Tax Shelters: The New Compliance Environment

D. French Slaughter III
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I. Introduction.

Despite continuing legislation by Congress and efforts on the part of the Internal Revenue Service and the Department of Treasury to regulate tax shelter investments and monitor taxpayer compliance in this area, tax shelters continued to proliferate through the 1970's and into the 1980's. While certainly the great majority of what can be described as tax shelter investments are legitimate and comply in all material respects with the internal revenue laws, it is equally clear that a substantial subset of tax shelter offerings are arrangements and planning techniques whose compliance with the internal revenue laws ranges between colorable and illusory. It is this segment of the tax shelter industry that created a crisis of unprecedented proportions in administration of the internal law which triggered in turn the legislative response of TEFRA.

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2 Cf., André Le Duc, *The Legislative Response of the 97th Congress to Tax Shelters, the Audit Lottery, and Other Forms of Intentional or Reckless Noncompliance*, Tax Notes 363 (Jan 31, 1983). One commentator has suggested the reason for the growth of abusive tax shelters:

In earlier years promoted tax benefits could be obtained with a high degree of assurance and often were used to enhance the marketability of an otherwise sensible investment. What abuse there was lay in the exaggerating effect of leverage which magnified the tax benefits of deductions that had been intended by Congress. But after the 1970's legislation neither leverage nor deductions could be readily obtained with the same high assurance of success. Instead, promoters were compelled to turn to more esoteric investments, often structured solely for tax benefits, usually unintended by Congress. Their result frequently was promotion and sale of a device with only marginal prospects for success, at least apart from the chance to avoid detection in the lottery of audit selection.

Sax, * supra* at 11. See also Testimony of Roscoe L. Egger, Commissioner of Internal Revenue, to the House Ways and Means Committee on Oversight (Sept. 28, 1982) reprinted in Tax Notes, 65, 65-68 (Oct. 4, 1982) [hereinafter cited as Egger Testimony].

3 For example, as of September 30, 1982, the Internal Revenue Service had under examination 284,828 returns with tax shelter issues, an increase of 36,000 returns of this type for the prior fiscal year. See 1982 Annual Report of the Commissioner and the Chief Counsel of the Internal Revenue Service 11 [hereafter cited as 1982 Annual Report]. See also S. Rep. No. 494, 97th Cong., 2d Sess. 266, reprinted in 1982 U.S. Cong. & Adm. News 781, 1014-17 [hereafter cited as 1982 Senate Report]. As of September 30, 1982, returns under audit with tax shelter issues amounted to more than 20 percent of all returns under audit by the Internal Revenue Service in which adjustments were proposed, an increase of 25 percent from the prior fiscal year. See 1982 Annual Report, * supra*, at 11, 56 (table 11). Approximately one third of the cases pending before the United States Tax Court involve tax shelters. See Statement of Former Chief Judge Theodore Tannenwald, Jr., United States Tax Court, to the Senate Finance Subcommittee on Oversight of the Internal Revenue Service (June 24, 1983).
The primary focus of the compliance provisions of the Tax Equity and Fiscal Responsibility Act of 19824 ("TEFRA"), was so-called "abusive tax shelters" and the problem of growing taxpayer noncompliance with the internal revenue laws facilitated by such shelters. The penalty provisions of TEFRA6 and the related abusive tax shelter injunction statute7 were enacted by Congress to provide the Internal Revenue Service with better enforcement tools to deal with the problem of abusive tax shelters.8 The Tax Reform Act of 1984 ("1984 Tax Reform Act") enacted additional provisions to assist the Service in policing tax shelters.8a The purpose of this chapter is to examine these recent legislative changes with emphasis on the practical aspects of their application.

Prior to TEFRA, the Internal Revenue Service could only respond to most tax shelter abuses by auditing the investor’s return and disallowing the improper deductions or credits claimed. This situation clearly favored the investor.9 In the event the investor’s return came up for audit and claimed tax

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5 See generally Staff of Joint Committee on Taxation, 98th Cong., 1st Sess., Report on Tax Shelters 2 (Com. Print 1983) [hereinafter cited as 1983 J. Com. Staff Report], reprinted in Daily Tax Rep. (BNA) No. 123, at J-17 (June 24, 1983). Various definitions of “abusive tax shelters” have been suggested. One commentator defines an abusive tax shelter as “a transaction or arrangement that involves claimed tax benefits that have an extremely low probability of being realized.” LeDuc, supra at 365 n. 13 (Jan. 31, 1983). That definition corresponds to the implied definition of abusive tax shelters under Section 6700 of the Internal Revenue Code. See infra.
6 The Internal Revenue Manual defines an abusive tax shelter as “one that lacks economic reality or viability when viewed in its entirety” and that is characterized by inflated appraisals, unrealistic allocations, or similar devices used to increase the claimed tax benefits. Int. Rev. Manual-Examination Tax Shelters Handbook, I.R.S. No. 4236, ch. 361 (1979), reprinted in [Index Vol.] Stand. Fed. Tax Rep. (CCH) 300 (1983) [hereinafter cited as Examination Tax Shelters Handbook].
7 The substantial understatement penalty, Section 6661 of the Internal Revenue Code of 1954 (26 U.S.C.) [hereinafter “Code"], the penalty for promotion of abusive tax shelters, Code Section 6700; and the penalty for aiding and abetting the improper avoidance of tax, Code Section 6701. See generally, infra.
9 Moreover, except in rare instances where criminal prosecution was possible, the Government
shelter deductions or credits disallowed, the Government was merely making a low-interest loan to the errant investor because the interest rate on any resulting tax deficiency was substantially below the market rate of interest.\(^\text{10}\)

The only credible risk to the investor was imposition of the negligence penalty (5 percent of the tax underpaid) or civil fraud penalty (50 percent) but neither penalty could be successfully imposed by the IRS as long as the investor could articulate a “reasonable basis” for the claimed but disallowed deduction or credit.\(^\text{11}\) Thus, taxpayers had little inducement to select conservative tax shelter investments or concede if audited, and every reason to take aggressive positions with the prospect of either avoiding detection altogether or, if caught, paying off the deficiency at favorable interest rates.\(^\text{12}\)

Recognizing that this system favored—indeed encouraged—noncompliance, Congress in enacting TEFRA introduced a new strategy with specific emphasis on dealing directly with abusive tax shelters.\(^\text{13}\) With the TEFRA and 1984 Tax Reform Act legislation the Internal Revenue Service may now impose substantial penalties on taxpayers whose claims fail to meet certain minimum standards of justification, with an even stricter standard of compliance imposed in the case of “tax shelter” claims;\(^\text{14}\) enjoin with court approval the promotion of “abusive tax shelters”\(^\text{15}\) and penalize culpable third parties who assist taxpayers in tax avoidance.\(^\text{16}\)

had no recourse at all against the promoter of a shelter whose tax benefits could not survive audit scrutiny.

\(^\text{10}\) Of course, if the IRS failed to audit of the return, the investor escaped all liability. He had won the “audit lottery” The ability of the IRS to detect questionable returns has been substantially increased in recent years by automation of return processing and selection of returns for examination. 1982 Annual Report, supra.

\(^\text{11}\) Code Section 6653. See e.g., Durovic v. Commissioner, 54 T.C. 1364 (1970), aff’d 487 F. 2d 26 (7th Cir. 1983); cert. denied 417 U.S. 915 (1974); Michael I. Saltzman, IRS Practice and Procedure, 7-73 to 7-75 (Warren, Gorham & Lamont) (1981) [hereinafter Saltzman].

\(^\text{12}\) See generally Stuart E. Siegel, New Penalty Provisions - Some Practical Considerations, 61 Taxes 788, 789 (Dec. 1983). Even the recent amendment to Code Section 6621(c) by the Economic Recovery Tax Act of 1981 (“ERTA”) setting the interest rate for tax deficiencies at 100 percent of the rate for Government securities may be of limited effect for taxpayers who may otherwise borrow at higher rates.


\(^\text{14}\) Code Section 6661 (substantial understatement penalty). See Section III, A., infra.

\(^\text{15}\) Code Section 6700 (abusive tax shelter promoter penalty); Code Section 6701 (aiding and abetting penalty). See Sections II. A. and III. B., infra.
II. **TEFRA and Abusive Tax Shelters**

As the legislative history indicates,1 Congress added sections 6700 and 7408 to the Code to reduce the onerous burden abusive tax shelters place on the federal tax system.2 Section 6700 subjects tax shelter promoters, salesmen, and those who assist them to penalties for organizing or selling abusive tax shelters.3 Section 7408 complements the promoter penalty by authorizing the government to institute an action in federal district court, to "enjoin any person from further engaging in conduct subject to penalty under section 6700."4

A. **The Promotor Penalty - Section 6700**

1. *Generally*

Section 67005 penalizes two types of statements: a statement with respect to the securing of any tax benefit which the person penalized knows or has reason to know if false or fraudulent as to any material matter, or a "gross

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2 The Senate Finance Committee described the problem as follows: "The widespread marketing and use of tax shelters undermines public confidence in the fairness of the tax system and in the effectiveness of existing enforcement provisions. These tax schemes place a disproportionate burden on the Internal Revenue Service resources." 1982 Senate Report, supra note 14, at 266, reprinted in 1982 U.S. Code Cong. & Ad. News at 1014. One commentator described the import of the TEFRA legislation: TEFRA does not follow the past strategy of changing the underlying substantive rules. Rather it restructures the calculus of investors, promoters, and their advisors with respect to tax benefits that are problematic or uncertain, reducing the appeal of shelters that offer such benefits. LeDuc, supra at 369. See also Holden, "Treasury Wages War on Abusive Tax Shelters", Legal Times, Oct. 25, 1982, at 11.


