the following:

> Willfully assisting, counseling, encouraging a client or prospective client in violating, or suggesting to a client or prospective client to violate any federal tax law, *or* knowingly counseling or suggesting to a client or prospective client an illegal plan to evade federal taxes or payment thereof.[46]

Punishments vary depending on the conduct, but they can consist of a temporary suspension, permanent disbarment, public censure, and/or monetary penalty.[47] With respect to the last item on the list, the OPR has latitude to impose a financial toll reaching the gross income that the person derived, or will derive, from the conduct giving rise to the penalty.[48]

Coordination with Criminal Investigation Division. Revenue Agents are instructed to do several things at the start of a promoter investigation, one of which is checking to see whether the Criminal Investigation Division is already involved. If so, Revenue Agents are encouraged to conduct "parallel investigations" with their coworkers on the criminal side.[49] These consist of simultaneous, yet separate, actions by the Civil Examination Division (conducted by a Revenue Agent) and by the Criminal Investigation Division (led by a Special Agent). These are not joint investigations.[50]

The Internal Revenue Manual tells IRS personnel that sharing information among Revenue Agents, Special Agents, and government attorneys "is the key ingredient in developing civil and criminal investigations simultaneously and efficiently."[51] The Internal Revenue Manual further tells Special Agents, who focus on criminal actions, to develop as much evidence as possible (using summonses, search warrants, undercover operations, and other tools) before resorting to the grand jury process. This is because the Criminal Investigation Division can only share non-grand-jury information with the Civil Examination Division.[52]

Promoters *either* organize, or assist in the organization of, a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement, *or* they participate (directly or indirectly) in the sale of ownership interests in such entity, plan, or arrangement.

All those working related cases are told to exchange information throughout the process via multi-party conferences.[53] Timing and toe-stepping should not be a problem because the Internal Revenue Code features both civil and criminal provisions to address tax shelter promotions, and Revenue Agents "may conduct civil [promoter penalty] investigations *before, during, or after* criminal investigations of a promoter."[54]

The IRS might allege various crimes in a tax shelter case. Examples from a pending case consist of tax fraud conspiracy, wire fraud, aiding the filing of false tax returns, executing false tax returns, and money laundering.[55]

Individual Income Tax Audits of Promoters. The IRS observes that many promoters generate significant income from their activities and they "often use their own promotions" to reduce or eliminate taxes on such income.[56] Consequently, a promoter penalty investigation under Section 6700 frequently leads to a federal income tax audit of a promoter's own Forms 1040 (U.S. Individual Income Tax Returns). The IRS does not see a major conflict for a Revenue Agent in wearing two hats, stating that "you may conduct *both* the promoter's income tax examination *and* the promoter investigation."[57] If the individual audit of the promoter results in a tax understatement, then the Revenue Agent will propose additional income taxes and penalties.[58]

Referral for Injunction Suit. In addition to the actions described above, the IRS, with assistance from the DOJ, can take more urgent actions. Specifically, if the circumstances warrant it, the DOJ can file a lawsuit with the proper District Court seeking an injunction. This legal mechanism prohibits a person from engaging in any action that would trigger promoter penalties under Section 6700 or any violation of Circular 230.[59] The

tice 2007-39.

49 Internal Revenue Service. Tax Shelter Promoter Investigations under IRC 6700. LB&I Process Unit, Document Control Number PEN-P-005 (2021), pg. 10; Internal Revenue Manual section 4.32.4.5 (06-04-2018).

50 Internal Revenue Manual section 4.32.2.7 (09-23-2011).

51 Internal Revenue Manual section 4.32.2.7.7 (06-04-2018).

52 Internal Revenue Manual section 4.32.2.7.7 (06-04-2018).

53 Internal Revenue Service. Tax Shelter Promoter Investigations under IRC 6700. LB&I Process Unit, Document Control Number PEN-P-005 (2021), pg. 10; Internal Revenue Manual section 4.32.4.5 (06-04-2018); Internal Revenue Manual section 4.32.2.7.3.1 (06-04-2018). Parallel investigations entail periodic "six-way conferences" with participation by the Revenue Agent, Examination Group Manager, IRS Civil Counsel, Special Agent, Supervisory Special Agent, and IRS Criminal Tax Counsel.

54 Internal Revenue Manual section 4.32.2.7 (09-23-2011) (emphasis added).

55 18 U.S.C. section 371, 18 U.S.C. section 1349, 18 U.S.C. section 1343; 26 U.S.C. section 7206(2); I.R.C. Section 7206(1); 18 U.S.C. section 1957. See, e.g., *Fisher et al*, First Superseding Criminal Indictment, District Court, Northern District of Georgia, Case No. 1:21-CR-00231, February 24, 2022.

56 Internal Revenue Service. Tax Shelter Promoter Investigations under IRC 6700. LB&I Process Unit, Document Control Number PEN-P-005 (2021), pg. 22.

57 Internal Revenue Service. Tax Shelter Promoter Investigations under IRC 6700. LB&I Process Unit, Document Control Number PEN-P-005 (2021), pg. 22 (emphasis added).

58 Internal Revenue Service. Tax Shelter Promoter Investigations under IRC 6700. LB&I Process Unit, Document Control Number PEN-P-005 (2021), pg. 22; Internal Revenue Manual section 4.32.2.8.3.4 (06-04-2018).

59 I.R.C. Section 7408(c); Internal Revenue Service. Tax Shelter Promoter Investigations under IRC 6700. LB&I Process Unit, Document Control Number PEN-P-005 (2021), pg. 28.

factors considered by the IRS before referring a case, and by the DOJ before elevating matters to the judicial level, are the gravity of harm to the government, extent of participation, acknowledgement of wrongdoing by the promoter, and anticipation of future violations.[60]

Notably, although the behavior to be enjoined must be subject to certain penalties, it is *not* a prerequisite to filing an injunction suit that the IRS, OPR, or other authority has actually assessed penalties yet.[61] The speediness of the procedure is one of the very reasons that Congress introduced injunctions way back in 1982:

> Congress believed that the most effective way to curtail promotion of abusive tax shelters, etc. is through injunctions issued against violators to prevent recurrence of the offense. The ability to seek injunctive relief will ensure that the [IRS] can attack tax shelter schemes years *before* such challenges would be possible if the [IRS] were first required to audit investor tax returns.[62]

The term "gross valuation overstatement" threshold is relatively low. It means any statement regarding the value of any property or service that exceeds 200% of the correct amount, and the value is directly related to the amount of an income tax deduction or credit for any participant.

District Courts have broad authority to impose equitable relief. They can, for instance, enjoin particular conduct of a promoter, all actions by a promoter that might violate Section 6700, or behavior that tends to impede the proper administration of tax laws.[63] They can also force promoters to "disgorge," or relinquish, all or a portion of the money they made from improper activities.[64]

The IRS explains to its personnel that injunction suits constitute just one weapon to combat tax shelter activities; they are "separate and apart from other civil or criminal actions" against promoters."[65] The IRS also recommends that injunction actions proceed, even after a promoter has been criminally prosecuted and sentenced to incarceration, fines, probation, etc. This is because, from IRS's perspective, "a criminal sentence is punishment for *past* criminal behavior, while an injunction prohibits *future* behavior."[66]

Lastly, the IRS and DOJ use not only the law, but also the media, in trying to stop promoters. The guidelines state that "information regarding the government's enforcement actions should have the widest possible dissemination."[67] Among other things, personnel are instructed to distribute press releases to local and national media at various times. These include when the DOJ files an injunction suit, the District Court imposes a temporary restraining order, the District Court grants a preliminary or permanent injunction, and/or the DOJ starts a subsequent contempt action in instances where the promoter continues engaging in prohibited conduct.[68]

Material Advisor Examination. The IRS has trouble auditing transactions and halting the ones it opposes when it cannot identify them. The IRS, therefore, obligates taxpayers to report transactions on various tax and information returns, including Form 8918 (Material Advisor Disclosure Statement).

Persons categorized as "material advisors" normally must file Forms 8918 to alert the IRS of their involvement.[69] The IRS defines the term material advisor comprehensively, of course. It generally means a person who provides material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and such person derives a certain amount of income from doing so.[70]

The IRS asserts penalties when violations occur. In the case of a listed transaction, the penalty for an unfiled or late Form 8918 is $200,000 or 50% of the gross income that the material advisor obtained, whichever amount is larger.[71] Once the IRS assesses a Form 8918 penalty for a listed transaction, it does not have the authority to rescind it.[72]

In addition to filing Forms 8918, material advisors must maintain a list of information about their clients, the transactions in which they participated, the amount they invested, the tax benefits they derived, etc.[73] Material advisors must retain these lists for seven years and provide them to the IRS upon request.[74] If any material advisor fails to supply the list within 20 days of a written request, then the IRS can assert a penalty of $10,000 per day.[75] The IRS will forego sanctions, though, if the material advisor has "reasonable cause" for any delays.[76]

Many promoter penalty investigations focus on reportable transactions. Thus, by extension, most alleged promoters fall into the category of material advisors. This means that they should have filed Forms 8918 with the IRS, and they should have retained detailed records about the transactions and participants. Logically, Revenue Agents conducting promoter penalty investiga-

60 Internal Revenue Manual section 4.32.2.9.1 (06-04-2018).

61 I.R.C. Section 7408(a).

62 U.S. Joint Committee on Taxation. General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982. JCS-38-82 (Dec. 31, 1982), pg. 213 (emphasis added).

63 U.S. Joint Committee on Taxation. General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982. JCS-38-82 (Dec. 31, 1982), pg. 213.

64 I.R.C. Section 7402, I.R.C. Section 7406, I.R.C. Section 7408.

65 Internal Revenue Manual section 4.32.2.9.1 (06-04-2018).

66 Internal Revenue Manual section 4.32.2.9.1 (06-04-2018) (emphasis added).

67 Internal Revenue Manual section 4.32.2.13.1 (06-04-2018).

68 Internal Revenue Manual section 4.32.2.13.1 (06-04-

tions under Section 6700 are instructed to gather copies of all Forms 8918 and related records, imposing penalties against promoters, in their dual-capacity as material advisors, for any faults.[77]

Potential Impact on Participants

Taxpayers who participated in transactions that trigger promoter investigations might have little, if any, idea how such investigations could affect them personally. In other words, they ask themselves, what does this have to do with me? The answer to that critical inquiry is explored below.[78]

Various Consequences of Non-Disclosure. As explained above, standard procedure in a promoter investigation involves a Revenue Agent demanding extensive records from the alleged promoter. These instantly reveal to the IRS several things, among them the transactions in question, the identities of the taxpayers who participated, the amount the taxpayers invested, the tax benefits they claimed, and more.[79] The IRS then uses this data in a few ways. For instance, the IRS checks to see if it can penalize any taxpayer individually for not filing a timely Form 8886 (Reportable Transaction Disclosure Statement), as a "participant" in certain transactions.[80]

The concept of "participant" is widely defined. In situations where a transaction is conducted through a partnership, the term encompasses (i) the partnership that directly engaged in the transaction, (ii) the upper-tier partnership, if the transaction involved a multi-tier structure, with one partnership atop another, (iii) the partners who receive Schedules K-1 (Partner's Share of Income, Deductions, Credits, etc.) from the partnership, and (iv) any other person whose tax return reflects the relevant tax consequences or strategy.[81]

Non-compliance by participants triggers at least three consequences. If participants fail to file timely, complete Forms 8886, then the IRS generally can assert a penalty equal to 75% of the tax savings resulting from their participation.[82] In the case of a listed transaction, the maximum penalty for individual taxpayers is $100,000, while the cap for entities is $200,000.[83] Importantly, the IRS does *not* have authority to rescind or abate a penalty assessed against a listed transaction, and no "reasonable cause" exception exists.[84]