4 See Code Section 7408(a). Because suit for injunctive relief under § 7408 is brought in federal district court, the Tax Division of the U.S. Department of Justice actually litigate the injunction cases on behalf of the Internal Revenue Service in coordination with the United States Attorney in the district where the action is brought. See infra Section II B. However, the prospective defendants are initially identified by the Service which, at the appropriate stage of its investigation, refers the matter to the Department of Justice for institution of suit. See infra Section II. C. See Int. Rev. Manual—II Audit (CCH) § 4565.43 (1981); Code Section 7701(a) (12) (A) (ii); Treas. Reg. § 301.7701-9.

5 Code Section 6700 provides:

SEC. 6700. PROMOTING ABUSIVE TAX SHELTERS, ETC.

(a) Imposition of Penalty.—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
valuation overstatement” as to any material matter.\(^6\) A gross valuation overstatement is the valuation of property or services at more than 200 percent of its correct value.\(^7\)

2. **Scope of the Penalty**

The Section 6700 penalty applies to any person who makes or furnishes the proscribed statements in connection with the organization or sale of “a partnership or other entity, any investment plan or arrangement or any plan or arrangement.”\(^8\) Persons subject to penalty under section 6700 include not only the actual promoter or syndicator who organizes the tax shelter but also those who “assist in the organization of” or “participate in the sale of any

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\(^6\) See Code Section 6700(a) (2). The penalty is “the greater of $1,000 or 20 percent of the gross income derived or to be derived by such person from such activity.” Code Section 6700(a). See Section III.B.\(3\), infra.

\(^7\) See Code Section 6700(a) (2) (B) and (b) (1).

\(^8\) See Code Section 6700(a) (1). The statute does not define “tax shelters.” Rather, it enumerates in broad brush a class of entities subject to the statute: “(i) a partnership or other entity, (ii) any investment plan or arrangement, or (iii) any other plan or arrangement.” Code Section 6700(a) (1) (A). Hence, the statute is not limited to conventional tax shelter investments but is equally applicable to such abusive tax avoidance schemes as mail order ministries and family trusts. See Staff of the Joint Committee on Taxation, 97th Cong., 2d. Sess., General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 at 211 (Comm. Print 1982) [hereinafter cited as 1982 Joint Comm. Explanation]. Indeed, it appears that the great bulk of litigation under Sections 6700 and 7408 has involved such schemes. See e.g., United States v. Hutchinson, 83-1 U.S. para. 9322 (S.D. Cal. 1983) (family trust promoter enjoined under § 7408); United States v. Buttorff, 563 F. Supp. 450 (N.D. Tex. 1983) United States v. Jones, 53 A.F.T.R. 2d 84-370, 83-2 U.S.T.C. para. 9741 (N.D. Tex 1983); United States v. White, 84-1 U.S.T.C. para. 9441 (D. Minn. May 1, 1984). Cf. Code Section 6661 (defining “tax shelter,” for purposes of the substantial understatement penalty, as any entity, plan or arrangement where the “principal purpose” is tax avoidance or evasion). See Section III.A, infra.
interest in" the shelter.\textsuperscript{9} Thus professional advisors such as attorneys and accountants who furnish opinions, draft offering documents or compile projections come within the class of persons subject to statute.\textsuperscript{10} The variety of persons potentially subject to penalty under section 6700 is amply demonstrated by the types of defendants named by the Department of Justice in abusive tax shelter injunction suits filed to date.\textsuperscript{11} Those named in injunction suits have included attorneys,\textsuperscript{12} accountants,\textsuperscript{13} appraisers\textsuperscript{14} and salesmen.\textsuperscript{15}

3. \textit{Amount of Penalty}

Code Section 6700(a) specifies that the penalty for engaging conduct subject to penalty under Section 6700 shall be "the greater of $1,000 or 20 percent of the gross income derived or to be derived by [the penalized] person from such activity"\textsuperscript{16}

The legislative history provides little guidance for calculating the "gross income derived or to be derived" for purposes of the § 6700 penalty.\textsuperscript{17} The use of "gross income" rather than net income or other measure of actual profits suggests that the penalty should be determined without reference to the out-of-pocket expenses and other costs of the person penalized.\textsuperscript{18} The

\textsuperscript{9} Code Section 6700(a) (1).
\textsuperscript{10} See 1982 Senate Report at 266, reprinted in 1982 U.S. Code Cong. & Ad. News at 1014; 1982 Joint Comm. Explanation at 211. Indeed the legislative history also appears to construe the penalty, and in turn the injunction remedy, as extending even to the advisor whose only role may have been advising a single client: Thus, 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 in the arrangement. For example, the penalty could apply to someone organizing or selling an investment to or for a particular client.

1982 Joint Comm. Explanation, at 211 (emphasis supplied).

\textsuperscript{11} Code Section 7408 allows the Government to seek a court ordered injunction to enjoin further promotion of abusive tax shelters upon a showing that the defendants to be enjoined have engaged in conduct subject to penalty under Section 6700 and that injunctive relief is otherwise appropriate. See, Section II.B infra.


\textsuperscript{14} See, e.g., United States v. Music Masters Ltd., No. C-C-84-228-P (W.D. N.C. Government complaint filed May 2, 1984).


\textsuperscript{16} Code Section 6700(a). TEFRA provided that the penalty was to be $1,000 or 10% of gross income. TEFRA § 320. The percentage amount was increased to 20% by the Tax Reform Act of 1984. TRA § 143. See 1984 Conf. Rep. at 227.


\textsuperscript{18} However, some preliminary pronouncements by Government officials indicate that the penalty may be calculated based on gross receipts less cost of goods sold. See Remarks of Carolyn M. Parr, Special Counsel/Acting Chief, Office of Special Litigation, Tax Division, U.S. Department of Justice, to ABA Section of Taxation Winter Meeting, Las Vegas, Nevada (Feb. 11, 1984).
legislative history suggests that the penalty should include the present value of all future payments which the penalized party “reasonably expects” to receive, such as future payments of debt service.19

4. Conduct Subject to Penalty
   a. Generally

Whether the subject conduct at issue is that of false or fraudulent statement or gross valuation overstatement, three elements are common to both types of statements. Regardless of whether the actionable statement is a false or fraudulent statement or a gross valuation overstatement, there must be a “statement.”20 Second, the statement must be “made or furnished” in connection with the organization or sale of the tax shelter.21 Third, both grounds of culpability require a showing that the statement is a material one.22

The statement requirement of section 6700(a) (2) presents few interpretative problems. Oral as well as written statements have been held actionable under Code Section 6700.23 An omission, however, would appear to be outside the scope of the penalty provision.24

The “makes or furnishes” requirement raises the question of whether a prospective defendant who is an integral party to the tax shelter arrangement is liable under the statute if he does not directly make or furnish the actionable statement. Read literally, the statute appears not to impose liability on such a defendant. On the other hand, such a result would conflict with the broad remedial purpose expressed in the legislative history.25 Such a literal

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19 See 1982 Senate Report at 267. The Joint Committee Explanation states:
   If the Internal Revenue Service cannot determine the entire amount of the gross income to be derived from an activity it may assess the penalty on the present value of the portion of such gross income that may be determined. In determining the penalty with respect to the amount of gross income yet to be derived from an activity, the Secretary may look only to unrealized amounts which the promoter or other person may reasonably expect to realize.
20 See Code Section 6700(a) (2).
21 See id.
22 Code Section 6700 proscribes a statement with respect to tax benefits which the prospective defendant “knows or has reason to know is false or fraudulent as to any material matter,” or alternatively, “a gross valuation overstatement as to any material matter.” Id. (emphasis added).
24 See Code Section 6700(a) (2). In contrast, an omission is expressly actionable under the securities law. Compare 15 U.S.C. 771 (2) (1976) with Code Section 6700(a) (2).
reading would allow culpable persons to circumvent the statutory framework by the use of alter-ego entities to make or furnish the actionable statements. A more logical construction consistent with the legislative history would subject a person to penalty by virtue of taking an integral part in aiding and abetting the shelter's organization and promotion, and regardless of whether participation in the actual making or furnishing of the actionable statements was direct or indirect.26

It appears Congress recognized the limitations imposed by the “making or furnishing” element when it added conduct subject to penalty under Code Section 6701 (penalty for aiding and abetting understatement of tax liability) as actionable conduct under Section 7408.26a

In defining materiality, the legislative history of section 6700 tracks the definition of material under the securities law: “[a] matter is material to the arrangement if it would have a substantial impact on the decision-making process of a reasonably prudent investor.”27 However, neither reliance by the purchasing taxpayer or actual unreporting of tax is required to establish materiality under Section 6700.28

b. False or Fraudulent Statement

To establish grounds for the penalty under Section 6700 based on “false or fraudulent” statement, the Government must demonstrate that the person to be penalized know or had “reason to know” of the alleged false or fraudulent statement.29 The “knows or has reason to know” phrasing is not entirely new


26 Under the securities laws, persons indirectly participating in violations have been liable or subject to enforcement action as aiders and abettors, under theories of conspiracy, or by expansive definitions of what constitutes a “seller” for purposes of the securities laws. See generally Ruder, Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification and Contribution, 120 U. Pa. L. Rev. 597 (1972). See also Annot., 56 A.L.R. Fed. 659 (1982).


27 1982 Senate Report, at 267, reprinted in 1982 U.S. Code Cong. & Ad. News at 1015. Cf., TSC Industries, Inc. v. Northway, Inc. 426 U.S. 438, 449 (1976) (omitted fact deemed material if there is a substantial likelihood that the omitted fact's disclosure would be viewed by a reasonable shareholder as important in deciding how to vote). Compare the more objective definition in ABA Revised Opinion 346, (materiality defined as “any income or excise tax issue relating to the tax shelter that would have a significant effect in sheltering from federal taxes income from other sources by providing deductions in excess of the income from the tax shelter investment in any year”). See also Final Rule, Treasury Department Circular 230, 49 Fed. Reg. 6719 (Feb. 23, 1984).