The IRS can penalize taxpayers in others ways, too. In particular, if a taxpayer participates in a reportable transaction, and the IRS later disallows the benefits claimed, then the IRS can impose a special penalty equal to 20% of the tax increase.[85] The rate jumps to 30% if the participant fails to file a Form 8886.[86]

In addition to financial penalties, if a participant does not enclose a Form 8886 with a tax return, then the assessment-period with respect to the tax return can remain open for a long time. Specifically, the assessment-period extends until one year after the participant eventually files Form 8886 or a material advisor remits the relevant records to the IRS, whichever occurs earlier.[87] The IRS has authority during the prolonged assessment-period to assess *any* taxes, penalties or interest, whether or not related to the listed transaction.[88]

Individual Income Tax Audits. The IRS frequently initiates federal income tax audits of participants in transactions that are subject to promoter penalty investigations. These related, yet distinct, actions often get carried out at the same time. The IRS tells its personnel the following in this regard: "Participant examinations are frequently conducted simultaneously with a promoter investigation. Do not delay or suspend the promoter investigation pending the outcome of any participant exam."[89] When utilizing two Revenue Agents to divide and conquer, with one conducting the promoter penalty investigation and the other effectuating the related federal income tax audit of a participant, the former prepares a "participant job aid" to facilitate the work of the latter. This aid ordinarily features information about the promoter, key tax issues, suggested audit techniques, interview questions, and potential penalties.[90] The IRS clar-

2018).

69 I.R.C. Section 6111(a); Treas. Reg. 301.6111-3(a); Treas. Reg. 301.6111-3(d)(1); Treas. Reg. 301.6111-3(g). Taxpayers can opt to file "protective" Forms 8918 instead.

70 Treas. Reg. 301.6111-3(b)(1). In this context, a person has material involvement if he (i) makes or provides a "tax statement," (ii) either directly to, or for the benefit of, certain taxpayers or other material advisors, (iii) before the first tax return reflecting the benefits of the reportable transaction has been filed with the IRS, and (iv) derives a certain amount of income for doing so. See I.R.C. Section 6111(b)(1)(A); Treas. Reg. 301.6111-3(b)(2)(i).

71 I.R.C. Section 6707(a), (b)(2); Treas. Reg. 301.6707-1(a)(1)(ii)(A).

72 I.R.C. Section 6707(c); Treas. Reg. 301.6707-1(e)(1)(i).

73 I.R.C. Section 6112; Treas. Reg. 301.6112-1.

74 I.R.C. Section 6112(b)(1); Treas. Reg. 301.6112-1(b), (d), and (e).

75 I.R.C. Section 6708(a)(1); Treas. Reg. 301.6708-1(a).

76 I.R.C. Section 6708(a)(2); Treas. Reg. 301.6708-1(g), (h).

77 Internal Revenue Manual section 4.32.2.8.2.2 (06-04-2018).

78 Promoter investigations not only affect participants, but also return preparers, appraisals and others. See Sheppard, "Conservation Easements, Notice 2017-10, Injunction Action, and the Potential Reach of Return Preparer Penalties under Section 6694," 21(1) Journal of Tax Practice & Procedure 23 (2019); Sheppard, "No Notice, No Examination, No Problem: IRS Further Deprives Appraisers of Procedural Protections, 136(1) JTAX 8 (2022).

79 I.R.C. Section 6112; Treas. Reg. 301.6112-1.

80 Internal Revenue Service. Tax Shelter Promoter Investigations under IRC 6700. LB&I Process Unit, Document Control Number PEN-P-005 (2021), pg. 4.

81 Treas. Reg. 1.6011-4(e)(1).

82 I.R.C. Section 6707A(a), (b); Treas. Reg. 301.6707A-1(a).

83 I.R.C. Section 6707A(b)(2); Treas. Reg. 301.6707A-1(a). The minimum penalty is $5,000 for individuals and $10,000 for entities. See I.R.C. Section 6707A(b)(3); Treas. Reg. 301.6707A-1(a).

84 I.R.C. Section 6707A(d)(1); *Barzillai*, 137 Fed Cl. 788, 121 AFTR 2d 2018-1582 (April 30, 2018); *Larson*, 888 F.3d 578, 121 AFTR 2d 2018-1598 (April 25, 2018).

85 I.R.C. Section 6662A(a).

86 I.R.C. Section 6662A(c).

87 I.R.C. Section 6501(c)(10).

88 Treas. Reg. 301.6501(c)-1(g)(7); see also Treas. Reg. 301.6501(c)-1(g)(8) (Example 14).

89 Internal Revenue Service. Tax Shelter Promoter Investigations under IRC 6700. LB&I Process Unit, Document Control Number PEN-P-005 (2021), pg. 12; Internal Revenue Manual section 4.32.4.2(20) (06-04-2018).

90 Internal Revenue Service. Tax Shelter Promoter Investigations under IRC 6700. LB&I Process Unit, Document Control Number PEN-P-005 (2021), pg. 14; Internal Revenue Manual section 4.32.2.8.3.6.2 (06-04-2018).

ifies that its objectives in scrutinizing promoters (for penalties) and participants (for taxes) are distinct, hence the need for both:

> The goals of a promoter investigation and an income tax examination are significantly different. The goal of the promoter investigation is to identify and quickly terminate the abusive promotion or activity, assert promoter penalties where applicable, and identify participants in the abusive transactions. The goal of an income tax examination is to determine the correct income tax liability of the participant.[91]

Contacts as Potential Witnesses. In addition to pursuing Form 8886 penalties and conducting federal income tax audits of participants, Revenue Agents leading promoter penalty investigations also look to participants as potential witnesses against promoters. Indeed, the IRS tells its Revenue Agents that contacting participants is a "critical component" in the development of a promoter investigation, because they are uniquely positioned to supply the IRS data about how the transaction operates, the parties involved, the cash flow, the extent of the tax revenue loss, and more.[92]