29 Code Section 6700(a) (2) (A). The “reason to know” language was not reflected in the
While the inclusion of the "reason to know" standard relaxes somewhat the Government's burden of proving scienter as to a false or fraudulent statement, the legislative history is careful to point out that the language should not be viewed as imposing upon a defendant a duty of inquiry "beyond the level of comprehension required by his role in the transaction." Nonetheless, a professional advisor otherwise within the scope of the statute may be subject to an ethically imposed duty of inquiry or due diligence requirement and thereby be deemed to have "reason to know" of the false or fraudulent nature of statements in an offering despite an otherwise limited role in the offering. For example, under ABA Opinion 346, an attorney is subject to a duty of inquiry in connection with the issuance of a tax shelter opinion. A similar duty is reflected in the revised Treasury Department

original Senate version of TEFRA and was added in conference. The conference report provides:

The addition of "has reason to know" clarifies that the Secretary may rely on objective evidence of the knowledge of a promoter or salesperson (for example) to prove that he deliberately furnished a false or fraudulent statement. For example, a salesman would ordinarily be deemed to have knowledge of the facts revealed in the sales material which are furnished to him by the promoter.


The "knows or has reason to know" standard is found in the innocent spouse provisions of § 6013(e). See Code Section 6013(e) (1) (B). In that context, the courts have used as a guideline what a reasonable person in the circumstances of the spouse could be expected to know. See Sanders v. United States, 509 F. 2d 162, 166-67 (5th Cir. 1975); Terzian v. Commissioner, 72 T.C. 1164, 1170 (1979); Khoury, TEFRA's Compliance Provision: Impact on Tax Shelter Investments, 7 Tax'n for Indiv. 195. at 203-04 (1983).

The Restatement of Agency characterizes the phrase "reason to know" as follows:

A person has reason to know of a fact if he has information from which a person of ordinary intelligence, or of the superior intelligence which such person may have, would infer that the fact in question exists or that there is such a substantial chance of its existence that, if exercising reasonable care with reference to the matter in question, his action would be predicated upon the assumption of its possible existence.

Restatement (Second) of Agency § 9 comment a (1958).


See ABA Revised Opinion 346. ABA Revised Opinion 346 adopts portions of ABA Comm. on Ethics and Professional Responsibility, Formal Op. 335 (1974), dealing with assumed-facts opinions in connection with the sale of unregistered securities. Opinion 335, as quoted in Opinion 346, provides:

[T]he lawyer should, in the first instance, make inquiry of his client as to the relevant facts and receive answers. If any of the alleged facts, or the alleged facts taken as a whole, are incomplete in a material respect; or are suspect; or are inconsistent; or either on their face or on the basis of other known facts are open to question, the lawyer should make further inquiry . . .

[A]ssuming that the alleged facts are not incomplete in a material respect, or suspect, or in any way inherently inconsistent, or on their face or on the basis of other known facts open to question, the lawyer may properly assume that the facts as related to him by his client, and checked by him by reviewing such appropriate documents as are available, are accurate.
Circular 230 which regulates practice before the Service of both attorneys and accountants.\(^3\)

False or fraudulent statements are essentially of two types: (1) those regarding factual matters and (2) those regarding the law or conclusions of law, specifically in this context the availability of various tax shelter benefits under the internal revenue laws. The former would encompass offerings structured around tax shelter assets that are overvalued or nonexistent. In cases involving overvalued assets, the alternative ground under Section 6700, that of gross valuation overstatement, may also apply. Tax shelter promotions based on complete factual fabrications have generally been the focus of criminal prosecutions.\(^3\) Generally speaking, the nature of any action based on a false or fraudulent statement as to factual matters will necessarily depend on the particular facts.

Proving false or fraudulent an explanation of law proffered in connection with a tax shelter may present the Government with substantial difficulties of proof given the structure of most tax shelter offerings. Often, it may be difficult to demonstrate an unequivocal false or fraudulent statement under Section 6700 since tax shelter offering materials, particularly the tax opinion portions, are drafted with careful attention to qualifying or disclaiming the accuracy of any statement or conclusion as to current law. On the other hand, TEFRA's substantial understatement penalty, Code Section 6661, complicates the ability of promoters and tax opinion authors to offer highly qualified opinions and avoid direct conclusions as to the likelihood that tax benefits represented will be realized.\(^3\) Under new Section 6661, tax shelter opinions must state that a shelter's tax benefits are "more likely than not" to

The essence of this opinion . . . is that, while a lawyer should make adequate preparation including inquiry into the relevant facts . . . and while he should not reasonably believe to be true, he does not have the responsibility to "audit" the affairs of his client or to assume, without reasonable cause, that a client's statement on the facts cannot be relied upon.

Opinion 346 continues:

For instance, where essential underlying information, such as an appraisal or financial projection, makes little common sense, or where the reputation or expertise of the person who has prepared the appraisal or projection is dubious, further inquiry clearly is required. Indeed, failure to make further inquiry may result in a false opinion.

be realized for the investor to avoid the understatement penalty. Similar requirements including limitations on qualified and so-called "assumed facts" opinions are imposed by Treasure Department Circular 230 and ABA Opinion 346.

Assuming the tax opinion or other promotional material misstates the law or erroneously applies the law to the facts, the Government must still establish that the defendant knew or had reason to know of the misstatement. The ability of the Government to establish such scienter is clouded by the recent decision in United States v Dahlstrom. In Dahlstrom, the Ninth Circuit overturned the criminal conviction of a tax shelter promoter because the validity for tax purposes of the offshore trust promotion at issue was held by the Court to be unclear under the legal precedents existing at the time of indictment. Accordingly, the Court reasoned that the Government could not establish "willfulness" on the part of the defendant necessary to sustain the conviction. It may be similarly difficult for the government to establish that defendants in an injunction action knew or had reason to know of the false or fraudulent nature of a given statement of law if the shelter at issue was based on novel and untested interpretations of the internal revenue laws.

c. Gross Valuation Overstatement

A gross valuation overstatement is basically a statement purporting to value an asset for tax purposes at more than 200% of its correct value. In

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35 See Section III.A infra.
36 See Code Section 6661(b) (2) (C); Prop. Treas. Reg. § 1.6661-5(d) (Mar. 15, 1983). The failure of any offering to state that the tax benefits will be more likely than not realized based on a thorough discussion of the relevant issues will no doubt substantially affect marketability of the shelter. See Holden, "Treasury Wages War on Abusive Tax Shelters," Legal Times, Oct. 25, 1982, at 23.
37 See supra, notes 29 through 33 and accompanying text.
39 The Dahlstrom court states (713 F.2d): "We are convinced that the legality of the tax shelter program advocated by the appellants in this case was completely unsettled in the indictment. "It is settled that when the law is highly debatable, a defendant—actually or imputedly—lacks the requisite intent to violate it." A criminal proceeding pursuant to section 7206 "is an inappropriate vehicle for pioneering interpretations of tax law."
(1) GROSS VALUATION OVERSTATEMENT DEFINED.-For purposes of this section, the term "gross valuation overstatement" means any statement as to the value of any property or services if—
(A) the value so stated exceeds 200 percent of the amount determined to be the correct valuation, and
(B) the value of such property or services is directly related to the amount of any deduction or credit allowance under chapter 1 to any participant.

The applicable percentage was reduced in conference from the
contrast to "false or fraudulent" statement as a ground for liability under Section 6700, there is no requirement of knowledge on the defendant's part as to making or furnishing a "gross valuation overstatement." Even disclaimer of knowledge regarding the accuracy of a valuation is insufficient to avoid liability. Thus, liability would attach to an advisor otherwise subject to the statute even if the advisor in good faith disclaims knowledge as to the accuracy of any valuation and complies with any ethical duty of inquiry or standard of due diligence. The standard of liability for a gross valuation overstatement is therefore one of strict liability—any making or furnishing of a gross valuation overstatement is actionable without regard to the good faith or reasonableness of the person making or furnishing the statement. A professional advisor, such as tax counsel, may be deemed to have made or furnished a gross valuation overstatement by merely restating the promoter's valuation of the tax shelter asset as an assumed fact in the tax opinion.

The primary element in establishing a gross valuation overstatement is determining the "correct valuation" of the asset alleged to be overvalued. Correct valuation will generally equate with an asset's fair market value. A professional advisor, such as tax counsel, may be deemed to have made or furnished a gross valuation overstatement by merely restating the promoter's valuation of the tax shelter asset as an assumed fact in the tax opinion.

Senator's proposed 400% to the present 200%. See 1982 Conference Report, at 573, reprinted in 1982 U.S. Code Cong. & Ad. News at 1344-45. Compare Code Section 6700(b) (1) with § 6659 ("valuation overstatement" defined as a value in excess of 150% of correct value). See Section III, infra. While "overstatement" under 6659 applies only to property, "gross valuation overstatement" under 6700 includes both property and services. See Code Section 6700(b) (1) (B). Deductions for services have been disallowed in tax shelter cases on the ground that the value of the services was inflated. See Blitzer v. United States, 684 F. 2d 874 (Ct. Cl. 1982); Keller v. Commissioner, 79 T.C. 7 (1982). The Senate Finance Committee Report on Tangement or any other plan or arrangements when, in connection with such organization or sale, the person makes or furnishes . . . a gross valuation overstatement as to a matter material to the entity, plan or arrangement, whether or not the accuracy of the statement is disclaimed. 1982 Senate Report, at 267, reprinted in 1982 U.S. Code Cong. & Ad. News at 1015 (emphasis added.)

But compare Section II.A[6], infra (waiver of penalty).

Cf. supra notes 32 and 33.