Challenges to Privilege Claims. The tax practitioner privilege generally provides that the protections applicable to communications between taxpayers and their attorneys also pertain to communications between taxpayers and their tax professionals.[93] However, these expanded protections *only* apply to (i) "tax advice," not return-preparation and other services, (ii) provided by a qualified person, such as a certified public accountant, enrolled agent, registered return preparer, and others, (iii) involving non-criminal matters, (iv) in connection with an administrative or judicial tax matter, where the IRS or DOJ is a party, and (v) not regarding "tax shelters."[94] In situations where the IRS is carrying out a promoter penalty investigation, it often argues that the relevant transactions constitute "tax shelters" and thus cannot take refuge in the tax practitioner privilege.[95]

Potential Extensions of Assessment-Periods. The IRS generally has three years from the date on which a taxpayer files a return to assess additional taxes and penalties related to that return.[96] The IRS can extend the three-year period in various situations. One tactic utilized by the IRS is to allege that the taxpayer engaged in seriously bad acts. In particular, if a taxpayer files a false or fraudulent return with intent to evade taxes, the IRS may assess at any time.[97] When the taxpayer at issue is a partnership, the IRS and courts look to the intent, actions and inactions of its leadership to determine whether fraud occurred. This often means the Managing Member or General Partner, who might be considered a promoter, too.[98]

In situations involving false or fraudulent statements, the penalty equals 50% of the income that the promoter has already derived, or will derive, from the activity.

Limitation on Penalty Defenses. The IRS often proposes a long list of alternative penalties in cases involving supposed tax shelters. These include sanctions for negligence, substantial understatements of tax liabilities, substantial valuation misstatements, gross valuation misstatements, or understatements of tax liabilities involving reportable transactions.[99]

Some penalties can be avoided if the taxpayer can demonstrate that there was "reasonable cause" for the violation.[100] Others will not be asserted if the valuation under scrutiny was based on a qualified appraisal by a qualified appraiser, and the taxpayer made a good faith investigation of the value of the property.[101] Finally, certain penalties, like the one for making a gross valuation misstatement, cannot be overcome by evidence of "reasonable cause." It is mathematical in nature; that is, if the value originally claimed by the taxpayer exceeds the value ultimately determined by the Tax Court by a certain percentage, then the penalty applies, period.[102]

In an attempt to ward off penalties, taxpayers often introduce the reasonable-reliance defense.[103] The Supreme Court has emphasized that the IRS must liberally construe this defense.[104] However, the Tax Court has held that reasonable cause exists only where three elements are present: The adviser was a

91 Internal Revenue Service. Tax Shelter Promoter Investigations under IRC 6700. LB&I Process Unit, Document Control Number PEN-P-005 (2021), pg. 4.

92 Internal Revenue Manual section 4.32.2.8.3.5 (06-04-2018); Internal Revenue Service. Tax Shelter Promoter Investigations under IRC 6700. LB&I Process Unit, Document Control Number PEN-P-005 (2021), pg. 12.

93 I.R.C. Section 7525(a)(1).

94 I.R.C. Section 7525(a)(1), I.R.C. Section 77525(a)(2), I.R.C. Section 7525(a)(3); I.R.C. Section 7525(b); 31 U.S.C. section 330; and 31 C.F.R. section 10.3.

95 See, e.g., *Microsoft Corporation et al*, 125 AFTR 2d 2020-547 (DC WA 2020); see also Internal Revenue Manual section 4.32.2.8.3.6 (06-04-2018).

96 I.R.C. Section 6501(a).

97 I.R.C. Section 6501(c)(1).

98 See, e.g., *Jade Trading, LLC*, 81 Fed. Cl. 173, 176-177 (2008); *Palm Canyon X, LLC*, T.C. Memo 2009-288; *Southgate Master Fund, LLC*, 659 F.3d 466, 293 (5th Cir. 2011); *Stobie Creek Investment, LLC*, 608 F.3d 1366, 1381 (Fed. Cir. 2010).

99 I.R.C. Section 6662; I.R.C. Section 6662A.

100 I.R.C. Section 6664(c)(1); I.R.C. Section 6664(d)(1); Treas. Reg. 1.6664-4.

101 I.R.C. Section 6664(c)(3); Treas. Reg. 1.6664-4.

102 I.R.C. Section 6664(c)(3); Treas. Reg. 1.6664-4.

103 Treas. Reg. 1.6664-4(c)(1).

104 *Boyle*, 469 U.S. 241, 251 (1985).

105 *Neonatology Associates., P.A. et al*, 115 T.C. 43, 99 (2000)

106 *Id.*, at 88-94 (2000).

107 I.R.C. Section 6664(a); Treas. Reg. 1.6664-2(a). The definition of "underpayment" is considerably more complicated, but a simplified and abbreviated version suffices to make the critical points in this article.

108 I.R.C. Section 6664(c)(1).

109 Treas. Reg. 1.6664-2(c)(2).

110 T.D. 9186 (March 2, 2005), Preamble, Background (emphasis added).

111 Treas. Reg. 1.6664-2(c)(3)(i)(A).

112 Treas. Reg. 1.6664-2(c)(3)(i)(B).

competent professional who had sufficient expertise to justify reliance, the taxpayer provided necessary and accurate information to the adviser in a timely manner, and the taxpayer actually relied in good faith on the adviser's advice.[105] The IRS frequently cites this Tax Court precedent for the proposition that any purported reliance by a taxpayer is *not* "reasonable" where the person offering advice or guidance does not possess sufficient expertise, has an inherent conflict of interest, is an insider or promoter, or lacks financial independence.[106]

Inability to File Qualified Amended Returns. In the case of an individual taxpayer, a tax "underpayment" generally means the difference between the tax liability the taxpayer actually reported on his Form 1040 and the tax liability he should have reported, if he had done things correctly in the first place.[107] For instance, where the taxpayer's true tax liability was $100,000 but he only reported $80,000 on his Form 1040, then the IRS ordinarily could assert a penalty of $4,000 (*i.e.*, a $20,000 tax understatement multiplied by 20%).[108]

There is an obscure mechanism that allows taxpayers to eliminate a tax "underpayment" *after* filing the original Form 1040 with the IRS: the qualified amended return (QAR). In essence, if an individual files a Form 1040 and later realizes that it showed a tax underpayment, he has a limited opportunity to submit a QAR, a Form 1040X (Amended U.S. Individual Return), to rectify the situation and avoid penalties. The taxpayer obtains the benefit in the following manner: the tax liability shown on the original Form 1040 is deemed to include the amount of additional tax reflected on the subsequent QAR.[109] Modifying the basic example above, if the taxpayer filed a Form 1040 showing a tax liability of $80,000 but subsequently submitted a QAR indicating a revised liability of $100,000, then no "underpayment" would exist, and the IRS would thus have no grounds for asserting an accuracy-related penalty.