See e.g. I.R.C. § 48(d) (proper asset valuation for purposes of investment tax credit pass-through to lessee is asset's fair market value). See also Estate of Franklin v. Commissioner, 544 F. 2d 1045, 1048 (9th Cir. 1976) (limited partner denied deductions related to property after failing to show that purchase price was at least approximately equal to fair market value of property); Brannen v. Commissioner, 722 F. 2d 695 (11th Cir.), aff'd 78 T.C. 471, 494-95 (1982); Lemmen v. Commissioner, 77 T.C. 1326, 1348 (1981) (cost basis in cattle-raising tax shelter limited to fair market value rather than purchase price where "transaction is not conducted at arm's length by two economically self-interested parties or where a transaction is based upon 'peculiar circumstances' which influence the purchaser to agree to a price in excess of the property's fair market value"). See generally Avent and Grimes, Inflated Purchase Money Indebtedness in Real Estate and Other Investments, 7 J. Real Est. Tax. 99 (1981).
laws with reference to the willing buyer-willing seller test of valuation.47 Proving valuation in tax shelter cases typically requires competent expert testimony, which may be difficult to develop if the tax shelter asset is, as is often the case, unique, obscure or otherwise difficult to value.48 Establishing gross valuation overstatement also requires that the value of the subject property or services be "directly related to the amount of any deduction or credit allowable under chapter 1 [of the Code] to any participant."49 While the legislative history is silent, the statute appears to require that the asset valuation in question be shown to affect directly the amount of tax credit or deduction allowable to the investor under the internal revenue laws.50 Given the materiality requirement, however, the "directly related" element may be unnecessary surplusage.

5. Contesting the Penalty

Code Section 6703 sets forth the procedure for contesting any penalty imposed under Section 6700.51 The penalty may be contested only in federal district court; neither the Tax Court nor the Claims Court has jurisdiction.52 However, unlike a typical refund suit, the penalty may be contested upon the payment of only 15 percent of the penalty amount.53

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48 See, e.g., Anselmo v. Commissioner, 80 T.C. 872 (1983) (proper valuation of gemstones for purposes of charitable deduction); Siegel v. Commissioner, 78 T.C. 659 (1982) (valuation of motion picture). The task of proving overvaluation under § 6700 is further complicated by the fact that, unlike proceedings in the Tax Court or actions for refund, the government under § 6700 bears the burden of proof. See infra Section II.A.[5].

Recognizing the burden of proving overvaluation by experts on a case-by-case basis, the Service and Treasury Department applying in limited instances an approach to valuation based on the time value of money. Expressed in the simplest terms, the time value of money is the difference between the value of immediately available funds and the right to receive funds at some time in the future. M. Chirelstein, Federal Income Taxation 5 (3d ed. 1982). Under a time value of money approach to valuation, the Service compares the represented valuation of an asset for tax purposes (e.g., cost basis) with the present value of the consideration paid for the asset. See Rev. Rul. 82-224, 1982-2 C.B. 5. In Revenue ruling 82-224, a tax shelter investor was held subject to a § 6659 penalty for underpayment of tax attributable to valuation overstatement. The cost basis of the tax shelter asset, as stated in the shelter's promotional literature, was found by the Ruling to exceed 250% of the amount determined to be the asset's correct value, which the ruling arrived at by discounting to present value the principal-only recourse indebtedness financing the asset. Cf., Caruth v. United States, 566 F. 2d 901 (5th Cir. 1978).

49 Code Section 6700(b) (1) (B).

50 See id.

51 Section 6703 also applies to penalties assessed under Code Section 6701 (knowingly aiding and abetting in the understatement of another's tax), see, Section III. B., infra, and Code Section 6702 ($500 penalty for filing of a frivolous return).

52 See Code Section 6703(b).

In an action under Section 6703, the burden of proof is on the Government to prove liability for the Section 6700 penalty. While the specific standard of proof is not specified, the appropriate standard would appear to be proof by a preponderance of the evidence.\(^5\)

In contesting the penalty in district court under Section 7603, the party contesting the penalty has the right to trial by jury.\(^5\) Note, however, that the right to jury trial on the penalty would not be available if an earlier injunction proceeding under Code Section 7408 has already found the conduct at issue to be subject to the penalty.\(^5\) In that circumstance, collateral estoppel would appear to bar relitigating the issue of liability for the penalty altogether even though the bar denies the plaintiff his otherwise available right to a jury trial.\(^5\)

As a practical matter, liability for and amount of any Section 6700 penalty might be better determined as part of a settlement of an injunction action instituted under Section 7408 with the penalized party generally waived the right to contest any penalty agreed to.\(^5\) Even when a penalized party institutes an action under Section 6703 contesting the penalty under Section 6700 one should carefully consider whether a jury trial is strategically appropriate. Jurors are notoriously pro-Government in tax shelter cases.\(^5\) A jury trial, absent particular circumstances (e.g., governmental misconduct) is seldom a positive strategy in tax shelter compliance litigation.

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Section 6703 are almost identical to Section 6694 which provides for the contesting of tax return preparer penalties upon the payment of 15 percent of the assessed penalty. Code Sections 6694(c) (1) and (2), 6695; Treas. Reg. § 1.6696-1. The procedural requirements provided for in Section 6694 have been held to be jurisdictional and the failure to meet the specified requirements—e.g., filing of an action in district court within 30 days of denial of claim for refund—bars further contest of the penalties. See, e.g., Mayo v. United States, 82-2 U.S.T.C. para. 9488 (W.D. La. 1982); Powell v. Kopman, 81-1 U.S.T.C. para. 9383 (S.D. N.Y. 1981). See generally, Saltzman, 4.05[3].

\(^5\) See Section II.B.[5], infra. Cf., Code Section 7427 (burden of proof on Government to prove tax preparer willful understatement of tax).


\(^5\) Establishing conduct subject to penalty under Section 6700 is an element in obtaining an injunction under Code Section 7408. See Section II.B., infra.


\(^5\) Indeed, the IRS has generally sought 6700 penalties to date only in conjunction with suits for injunction under Section 7408 and not as separate assessments. See United States v. Krupp, et al., No. 84-1327 RMT(GX) (C.D. Calif. May 24, 1984) (leasing of master recordings) (promoter consent to § 7408 injunction) (undisclosed amount of § 6700 penalties settled by separate closing agreement); United States v. Day, et al., No. C-84-563A (N.D. Ga. Mar. 20, 1984) (computer leasing shelter) (promoter consent to § 7408 injunction) (includes $36,000 in total § 6700 penalties imposed as to two defendants, penalty waived as to third defendant); United States v. Computer Alternatives, et al., No. C-84-1032 (N.D. Calif. Mar. 6, 1984) (computer leasing shelter) (consent of promoters and salesman to § 7408 injunction) (includes payment of $50,000 in § 6700 penalties); United States v. Mid-American Consultants, Inc., et al., No. 83-2662 C(3) (E.D. Mo. Nov. 23, 1983) (interest accrual real estate time-sharing shelter) (promoter consent to § 7408 injunction) (includes payment of $38,000 in § 6700 penalty); United States v. Packaging Industries Group, Inc., et al., No. 83-2307-N (D. Mass. Aug. 8, 1983) (equipment leasing shelter) (promoter and attorney consent to § 7408 injunction) (includes payment of $451,000 in § 6700 penalty by promoter).

No statute of limitations is specified for any penalty imposed under Section 6700. Code Section 6501 specifies the statute of limitations generally applicable in tax cases by reference to the filing of a return. However, since Section 6700 may be imposed without regard to the filing of any return the period of limitations under Section 6501 would appear inappropriate. Compare the statute of limitations applicable to criminal conspiracy to evade taxes, which is six years and begins to run from the date of the last overt act committed in furtherance of the conspiracy even though the overt act may not itself violate any law.

6. Waiver

Section 6700(b) (2) provides that the penalty may be waived on a showing of reasonable basis and good faith, but this waiver authority applies only to penalties imposed for gross valuation overstatements. No waiver authority applies to penalty based on false or fraudulent statement. The waiver authority sets forth both objective (“reasonable basis”) and subjective (“good faith”) standards, the same standards applicable for waiver of the substantial understatement penalty.

The waiver authority gives the Service discretion in asserting the penalty. For example, the waiver provision might be applied when the person otherwise subject to penalty, acting in good faith, had no knowledge or reason to know of the overvaluation at issue. The waiver provisions mitigate somewhat the otherwise harsh result dictated by defining gross valuation overstatement in Section 6700 without reference to any scienter on the person

[References and citations omitted for brevity]
subject to the penalty.\textsuperscript{71} On the other hand, there is no provision in the statute for review if the Service refuses to waive all or part of the penalty.

B. Injunction of Abusive Tax Shelters

1. Generally

Code Section 7408,\textsuperscript{72} as enacted by TEFRA, provided that a district court obtained, and the appraiser's relationship to the investment or promoter.

Joint Comm. Explanation, at 212.

\textsuperscript{71} See Section II.A. [4] [c], supra. In United States v. Day et al., No. C-84-563A (N.D. Ga. Mar. 20, 1984), two individuals and one corporate defendant, without admitting or denying liability, entered into consent judgements of injunction under Section 7408. The United States waived the 6700 penalty as to one defendant whom it asserted in its Complaint had made or furnished gross valuation overstatements by virtue of his role in tax shelter promotions at issue.

Though the waiver was actually covered by a separate and undisclosed closing agreement, the court order of judgement provides:

5. It is further ORDERED, ADJUDGED AND DECREED that, as provided by a separate agreement among [the defendant] and the Internal Revenue Service dated March 20, 1984, the United States of America waives the penalty provided in Section 6700 of the Internal Revenue Code of 1954, as amended (26 U.S.C.) relating to the organization and sale of interests in Omni Energy Management I and II, Poultry Energy Management I and Fast Food Energy Management (the "tax shelters"). As further provided in said agreement, the United States makes this waiver in complete satisfaction of the amount of any penalty which may be imposed upon [the defendant], pursuant to Sections 6700 and 6701 of the Internal Revenue Code relating to the organization and sale of interests in the above-named tax shelters.


\textsuperscript{72} Code Section 7408 provides:

SEC. 7408. ACTION TO ENJOIN PROMOTERS OF ABUSIVE TAX SHELTERS, ETC.

(a) Authority to Seek Injunction.—A civil action in the name of the United States to enjoin any person from further engaging in conduct subject to penalty under section 6700 (relating to penalty for promoting abusive tax shelters, etc.) or section 6701 (relating to penalties for aiding and abetting understatement of tax liability) may be commenced at the request of the Secretary. Any action under this section shall be brought in the district court of the United States for the district in which such person resides, has his principle place of business, or has engaged in conduct subject to penalty under section 6700 or section 6701. The court may exercise its jurisdiction over such action (as provided in section 7402(a)) separate and apart from any other action brought by the United States against such person.

(b) Adjudication and Decree.—In any action under subsection (a), if the court finds—

(1) that the person has engaged in any conduct subject to penalty under section 6700 (relating to penalty for promoting abusive tax shelters, etc.) or section 6701 (relating to penalties for aiding and abetting understatement of tax liability, and

(2) that injunctive relief is appropriate to prevent recur-
may enjoin a defendant if it finds that the defendant has engaged in conduct subject to penalty under either Code Section 6700 and that an injunction is "appropriate to prevent recurrence of such conduct." Section 7408 was amended by the Tax Reform Act of 1984 to include conduct subject to penalty under 6701 as additional grounds for seeking injunction. While the discussion here will focus primarily on interaction between Section 7408 and Section 6700, the principles are generally applicable and Section 6701 as well. Note, however, that the penalty under Section 6701 is fairly limited because of strict scienter requirement. See Section III, B., infra.

2. Actionable Conduct

Obtaining injunctive relief is predicated on establishing that the defendant's conduct is actionable under Section 6700 or Section 6701. However, while the statute requires that the defendant be found to have engaged in conduct subject to either of the penalties, the penalties need not have been imposed prior to seeking injunctive relief. Congress intended that the new injunctive remedy be available without regard to any other power or authority of the Service, including the assessment of penalties. Further, section 7408 injunctive relief may be granted regardless of whether returns have been filed or audited.

3. Appropriateness of Injunctive Relief

If the court concludes that the defendant has engaged in conduct actionable under section 6700 or section 6701.


ble under Code Section 6700 or Code Section 6701, to grant injunctive relief the court must also determine "that injunctive relief is appropriate to prevent recurrence of such conduct." The identical language is employed under Code Section 7407 which authorizes injunctive actions against return preparers who engage in specific types of improper conduct. Decisions entering or denying injunctions under Section 7407 to date have not addressed the evidentiary foundation necessary to support a finding that injunctive relief is "appropriate to prevent recurrence" and the legislative history is similarly unrevealing.

In the first opinion issued under Code Section 7408, United States v. Buttorff, the district court found injunctive relief appropriate to prevent recurrence of the defendant's conduct. The defendant had previously been convicted of crimes involving illegal tax protestor activities similar to those at issue in the injunction action. The court first found that the defendant knew or had reason to know that his assertions as to the availability of tax benefits

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77 Code Section 7408(b) (2).
78 See id. Code Section 7407(b). Code Section 7407(b) provides in relevant part:
(b) Adjudication and Decrees.—In any action under subsection (a), if the court finds—
(1) that an income tax return preparer has
(A) engaged in any conduct subject to penalty under section 6694 or 6695, or subject to any criminal penalty provided by this title,
(B) misrepresented his eligibility to practice before the Internal Revenue Service, or otherwise misrepresented his experience or education as an income tax return preparer,
(C) guaranteed the payment of any tax refund or the allowance of any tax credit, or
(D) engaged in any other fraudulent or deceptive conduct which substantially interferes with the proper administration of the Internal Revenue laws, and
(2) that injunctive relief is appropriate to prevent the recurrence of such conduct, the court may enjoin such person from further engaging in such conduct.

Id. Code Section 7407 was enacted as part of the Tax Reform Act of 1976 along with several other provisions and amendments directed at controlling abuses by tax return preparers. See supra note 75.
81 563 F. Supp. 450 (N.D. Tex. 1983) defendant appeal docketed, No. 83-1368 (5th Cir.). Buttorff was the first case filed by the government under § 7408 and the only case to date in which an opinion has been issued. Buttorff is also indicative of the scope of Sections 6700 and 7408 in reaching beyond typical "tax shelter" investments to include such tax avoidance schemes as mail order ministries and family trust arrangements. See 1982 Joint Comm. Explanation, at 211.
82 Id. at 455.
83 Id. Buttoroff had been convicted of aiding and abetting taxpayers in filing false withholding
were false or fraudulent in violation of section 6700(a) (2) (A). Based on the defendant's prior conviction and continued activities that were the subject of the injunction suit, the court then found it likely that he would continue the abusive activities at issue unless enjoined. Accordingly, the court enjoined the defendant from engaging in further promotion and sale of the "Constitutional Pure Equity Trust," a family trust arrangement which had no validity for federal income tax purposes.

Case law in the area of securities regulation provides additional reference for construing the appropriateness of injunctive relief standard under Code Section 7408. The Securities and Exchange Commission (SEC), acting under its own civil injunction statutes, is entitled to injunctive relief upon a "proper showing" that any person "is engaged or is about to engage" in violations of the securities laws. The courts have construed a "proper showing" as requiring the SEC to establish (1) that a statutory violation of the securities laws has occurred and (2) that defendant's illegal conduct is reasonably likely to recur. In determining the likelihood of recurrence where the violation conduct has ceased, courts in the securities context have traditionally relied upon a defendant's past conduct, including the conduct precipi-

forms based on his claims that the federal income tax was unconstitutional. See United States v. Buttoroff, 572 F. 2d 619 (8th Cir.), cert, denied, 437 U.S. 906 (1978)

The legislative history of Code Section 6700 and 7408 notes the parallels between those statutes and the securities laws. The Senate Finance Committees stated: "The Committee recognizes that the Securities and Exchange Commission has power that may be directed toward some tax shelter promoters but believes Internal Revenue Service enforcement in this area will materially contribute to a solution of this problem in a number of ways." 1982 Senate Report, supra note 14, at 266, reprinted in 1982 U.S. Code Cong. & Ad. News at 1014.

The SEC consists of five commissioners and support staff. The SEC has enforcement jurisdiction over tax shelter offerings to the extent such offerings constitute "securities." See, e.g. SEC v. Aqua-Sonics Prod. Corp., 687 G. 2d 577, 582-83 (2d Cir. 1982), cert. denied, 103 S. Ct. 568 (1983); SEC v. Murphy, 626 F. 2d 633, 641 (9th Cir. 1980). See generally, Lynch and Murphy, "The SEC's Enforcement Efforts Against Tax Shelters", Tax Shelter Controversies, 136-199 (Law and Business, Inc. 1983); Gourevitch, The Role of the SEC in Tax Matters, 33 Inst. on Fed. Tax'n 1317 (1975). Abusive tax shelter offerings often attempt to circumvent SEC or state securities enforcement actions by claiming that the interests offered do not constitute "securities." See 15 Sec. Reg. & L. Reg. (BNA), No. 5, at 283 (1983) (Wisconsin Securities Commissioner to consider further whether a postage stamp leasing arrangement involved the sale of securities where "formalities" of arrangement indicated that leases were not securities, but "practicalities" indicated otherwise). Cf. SEC v. Aqua-Sonics Prod. Corp., 687 F. 2d 577 (2d Cir. 1982), cert. denied, 103 S. Ct. 568 (1983).


See, e.g., SEC v. Monarch Fund, 608 F. 2d 938 (2d Cir. 1979) (test is whether defendant's past conduct indicates a reasonable likelihood of future violations; SEC v. American Realty Trust, 586 F. 2d 1001 (4th Cir. 1978) (injunction granted upon showing that material statements
tating the injunctive action.\textsuperscript{91} Other factors relevant in determining whether a "proper showing" has been made include character or past violations, effectiveness of discontinuance, bona fide expression of intent to comply, number and duration of past wrongs, time elapsed since the last violation, opportunity to commit further illegal acts, novelty of the violation, harmful impact of injunction on defendant, and willfulness or bad faith in the defendant's conduct.\textsuperscript{92} The courts have recently emphasized these factors in SEC injunction actions and have correspondingly de-emphasized somewhat the role of past violations in finding a reasonable likelihood of continued violations.\textsuperscript{93} For example, in \textit{SEC v. Bausch & Lomb, Inc.},\textsuperscript{94} the Second Circuit stated that "there is no \textit{per se} rule requiring the issuance of an injunction upon the showing of a past violation," and that the Commission must prove "something more than the mere possibility" that violations will be repeated.\textsuperscript{95}

Under Section 7408, the government must prove that injunctive relief is "appropriate" to prevent recurrence of section 6700 conduct,\textsuperscript{96} which is

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and omissions in proxy statement and prospectus resulted from negligence); \textit{SEC v. North Am. Research and Dev. Corp.}, 424 F. 2d 63 (2d Cir. 1970) (case remanded to determine the likelihood of defendants' engaging in proscribed conduct in the future); \textit{SEC v. Paro}, 468 F. Supp. 635 (N.D.N.Y. 1979) (to obtain injunction, SEC must demonstrate probable success on the merits and a likelihood of continuing violations).\textsuperscript{91} See, e.g., \textit{SEC v. Manor Nursing Centers, Inc.}, 458 F. 2d 1082, 1100 (2d Cir. 1972) (expectations of future violations reasonable where defendants did not attempt to cease unlawful activity until SEC investigations began); \textit{SEC v. Culpeper}, 270 F. 2d. 241, 250 (2d Cir. 1959) (in assessing the need for injunctive relief, courts should consider the public interest involved as well as the character of defendants' past behavior); \textit{SEC v. Globus Int'l, Ltd.}, 320 F. Supp. 158, 160 (S.D.N.Y. 1970) (illegal past conduct implies that defendant is reasonably likely to violate statute in the future). Cf. \textit{SEC v. Management Dynamics, Inc.} 515 F. 2d. 801, 808-09 (2d Cir. 1975) (issuing an injunction automatically upon showing of illegal activity not justified absent a finding of a reasonable likelihood the wrong will be repeated); \textit{SEC v. Cal-Am. Corp.}, 445 F. Supp. 1329, 1336 (C.D. Cal. 1978) (current misfeasance one of the best indications of the likelihood of future violations).