The purpose of the QAR rules is "to encourage voluntary compliance by permitting taxpayers to avoid accuracy-related penalties by filing a [QAR] *before the IRS begins an investigation of the taxpayer or the promoter of a transaction in which the taxpayer participated.*"[110] Consistent with that objective, a Form 1040X will *not* be a QAR, *unless* the taxpayer files it *before* any one of several key dates.

- The date on which the IRS contacts the taxpayer about a civil examination or criminal investigation of the relevant Form 1040.[111]
- The date on which the IRS contacts any person concerning a promoter penalty investigation under Section 6700 for an activity with respect to which the taxpayer claimed a tax benefit on his Form 1040, directly or indirectly.[112] Importantly, this criteria applies "regardless of whether the IRS ultimately establishes that such person violated Section 6700."[113]
- In the case of items attributable to a pass-through entity (*e.g.*, partnership, subchapter S corporation, or trust), the date on which the IRS first contacts the entity in connection with the civil examination of its return.[114]
- The date on which the IRS serves a Summons relating to the tax liability of a group or class of which the taxpayer is a part regarding an activity for which the taxpayer claimed a tax benefit on his Form 1040, directly or indirectly.[115]
- The date on which the IRS announces a settlement initiative with respect to a listed transaction, and the taxpayer participated in such transaction during the relevant year.[116]

Also, the ability to eliminate an underpayment by filing a QAR disappears where the position taken on the original Form 1040 was fraudulent in the first place.[117]

Taxpayers often face challenges in convincing the courts that what they filed with the IRS constitutes a QAR. In *Perrah v. Commissioner*, for example, the Tax Court rejected QAR status because the Forms 1040X were filed after the IRS had commenced an examination of the taxpayer.[118] Likewise, the Tax Court held in *Bergmann v. Commissioner* that the taxpayer had not filed QARs because, by the time the Forms 1040X reached the IRS, it had already started a promoter investigation and issued Summonses seeking data about the pertinent transactions.[119]

Disclosure in Multiple Venues

When it comes civil examinations of supposed tax shelters, the IRS attempts to circumvent Section 6103. That provision generally requires the IRS to safeguard the confidentiality of "returns" and "return information."[120]

There are several exceptions to the customary prohibition against IRS disclosure, including the following. First, IRS personnel ordinarily have access to returns and return information if their official duties require inspection or disclosure for tax administration purposes (Tax Administration Test).[121] Second, IRS personnel can reveal a return or return information in a judicial or administrative proceeding, provided that such proceeding pertains to tax administration, and the taxpayer is a party to the proceeding (Party Test).[122] Third, disclosure is permitted in a proceeding re-

[113] T.D. 9186, Preamble, Explanation of Provisions.

[114] Treas. Reg. 1.6664-2(c)(3)(i)(C).

[115] Treas. Reg. 1.6664-2(c)(3)(i)(D)(1).

[116] Treas. Reg. 1.6664-2(c)(3)(i)(E). An expanded set of criteria applies in situations involving "undisclosed listed transactions," which means transactions that are the same as, or substantially similar to, a listed transaction, but were not revealed to the IRS on Forms 8886. See Treas. Reg. 1.6664-2(c)(3)(ii).

[117] Treas. Reg. 1.6664-2(c)(2).

[118] *Perrah*, T.C. Memo 2002-283.

[119] *Bergmann*, 137 T.C. 136 (2011). There are several other cases in which the courts declined to grant taxpayers the benefit of QAR status. See, e.g., *Perry*, T.C. Memo 2016-172 (taxpayer filed relevant Form 1040X after the IRS notified her of an examination); *Planty*, T.C. Memo 2017-240 (taxpayer filed Form 1040X after start of examination); *Scully*, T.C. Memo 2013-229 (taxpayer filed Forms 1040X and otherwise changed tax positions during the trial); *Sampson*, T.C. Memo 2013-212 (taxpayer filed relevant Forms 1040X after the IRS notified him of an examination).

lated to tax administration, if "the treatment of an item reflected on [a third-party's return] is directly related to the resolution of an issue in the proceeding" (Item Test).[123] Fourth, a return or return information of a third-party can be disclosed in a proceeding related to tax administration, in situations where it "directly relates to a transactional relationship between a person who is a party to the proceeding and [the third-party], and directly affects the resolution of an issue in the proceeding" (Transactional Test).[124] Fifth, IRS personnel are authorized to disclose returns and return information when they will be used in, or in preparation for, an administrative action or proceeding under Circular 230 (OPR Assistance Test).[125]

In summary, Section 6103 mandates that the IRS not disclose, internally or externally, any "returns" or "return information," as these concepts are broadly defined. The IRS can disregard the general non-disclosure rule, however, when a situation meets the Tax Administration Test, Party Test, Item Test, Transactional Test, or OPR Assistance Test.