\textsuperscript{92} See, e.g., \textit{SEC v. Universal Major Indus. Corp.}, 546 F. 2d. 1044, 1048 (2d Cir. 1976) (court may consider the likelihood of future violations, the degree of scienter involved, the sincerity of defendant's assurances against future violations, the nature of the infractions, and defendant's recognition of his wrongdoing), cert. denied, 434 U.S. 834 (1977); \textit{SEC V. Management Dynamics, Inc.} 515 F. 2d. 801, 807-09 (2d Cir. 1975) (whether defendant is likely to repeat wrongful acts depends on the totality of facts and circumstances); \textit{SEC v. Paro}, 468 F. Supp. 635 (N.D.N.Y. 1979) (in addition to establishing past violations, the SEC should be ready to present proof concerning the degree of intent involved, the degree and frequency of the violations, whether the defendant continues to maintain that his past conduct was blameless, the sincerity of defendant's assurances against future violations, and whether future violations can be reasonably expected given defendant's professional standing).

\textsuperscript{93} See, e.g., \textit{SEC v. Mize}, 615 F. 2d. 1046 (5th Cir.) (case remanded for determination of likelihood of future violations considering all the facts and circumstances involved), cert. denied, 449 U.S. 901 (1980); \textit{SEC v. Caterinicchia}, 613 F. 2d. 109 (5th Cir. 1980) (denial of injunction affirmed even though defendants had previously violated the securities laws); \textit{SEC v. Arthur Young}, 590 F. 2d. 785 (9th Cir. 1979) (finding that auditors would not violate securities laws in the future not clearly erroneous); \textit{SEC v. Commonwealth Chem Sec.}, 574 F. 2d. 90, 99-100 (2d Cir. 1978) (SEC needs to prove more than past violations). See Eisenberg, \textit{SEC Injunctions—Standards for Imposition, Modification and Dissolution}, 66 Cornell L. Rev. 27, 32-41 (1980).

\textsuperscript{94} 565 F. 2d. 8 (2d. Cir. 1977).

\textsuperscript{95} Id. at 18. Cf., \textit{Aaron v. SEC}, 446 U.S. 680, 700-02 (1980).

\textsuperscript{96} See Code Section 7408(b) (2).
arguably a less restrictive standard from the government's standpoint than the "is engaged or about to engage [in a violation]" standard applicable under the securities laws. 97 A court could conceivably find injunctive relief "appropriate" under Section 7408 when recurrence is merely a possibility, even a remote one. On the other hand, as a practical matter, a court acting in its discretion to determine whether an injunction is "appropriate to prevent recurrence" is unlikely in a contested action to enter an injunction for the government if the likelihood of recurrence is remote. Indeed, for the government to urge the entry of an injunction under Section 7408 where the likelihood of recurrence is remote would be subject to challenge and criticism as abuse of its authority. In the parallel context the SEC has been criticized by commentators for overusing its injunctive authority, its most frequently utilized enforcement weapon. 98 Commentators have contended that the Commission sometimes pursues stale cases where there is no equity for an injunction and where the effect of the lawsuit is a public "branding" rather than a fair attempt to enjoin reasonably anticipated future statutory violations. 99

The government need not establish or plead irreparable injury or the

97 See supra notes 90-95 and accompanying text. Judge Friendly, in SEC v. Commonwealth Chem. Sec., 574 F. 2d. 90 (2d. Cir. 1978) noted:
The Securities Act and the Securities Exchange Act speak, after all, of enjoining "any person (who) is engaged or about to engage in any act of practices" which constitute or will constitute a violation . . . Our recent decisions have emphasized, perhaps more than older ones, the need for the SEC to go beyond the mere facts of past violations and demonstrate a realistic likelihood of recurrence.

Id. at 99-100. Cf., SEC v. Dimensional Entertainment Corp. 493 F. Supp. 1270 (S.D.N.Y. 1980). In Dimensional Entertainment, the court refused to grant the SEC's request of injunction premised on past violations that had led to an eight-year prison sentence. See id. at 1278-79. The court stated:

[The more "circumspect" approach toward issuing injunctions should consider both the likelihood of recurring violations and the relative imminence of this threat. While the SEC need not show that a defendant is likely to break the law next month, or even next year, the risk posed by a potential violator with an unexpired prison term exceeding six years is not sufficient to warrant injunctive relief. [The Commission must establish] that the likelihood of further violations is a real probability and not a distant prophecy.

Id. Only when the SEC introduced evidence that the defendant would probably be paroled in a year, had continued to insist that his conduct was lawful, and was likely to be employed in the securities field did the court reconsider its decision and grant the injunction. See SEC v. Dimensional Entertainment Corp., 518 F. Supp. 773 (S.D.N.Y. 1981).


99 See id. at 288. Commentators also contend that the SEC names too many defendants in cases where it may have strong proof against central defendants but tenuous proof against others more peripheral to the violative acts. See also R. Karmel, Regulation by Prosecution: The Securities Exchange Commission v. Corporate America (1982); Mathews, The SEC and Civil Injunctions: It's Time to Give the Commission an Administrative Cease and Desist Remedy, 6 Sec. Reg. L.J. 345 (1979).
absence of an adequate remedy at law to obtain an injunction.\textsuperscript{100} A showing of immediate and irreparable harm would, however, be necessary if injunctive relief were sought \textit{ex parte} by temporary restraining order.\textsuperscript{101} The public interest, rather than the interest of the private litigant, is paramount in determining the propriety of and need for relief in injunction actions authorized by statute.\textsuperscript{102} By enacting Section 7408, Congress has determined that the proscribed conduct is inimical to the public interest.\textsuperscript{103} Thus, to be entitled to injunctive relief, the Government need only show that the statutory conditions have been met.\textsuperscript{104}

4. Jurisdiction and Venue

Code Section 7408(a) sets forth the proper jurisdiction and venue for an action instituted under Section 7408.\textsuperscript{105} Allowing as proper venue any district where a defendant "has engaged in conduct subject to penalty under section 6700 or section 6701" gives the government flexibility regarding where to file an action for injunction under section 7408. By analogy to securities regulation, venue could conceivably be laid in a district in which only a single investor resides, far removed from the promoter's residence or principal place of business.

\textsuperscript{100} See Code Section 7408. Cf. Aaron v. SEC, 446 U.S. 680, 700-01 (1980); FTC v. Rhodes Pharmacal Co., 191 F. 2d. 744, 747 (7th Cir. 1951) (preliminary injunction authorized by statute as involving the public interest should be granted if statutory conditions are satisfied); Bowles v. Huff, 146 F. 2d. 428 (9th Cir. 1944) (allegations and proof of absence of an adequate remedy at law and of presence of irreparable damage not required where injunctive relief authorized by statute); Henderson v. Burd, 133 F 2d. 515, 517 (2d. Cir. 1943).


\textsuperscript{102} See SEC v. Manor Nursing Centers, 458 F. 2d. 1082, 1102, (2d. Cir. 1971); SEC v. Culpeper, 270 F. 2d. 241, 250 (2d. Cir. 1959) (when public interest conflicts with private interest in injunction cases, public interest is paramount). Accord Hecht Co. v. Bowles, 321 U.S. 321, 330-31 (1944) (where injunctions authorized by statute, words of the statute should be construed to protect the public interest); Marshall v. Lane Processing, Inc., 606 F. 2d. 518, 519-20 (8th Cir. 1979) (defendant's public image and increased difficulty in obtaining loans were private interest and factors not to be weighed in considering whether an injunction should issue), cert. denied, 447 U.S. 922 (1980).

\textsuperscript{103} Cf., SEC v. Advance Growth Capital Corp., 470 F. 2d. 40, 53 (7th Cir. 1972) (public interest enunciated in the legislation is the criterion for the proper exercise of the trial court's equity powers); Lenroot v. Interstate Bakeries Corp., 146 F. 2d. 325, 327 (8th Cir. 1945) (public interest regarding child labor is a matter for Congress whose determination is binding on the courts).


\textsuperscript{105} Code Section 7408(a) provides:

(a) \textbf{AUTHORITY TO SEEK INJUNCTION.}—A civil action in the name of the United States to enjoin any person from further engaging in conduct subject to penalty under section 6700 (relating to penalty for promoting abusive tax shelters, etc.) may be commenced at the request of the Secretary. Any action
or business. However, in contrast to the securities laws, an injunction action under section 7408 does not have the benefit of nationwide personal jurisdiction and service of process. Personal jurisdiction and service of process in a Section 7408 action are controlled by Fed. R. Civ. P. 4 which establishes personal jurisdiction by reference to the state "long-arm" statute in the state where the federal district court is located.

5. Burden of Proof

Neither the burden nor the standard of proof applicable to an action under Section 7408 is specified by the statute or its legislative history. For actions contesting penalties imposed under Section 6700 or Section 6701, the statute

under this section shall be brought in the district court of the United States for the district in which such person resides, has his principal place of business, or has engaged in conduct subject to penalty under section 6700. The court may exercise its jurisdiction over such action (as provided in section 7402(a)) separate and apart from any other action brought by the United States against such person.