The IRS has issued a series of notices over the years about disclosure of data in situations involving "tax shelter matters."[126] Below are several examples from the notices showing how the IRS intends to utilize overlapping data about taxpayers and promoters in diverse settings.[127]

Item Test. In a judicial proceeding, the IRS argues that Investor A engaged in an abusive transaction for the sole purpose of tax avoidance. Investor A responds that the transaction was motivated by the non-tax purpose of portfolio diversification and was tailored for this specific purpose. The IRS refutes Investor A's contention by showing that the transaction was not unique and that other taxpayers (*i.e.*, Investors B, C, D, E and F) all participated in substantially similar transactions through the same promoter, all reported similar items of income, deduction and loss, and all claimed a similar non-tax purpose for entering into the transaction.

The treatment of an item reflected on the tax returns of Investors B, C, D, E and F is directly related to the resolution of an issue in Investor A's proceeding; that is, whether the loss reported by Investor A arose from a transaction that lacked economic substance or a business purpose. As a result, in the judicial proceeding regarding Investor A, the disclosure of tax information obtained during the IRS's examinations of Investors B, C, D, E and F is permissible as pattern evidence.[128]

The mere promotion of an abusive transaction suffices to trigger the penalty under Section 6700; it is *not* necessary that a taxpayer actually engage in the transaction or claim the tax benefits therefrom.

Transactional Test. In an injunction action against Promoter, the IRS intends to disclose certain tax information about Investor relating to his participation in the tax shelter promoted to him by Promoter. This consists of the information provided by Promoter to Investor outlining the details of the shelter and his specific investment in such shelter. Investor's tax information can be introduced in the injunction action against Promoter because it directly relates to a transactional relationship between Promoter and Investor and directly affects the resolution of an issue in the injunction proceeding.[129]

Item Test. Investor A files a Tax Court Petition claiming that the IRS wrongfully disallowed a loss related from a transaction promoted by Promoter, a law firm. In conjunction with the examination of Investor A, the IRS obtained promotional material and an opinion letter that Promoter gave Investor A, which concluded that the tax consequences of the transaction had substantial authority. The documents informed prospective investors of the anticipated amount of loss associated with various dollar amounts invested, too. The IRS also opened an examination of Investor B with respect to a transaction that was promoted by Promoter and that was substantially similar to Investor A's transaction. During the examination, the IRS obtained an opinion letter and promotional material given by Promoter to Investor B that uses language or has other features in common with Investor A's opinion letter and promotional material. Investor B's documents tend to prove that Promoter had a routine practice of promoting a set of transactions whose purpose was to generate a tax loss without any economic effect to the taxpayer.

The IRS may disclose Investor B's opinion letter and promotional material in the Tax Court litigation concerning Investor A because they satisfy the Item Test. The documents relate to the liability of Investor A because they are evidence that Investor A purchased a "cookie cutter" deal lacking a valid business purpose.[130]

Item Test. During an examination of Investor D for a transaction promoted by Promoter and carried out by Accommodation Party, the IRS obtains documents and testimony from Accommodation Party pursuant to a summons, including a document stating that the transactions did not reflect economic reality and that Investors G, H, and I (in addition to Investor D) were entering into the transactions to generate a capital loss.

The document produced by Accommodation Party can be disclosed in a refund suit filed by Investor G because it satisfies the Item Test. It relates to the liability of Investor G because it evidences the lack of economic substance of all transactions promoted by Promoter and Accommodation Party. Also, the document directly relates to an issue in Investor G's refund suit, *i.e.*, the capital loss.[131]

Item Test. During a summons enforcement action, Investor L asserts attorney-client privilege over the opinion letter issued by Promoter, a law firm, in conjunction with a transaction. During the examination of Investor N, who invested in a transaction that was promoted by Promoter and was substantially similar to Investor L's transaction, the IRS obtained an e-mail sent by Promoter that revealed that Promoter routinely disclosed opinion letters to Co-Promoters.

The IRS can disclose the e-mail in the summons enforcement action against Investor L because it satisfies the Item Test. The e-mail relates to the liability of Investor L, it provides evidence that the opinion letter was disclosed to third-parties, and it directly relates to whether Investor L may assert attorney-client privilege for the opinion letter.[132]

Party Test. In a Tax Court case, the IRS asserts that Partnership committed civil tax fraud based on the conduct of its managing member and Tax Matters Partner (TMP), Master LLC. Promoter organized Master LLC and is a partner therein. Promoter organized 10 other LLCs to act as managing members and TMPs in 10 other LLCs. Promoter is a direct or indirect partner in the 10 LLCs. They all engaged in similar transactions and were examined by the IRS. In each case, the land at issue was purchased in an arm's-length transaction, followed shortly thereafter by a conservation easement appraisal concluding that the value was multiple times higher than the value established in the prior transaction. Each of the 10 LLCs retained the same appraiser.

The IRS can introduce return information from the 10 other LLCs regarding their transactions in the Tax Court case involving Partnership pursuant to the Party Test. It authorizes the IRS to disclose in any tax administration proceeding the return information of anyone who is a party to the proceeding. Promoter is a party to the proceeding involving Partnership because Promoter is a direct or indirect partner through Master LLC. Therefore, Promoter's return information, including that from the examinations of the 10 other LLCs, may be disclosed.[133]

Tax Administration Test and Party Test. Promoter is under investigation by the Criminal Investigation Division. Promoter is also under examination by the Civil Examination Division regarding promoter penalties under Sections 6700 and aiding-and-abetting penalties under Section 6701. On a related note, Partnership and several other investor partnerships are under examination for their investments in transactions promoted by Promoter.

Everything obtained, received, or generated by either the Criminal Investigation Division or the Civil Examination Division with respect to Promoter's liability under the Internal Revenue Code, including liability for penalties under Section 6700 and Section 6701, constitutes Promoter's return information. The Tax Administration Test authorizes disclosure of returns and return information to IRS employees necessary for them to perform their duties. Thus, disclosure of Promoter's return information to the Revenue Agent examining the partnerships is authorized. Moreover, if Promoter is a partner in the Partnership, then Promoter is a party to the Partnership audit and his return information, including that relating to investments in other transactions via other partnerships, may be disclosed within the Partnership examination under the Party Test.[134]

Events Increasing Promoter Investigations

Several events have occurred recently that likely will result in more promoter investigations in the near future. First, in 2020, the IRS announced that it had formed the new "Fraud Enforcement Office."[135] The IRS augmented this news soon thereafter, indicating that it had named a "National Fraud Counsel."[136]

Second, the IRS appointed a "Promoter Investigations Coordinator." This individual is in charge of collaborating with the Civil Examination Division, Criminal Investigation Divi-

[120] I.R.C. Section 6103(a); I.R.C. Section 6103(b)(1); I.R.C. Section 6103(b)(2)(D).

[121] I.R.C. Section 6103(h)(1). The term "tax administration" means (i) the administration, management, conduct, direction, and supervision of the application of federal tax laws and treaties (ii) the development of federal tax policy related to existing or proposed federal tax laws or treaties, and (iii) assessment, collection, enforcement, litigation, publication, and statistical gathering functions under such laws or treaties. See I.R.C. Section 6103(b)(4)(A)(i); I.R.C. Section 6103(b)(4)(A)(ii); I.R.C. Section 6103(b)(4)(B).

[122] I.R.C. Section 6103(h)(4)(A).

[123] I.R.C. Section 6103(h)(4)(B).

[124] I.R.C. Section 6103(h)(4)(C).

[125] I.R.C. Section 6103(l)(4)(B).

[126] IRS Chief Counsel Directive 2006-003 (Oct. 25, 2005); IRS Chief Counsel Directive 2006-006 (Nov. 22, 2005); IRS Chief Counsel Directive 2020-008 (Sept. 8, 2020).

[127] The author divided, labeled, simplified, and otherwise modified the examples from the IRS in an effort to facilitate review and clarify for readers what, exactly, the IRS was trying to say.

[128] IRS Chief Counsel Directive 2006-003 (Oct. 25, 2005), Section 3.

[129] IRS Chief Counsel Directive 2006-003 (Oct. 25, 2005), Section 4.

[130] IRS Chief Counsel Directive 2006-006 (Nov. 22, 2005), Question and Answer 3.

[131] IRS Chief Counsel Directive 2006-006 (Nov. 22, 2005), Question and Answer 4.

[132] IRS Chief Counsel Directive 2006-006 (Nov. 22, 2005), Question and Answer 6.

[133] IRS Chief Counsel Directive 2020-008 (Sept. 8, 2020), Question and Answer 2.

[134] IRS Chief Counsel Directive 2020-008 (Sept. 8, 2020), Question and Answer 5.

[135] IRS News Release IR-2020-49 (March 5, 2020).

[136] IR-2020-102 (May 26, 2020).

sion, Chief Counsel, and OPR to develop comprehensive enforcement strategies to combat tax shelters.[137] The IRS, perhaps at the behest of the new Promoter Investigations Coordinator, commenced various promoter investigations.[138] The IRS then revealed, in 2021, that it had formed the "Office of Promoter Investigations." It was designed to expand on the nascent efforts of the Promoter Investigations Coordinator.[139]

Third, Congress enacted the Inflation Reduction Act in late 2022, which includes approximately $46 billion to strengthen IRS enforcement actions over the next decade. This funding supplements, not replaces, the normal appropriations for the IRS.[140] The IRS plans to utilize a portion of this money to increase enforcement by better using data analytics, technology, and centralized operations, and to focus on violations by high-income individuals, emerging issues, and reportable transactions.[141]

Fourth, the Government Accountability Office recently issued a study of the IRS's progress in handling promoter issues (GAO Report).[142] It contained background information and made several points. Here are a few interesting ones. As of September 2022, the IRS was in the process of investigating *more than 40 abusive tax schemes involving promoters*.[143] Among those identified by the IRS were excessive research tax credit claims, syndicated conservation easement donations, micro-captive insurance companies, misused Charitable Remainder Annuity Trusts, and Malta pension schemes.[144] The GAO Report also touted the results of promoter investigations over the past two years. In 2021, the IRS opened about 150 cases and assessed $47 million in penalties, while in 2022 it initiated 215 cases and imposed $71 million in penalties.[145] The GAO Report further explained that the IRS often enlists the assistance of legal and tax professionals in identifying tax shelters and their promoters. It does so using the following pitch: "[I]t is mutually beneficial for the IRS and tax practitioners to work together because compliant tax practitioners should not have to compete for business with abusive promoters and return preparers."[146] The GAO Report went on to indicate that the IRS is aware of its enforcement shortcomings and plans to take various steps to improve. These include (i) consolidating the current ways (characterized by multiple and inconsistent forms, websites, and hotlines) by which people can report tax shelter activity, (ii) creating a system that allows persons to report activity electronically, instead of having to send the IRS documents by mail or fax, (iii) providing specific instructions on the Dirty Dozen webpage about how to report misbehavior, and (iv) using the information generated by the "data analytics team" in the Office of Promoter Investigations to readily identify and halt tax shelter activities.[147] Finally, the GAO Report confirmed that the IRS agreed to finalize "specific, identifiable, and outcome-oriented goals and performance measures" for the Office of Promoter Investigations so that it can "evaluate its effectiveness."[148]

Conclusion

This article identifies several obscure realities, the most important of which is that IRS scrutiny of alleged promoters and outcomes for taxpayers are profoundly intertwined.

With respect to alleged promoters, the criteria for assessing penalties under Section 6700 is broad, requiring a valuation merely twice the size of the one originally claimed, or a false or fraudulent statement. The penalties can be high, reaching 50% of the income derived, or to be derived, by a promoter from the improper activities. The penalties are "assessable" in nature, meaning that promoters have no right to administrative review (by the IRS Appeals Office) or judicial review (by the Tax Court) beforehand. Importantly, no statute of limitation on assessment exists. The IRS, therefore, has no urgency and no deadline by which to identify potential offenders, audit them, and inflict financial pain.

Alleged promoters often encounter other unpleasantries, too. For instance, the IRS might pursue penalties under Section 6701 for aiding-and-abetting a tax understatement because the stan-

[137] Parillo. "IRS Assigns Point Person on Promoter Investigations," Federal Tax Notes Today Doc. 2020-6890 (Feb. 25, 2020); IR-2020-41 (Feb. 24, 2020).