Section 7402(a) provides:

(a) TO ISSUE ORDERS, PROCESSES, AND JUDGMENTS.—The district court of the United States at the instances of the United States shall have such jurisdiction to make and issue in civil actions, writs and orders of injunction, and of ne exeat republica, orders appointing receivers, and such other orders and processes, and to render such judgements and decrees as may be necessary or appropriate for the enforcement of the internal revenue laws. The remedies hereby provided are in addition to and not exclusive of any and all other remedies of the United States in such courts or otherwise to enforce such laws.


places the burden of proof on the government,\textsuperscript{109} but fails to define the applicable standard of proof.\textsuperscript{110} The standard of proof in SEC injunction actions, where the SEC bears the burden of proof, is proof by a preponderance of the evidence.\textsuperscript{111} Given that Code Section 7408 and SEC civil injunction actions serve similar remedial purposes,\textsuperscript{112} the burden of proof on the government by a preponderance of the evidence appears appropriate for civil injunction actions under Section 7408.\textsuperscript{113}

6. \textit{Collateral Estoppel}

   a. As Bar to Subsequent Action Contesting Any Related Penalty Determination

Because an injunction under Section 7408 is based on a finding that a defendant has engaged in conduct subject to penalty under section 6700 or section 6701, problems of collateral estoppel arise for any prospective defendant.\textsuperscript{114} A finding of penalty conduct in an action for injunction under Section 7408 may collaterally estop the defendant from relitigating the finding in a subsequent action to contest the penalty, or vice versa if the penalty action preceded the injunction action.\textsuperscript{115} For this reason, a defendant exploring settlement of the injunction action by consent, should consider also negotiating any penalty liability at the same time in order to avoid subsequent imposition of the penalty based on any findings, admissions or information obtained in the course of the injunction action,\textsuperscript{116} and care should be taken

\textsuperscript{109} See Code Section 6703(a), See Section II.A. [5]. \textit{supra.}

\textsuperscript{110} \textit{Id.} It has been suggested that government enforcement actions against tax shelters would be greatly enhanced if the taxpayer rather than the government bore the burden of proof. See Testimony of former Chief Judge Theodore Tannenwald, United States Tax Court, before the Senate Finance Subcommittee on Oversight of the Internal Revenue Service (June 24, 1983).


\textsuperscript{112} See supra note 87.


\textsuperscript{114} \textit{Under res judicata}, a final judgement on the merits bar further claims by the parties or those in privity with them on the same cause of action. Collateral estoppel bars the relitigation of issues common to different causes of action. \textit{Montana v. United States}, 440 U.S. 147, 153 (1979); \textit{Parklane Hosiery Co. v. Shore}, 439 U.S. 322, 326 n. 5 (1979). The Restatement of Judgments speaks of \textit{res judicata} as "claim preclusion" and of collateral estoppel as "issue preclusion." Restatement (Second) of Judgments § 27 (1982).

\textsuperscript{115} Cf., \textit{United States v. Abatti}, 463 F. Supp. 596 (S.D. Cal. 1978) (government estopped from raising in a criminal action issues decided for the taxpayer in a civil action). Under § 6703, imposition of the Section 6700 penalty may be contested in federal district court upon payment of 15% of the amount of such penalty. Code Section 6703(c). See Section II.A. [5]. \textit{supra.}

\textsuperscript{116} Cf., \textit{United States v. Gibraltar Properties, Inc.}, No. 3-83-641 (N.D. Tex. 1983) (promoters of condominium time sharing tax shelter consented to entry of § 7408 injunction and payment of § 6700 penalty in separate and undisclosed closing agreement.)
in drafting the consent language to avoid the effect of collateral estoppel.117

In the event the government litigated the issue of penalty conduct in the injunction action and lost on that issue, the prevailing injunction defendant could assert collateral estoppel to bar subsequent imposition of the underlying penalty.118 However, a person contesting the penalty on the same facts but who was not a defendant to the injunction proceeding which determined the issue of penalty conduct may not raise collateral estoppel against the Government to bar relitigation of the issue as it may apply to him.119

b. Exposure to Subsequent Suit By Investors

Collateral estoppel may also operate in a subsequent litigation brought by an investor or other private party seeking rescission or damages under federal or state securities laws.120 On the other hand, the defendant may avoid collateral estoppel by consenting to entry of an injunction without funding of fact by the court, such consent order constitutes no presentation or adjudication of the issue and collateral estoppel therefore does not apply.121

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117 See Section II.C. [4], infra.
119 United States v. Mendoza, U.S. , 52 U.S. L.W. 4019 (Sup. Ct. Jan 10, 1984) Though the Supreme Court conditionally approved the nonmutual offensive use of collateral estoppel in Parklane Hosiery Co. v. Shore, 439 U.S. 332 (1979) and had long abandoned the requirement of materiality of parties, Blonder-Tongue Laboratories, Inc. v. University of Illinois Foundation, 402 U.S. 313 (1971), the Court in Mendoza limited application of offensive nonmutual collateral estoppel to private litigants. The Court's holding would appear to apply the exception for the United States to all nonmutual estoppel whether defensive and "offensive" application. 52 U.S. L.W. at 4021. Offensive use of collateral estoppel occurs when a plaintiff seeks to foreclose a defendant from relitigating an issue the defendant has previously litigated unsuccessfully in another action against the same or a different party. Defensive use of collateral estoppel occurs when a defendant seeks to prevent a plaintiff from relitigating an issue the plaintiff has previously litigated unsuccessfully in another action against the same or a different party. Parklane Hosiery, supra, at 326 n. 4.

Indeed, the legislative history to Section 6700 notes the utility of an action under § 6700 to private investors seeking recourse against the promoters under the securities laws: "[if] the Internal Revenue Service establishes fraud by a promoter, the investors may be materially aided in their efforts to seek rescission of the contracts under which they invested." 1982 Senate Report, supra note 14, at 266 reprinted in 1982 U.S. Code Cong. & Ad. News at 1014; 1982 Joint Comm. Explanation, supra note 50, at 210-11.
c. Subsequent Criminal Prosecution

A prospective injunction defendant may also be the target of a criminal investigation. As to the application of collateral estoppel in subsequent criminal proceedings, if the Government prevails in an injunction or penalty action, the defendant is free to relitigate the adverse findings of fact in a subsequent criminal trial without bar by collateral estoppel because of the higher standard of proof applicable in criminal actions. If the Government lost the preceding injunction or penalty action, its ability to proceed with the criminal prosecution based on the same issues may be irreparably damaged.

(promoter consent to injunction under Section 7408 without admitting or denying Governments’ allegations in connection with a tax shelter based on leasing of master recordings). In Krupp the court granted substantial injunctive and ancillary relief based on carefully limited findings of facts. The Final Judgment reads in part:

2. The Court finds that defendants have neither admitted nor denied the Governments’ allegation that they have engaged in conduct subject to penalty under Section 6700 of the Internal Revenue Code and which interferes with the enforcement of the internal revenue laws.
3. The Court finds that defendants have consented to the entry of judgment for injunctive relief pursuant to Sections 7402 and 7408 of the Internal Revenue Code to prevent defendants from (i) engaging in conduct that is subject to penalty under Section 6700 of the Internal Revenue Code, and (ii) organizing, promoting or selling the tax shelters known as Fact-to-Face, One-on-One, Computronics, Ltd., Videotronics, Ltd. and Mediatronics, Ltd.

Cf., IB J. Moore's Federal Practice O. 444 [3] at 806 (2d. ed. 1983) Some commentators are of the view that collateral estoppel should not apply when the prior judgment was reached by consent even if findings were made in entering judgment since the consent process presupposes that there was no “full and fair opportunity” to litigate the issues so that collateral estoppel should operate to bar subsequent litigation of the issue. Id. See also IB Moore’s Federal Practice, O.418 [1] at 707-08 (2d. ed. 1983).

123 See Section II.B. infra. [7].

124 Adverse findings of fact in a civil proceeding to not bind the defendant in a subsequent criminal case because of the lesser standard of proof applicable in the civil proceeding. See United States v. Beery, 678, F. 2d. 856, 868 n. 10 (10th Cir. 1982). See also United States v. Koenig, 388 F. Supp. 670, 719-20 (S.D.N.Y. 1974).

Moreover, if the criminal case will often be based on different facts and involve different issues. See United States v. Mumford, 630 F. 2d. 1023, 1027-28 (4th Cir. 1980), cert. denied, 450 U.S. 1041 (1981). For example, if the subject conduct of the injunction action was overvaluation of the tax shelter asset, findings of facts as to valuation would not likely be elements in the criminal prosecution. Criminal prosecution are generally reserved for egregious cases involving traditional badges of fraud such as false, altered, or backdated documents or false representations as to material facts on the text return, and to date have not centered around valuation issues alone. See, e.g., United States v. Drape, 668 F. 2d. 22 (1st Cir. 1982) (backdated documents to avoid “at risk” provisions); United States v. Baskes, 649 F. 2d. 471 (7th Cir. 1980) (fraudulent transactions carried out through sham trust), cert. denied, 450 U.S. 1000 (1981); United States v. CRM, 529 F. 2d. 1380 (9th Cir. 1976) (assistance in preparation of knowingly false income tax returns).

124 See Dranow v. United States, 307 F. 2d. 545, 556, (8th Cir. 1962) (where both civil and
If the order of proceedings is reversed so that the criminal prosecution precedes an action for injunction (or penalty), a conviction will estop relitigation of facts decided in the criminal trial. Conversely, a defendant's prior acquittal will not bar the Government from raising the common issues anew in a subsequent civil action.