[138] Parillo, "IRS Looking for Promoter Links as Easement Crackdown Grows," Tax Notes, Doc. Number 2019-47134 (Dec. 13, 2019).

[139] IR-2021-88 (April 19, 2021); Hoffman, "IRS Names Acting Chief of Office of Promoter Investigations," 2021 Tax Notes Today Federal 75-1 (April 20, 2021).

[140] Public Law 117-58, Infrastructure Investment and Jobs Act, Title I, Subtitle A, Part 3; Congressional Research Service. IRS-Related Funding in the Inflation Reduction Act. Report IN11977 (Oct. 20, 2022).

[141] IRS Publication 3744, Internal Revenue Service Inflation Reduction Act Strategic Operating Plan (Rev. 4-2023), pgs. 62-64.

[142] U.S. Government Accountability Office. Abusive Tax Schemes – Additional Steps Could Further IRS Efforts to Detect and Deter Promoters. GAO-23-105843 (Dec. 2022). This is not the first time that the IRS has been scrutinized in this regard. See, e.g., Treasury Inspector General for Tax Administration. Improvements Are Needed to Corrected Continued Deficiencies in the Processing of Taxpayer Referrals of Suspected Tax Fraud. Report No. 2019-40-040 (May 23, 2019); Treasury Inspector General for Tax Administration. Taxpayer Referrals of Suspected Tax Fraud Result in Tax Assessments, But Processing of the Referrals Could be Improved. Report No. 2013-40-022 (Feb. 20, 2013); Treasury Inspector General for Tax Administration. The Process of Individuals to Report Suspected Tax Law Violations Is Not Efficient or Effective. Report No.2012-40-106 (Sept. 10, 2012).

[143] U.S. Government Accountability Office. Abusive Tax Schemes – Additional Steps Could Further IRS Efforts to Detect and Deter Promoters. GAO-23-105843 (Dec. 2022), pg. 7.

[144] U.S. Government Accountability Office. Abusive Tax Schemes – Additional Steps Could Further IRS Efforts to Detect and Deter Promoters. GAO-23-105843 (Dec. 2022), pgs. 7-9.

[145] U.S. Government Accountability Office. Abusive Tax Schemes – Additional Steps Could Further IRS Efforts to Detect and Deter Promoters. GAO-23-105843 (Dec. 2022), pg. 13.

[146] U.S. Government Accountability Office. Abusive Tax Schemes – Additional Steps Could Further IRS Efforts to Detect and Deter Promoters. GAO-23-105843 (Dec. 2022), pg. 14.

[147] U.S. Government Accountability Office. Abusive Tax Schemes – Additional Steps Could Further IRS Efforts to Detect and Deter Promoters. GAO-23-105843 (Dec. 2022), pgs. 15-20, 29-31.

dard for doing so is lower than that for assessing promoter penalties. The IRS might also refer the promoter to OPR for separate disciplinary actions, if he is an attorney, accountant, or other type of professional who "practices before the IRS," as this concept is broadly defined. To the list of potential indignities for an alleged promoter one can add a federal income tax audit of his personal Forms 1040, penalties for not filing Forms 8918 or maintaining required records about transactions and investors, an injunction action in District Court, and, in the worst case scenario, a criminal investigation leading to charges.

Taxpayers who made investments with, or engaged in transactions organized by, alleged promotors on the IRS's radar might experience corollary issues. For example, they might get audited for potential income tax liabilities, as well as penalties for unfiled Forms 8886. The IRS might also contact them as potential witnesses against the promoters. Moreover, the IRS might take the position that communications between alleged promoters and taxpayers, along with those with tax professionals, are not confidential or privileged because they involve "tax shelters." The IRS commonly goes on to argue that, thanks to attribution of intent and actions of the supposed promoters to the entities in which taxpayers invested, the assessment-period on taxes is limitless and certain defenses to penalties are void. The IRS might contend further that taxpayers are ineligible to file QARs because of the promoter investigation, issuance of Summonses, or federal income tax audit of a pass-through entity in which they have ownership. Finally, the IRS might introduce evidence about specific taxpayers in administrative and/or court proceedings centered on alleged promoters and other investors unknown to the taxpayers, and vice versa.

There is no statute of limitations on assessment of promoter penalties.

Several events suggest that promoter investigations, with all they entail, will increase in the future. The IRS recently created the Fraud Enforcement Office and corresponding National Fraud Counsel, it formed the Office of Promoter Investigations led by a Promoter Investigations Coordinator, it is poised to strengthen overall enforcement by deploying the $46 billion granted by Congress, it is in the process of investigating more than 40 supposedly abusive transactions implemented by promoters, and it is consolidating and facilitating the manners by which the public can report questionable activities.

Given the likely uptick in promoter investigations and the undeniable intersection with taxpayer issues, macro-thinking is a must. Specifically, those seeing the proverbial big picture likely will *first* direct all possible resources to defending the transactions in which the taxpayers engaged; that is, the supposed tax shelters. Why? If taxpayers manage to convince the IRS (or more likely the Tax Court) that the transactions complied with applicable tax rules, functioned in accordance with their form, were properly disclosed to the IRS, had a business purpose, involved significant due diligence and good faith, and counted on a valuation that was relatively close to the final amount determined, then the IRS will face serious challenges in attacking alleged promoters *later*. Indeed, if taxpayers were able to prevail on the preceding points, it would become extremely difficult for the IRS to demonstrate that an alleged promoter knowingly made a materially false or fraudulent statement, furnished a "gross valuation overstatement," prepared a document knowing that it would result in a tax understatement, willfully assisted a taxpayer in violating any tax law, or took any other actions warranting punishment. On the other hand, failure to *first* devote the necessary resources to the federal income tax disputes involving taxpayers could trigger the opposite effect. That is an outcome unwanted by alleged promoters and taxpayers alike. ■