7. Concurrent Criminal Investigation

A promoter who is under investigation for possible injunctive action under Section 7408 or penalty under Section 6700 or Section 6701 may also be under criminal investigation. While the Service has historically suspended civil enforcement actions that might conflict with an ongoing criminal investigation or prosecution, this general policy has been reevaluated in the context of Section 7408 injunctions and concurrent investigations appear criminal actions have as their object "punishment," collateral estoppel applies. Cf. United States v. Mumford, 630 F. 2d. 1023, 1027 (4th Cir. 1980) (criminal action might be barred where it raises same cause of action and issues as the unsuccessful civil action).

See, e.g., Gray v. Commissioner, F. 2d. (6th Cir. 1983), Amos v. Commissioner, 360 F. 2d. 358 (4th Cir. 1965) (collateral estoppel applies to issue of fraud in a subsequent civil action brought by taxpayer who had earlier been convicted of evasion); Moore v. United States, 360 F. 2d. 353 (4th Cir. 1965) (taxpayer's earlier criminal conviction supplies basis for a finding of fraud in subsequent civil proceeding), cert. denied, 385 U.S. 1001 (1967); Tomlinson v. Lefkowitz, 334 F. 2d. 262, 264 (4th Cir. 1964) (issue resolved against defendant in criminal prosecution may not be contested by the same taxpayer in a civil suit brought by the government), cert. denied, 379 U.S. 962 (1965); Armstrong v. United States, 354 F. 2d. 274, 291 (Ct. Cl. 1965) (same); Arctic Ice Cream Co. v. Commissioner, 43 T.C. 68, 75076 (1964) (collateral estoppel also applies where basis of earlier conviction was a guilty plea). See M. Saltzman, IRS Practice and Procedure 7.08(2) (b) (1981).

See Section II.C. [1][][ii], infra. [127]


The purpose of criminal tax investigations is to enforce the tax laws and to encourage voluntary compliance. Experience has demonstrated that attempts to pursue both the criminal and the civil aspects of a case concurrently may jeopardize the successful completion of the criminal case. It is, therefore, necessary in the overall interests of enforcement of the law, to identify those instances when criminal actions generally will take precedence over the civil aspects.

[T]he consequences of civil enforcement actions on the criminal investigation and prosecution of the case should be carefully weighed, and in general, only such actions will be taken as the Division Chiefs or the District Director agree should be taken.

sistent with the language of the statute.\footnote{130}

There exists no legal impediment, constitutional or otherwise, to concurrent criminal and civil investigations,\footnote{131} but concurrent investigations present pitfalls for both prospective defendants and the government. For example, information developed by the government in its criminal investigation may be used to develop its civil case against a defendant.\footnote{132} The prospective criminal defendant risks self-incrimination in defending himself in the civil action.\footnote{133} Courts generally have not stayed civil injunction proceedings to protect defendants' claims of Fifth Amendment privilege against self-incrimination.\footnote{134}

One of the Government's primary concerns in the case of parallel investigations is the defendant's use of broad civil discovery in the injunction case to obtain information relevant to the possible criminal prosecution. The Government may seek to limit discovery to only that evidence relevant in the injunction action and not permit wholesale discovery of its criminal case.\footnote{135}

\footnote{130}See Code Section 7408. Section 7408 provides in pertinent part: "The court may exercise its jurisdiction over such action (as provided in § 7402(a)) separate and apart from any other action brought by the United States against such person." Id. § 7408(a).

\footnote{131}See United States v. Kordel, 397 U.S. 1, 11-12 (1970) (federal law enforcement would be stifled if governmental agencies were required either to defer civil proceedings pending the outcome of a criminal trial or to forego criminal prosecution once civil relief is sought); Standard Sanitary Mfg. Co. v. United States, 226 U.S. 20, 52 (1912) (under the Sherman Act, criminal and civil proceedings may be brought simultaneously or successively at the government's discretion); SEC v. Dresser Indus., Inc., 628 F. 2d. 1368, 1375 (D.C. Cir.) (Constitution does not ordinarily require a stay of civil proceedings pending the outcome of criminal proceedings), cert. denied, 449 U.S. 993 (1980). See also Donaldson v. United States, 400 U.S. 517 (1971) (Service summons upheld in an investigation that was likely to lead to civil liability as well as criminal prosecution).

\footnote{132}See United States v. Chemical Bank, 593 F. 2d. 451, 456 (2d. Cir. 1979); United States v. Cleveland Trust Co., 474 F. 2d. 1234 (6th Cir.) (per curiam), cert. denied, 414 U.S. 866 (1973). However, grand jury material would not be available for use in an injunction investigation in which litigation has not yet commenced. See United States v. Baggot, 103 S. Ct. 3164 (1983). See also United States v. Sells Engineering, Inc., 103 S. Ct. 3133 (1983). Additionally, once referral of the criminal case is made to the Department of Justice for prosecution, any civil investigation by means of administrative summons must be suspended. See Code Section 7602(c). Cf., United States v. LaSalle Nat'l Bank, 437 U.S. 298 (1978) (Service summons under § 7602 not enforceable unless issued prior to Service's recommendation that criminal proceedings be initiated); SEC v. Dresser Indus., Inc., 628 F. 2d. at 1377-84.


\footnote{134}See SEC v. Gilbert, 79 F.R.D. 683, 686 (S.D.N.Y. 1978) (defendant not put to an unconstitutionally coercive choice where only immediate sanction for refusal to testify in civil case is possible raising of adverse inference which would not, standing alone, support a finding of liability).

\footnote{135}See SEC v. Dresser Indus., Inc., 628 F. 2d. 1328, 1376 (D.C. Cir. 1980) (courts must be cautious in granting discovery requests in concurrent civil and criminal proceedings so as not to expand discovery rights of criminal defendant); Campbell v. Eastland, 307 F. 2d. 478 (5th Cir. 1962) (taxpayers who had sued for refunds could not discover special agent's reports), cert. denied, 371 U.S. 955 (1963). Accord Founding Church of Scientology v. Kelley, 77 F.R.D. 378, 380 (D.D.C. 1977) (litigants should not be allowed to use liberal civil action discovery procedures to avoid criminal discovery restrictions and thus obtain documents they might not other-
8. **Scope and Form of Relief**

After a court makes the requisite findings that penalty conduct has occurred and that injunctive relief is appropriate to prevent recurrence of such conduct, or otherwise accepts jurisdiction to enter an injunction, as in the case of a consent decree, the court must address the nature and scope of the injunctive relief to be granted. The legislative history of section 7408 views broadly the court's discretion as to the scope of the relief. For example, even though the injunction may have been predicated on only one type of section 6700 conduct, the court may enjoin all future conduct proscribed by section 6700—both false or fraudulent statements and gross valuation overstatements. A more difficult question is whether a court may enjoin not only future section 6700 conduct, but also a promoter's involvement in legitimate tax shelter activity as a means "appropriate to prevent recurrence of [section 6700] conduct." A comparable provision, Code Section 7407 authorizing injunction of tax return preparers for prohibited conduct, explicitly grants the court power to enjoin a person from further acting as a tax return preparer, including engaging in legitimate preparer activities. The legislative history of Section 7408 appears at least implicitly to sanction such

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wise be entitled to use in criminal case). But cf., *Dellinger v. Mitchell*, 442 F. 2d. 782, 787 (D.C. Cir. 1971) (where related criminal proceeding is pending, civil action need not be halted entirely but is subject to some limitations, including discovery protective orders, to avoid unfairness or interference with the public interest).


137 In *United States v. Hutchinson*, 83-1 U.S. T.C. para. 9322 (S.D. Cal. 1983), the defendant, a promoter of a family trust scheme, consented to the entry of a Section 7408 injunction on the basis of alleged false or fraudulent statements. The court order, besides granting other relief, enjoined the defendant from "assisting in the organization of, or participating in the sale of interests in, any partnership, trust, entity, investment plan or other plan or arrangement to the extent conduct related thereto is subject to penalty under Code Section 6700." *Id*, See also *United States v. White*, supra; *United States v. Butterff*, supra; *United States v. Jones*, supra.

138 See Code Section 7408 (b) (2).

139 See id. Code Section 7407 (b). Section 7407 (b) provides in relevant part:

If the court finds that an income tax return preparer has continually or repeatedly engaged in any conduct described in subparagraphs (A) through (D) of this subsection and that an injunction prohibiting such conduct would not be sufficient to prevent such person's interference with the proper administration of this title, the court may enjoin such person from acting as an income tax return preparer.

See *U.S. v. Savoie*, No. 84-1043 (W.D. La.) (Gov't complaint filed April 16, 1984) (injunction suit filed seeking relief under 7402, 7407 and 7408 against tax protester leader asks court to bar defendant from any future preparation of tax returns whether or not legitimate); *U.S. v. Shugarman*, et al., No. 85-64-NN (E.D. Va.) (Gov't complaint filed April 16, 1984) (injunction suit filed seeking relief under 7402, 7407, and 7408 against tax protester organize associated with nationwide "Patriots" protester group asks Court to bar defendants from engaging in all tax return preparation); *U.S. v. Oaks*, No. 84-0349-CV-W-9 (W.D. Mo.) (Gov't complaint filed Mar. 19, 1984).
broad relief in appropriate cases.\textsuperscript{140}

The specific nature of ancillary relief granted under Section 7408 appears limited only by the imagination of counsel and the discretion of the court. The legislative history of Section 7408 provides that a court should exercise "great latitude" in fashioning the specific form of equitable relief.\textsuperscript{141} For example in United States \textit{v.} Packaging Industries Group, Inc.,\textsuperscript{142} the general partner and principal individual promoter of an allegedly abusive tax shelter consented, along with ten other defendants, to an injunction under Code Section 7408. As part of the settlement, the general partner agreed to notify the Service of his future tax shelter activity and to provide the Service, upon request, with the names of investors in any future tax shelter in which he might participate.\textsuperscript{143} Similar but more specific relief was granted in the Final Judgment in United States \textit{v.} Krupp et al.\textsuperscript{144}

\textsuperscript{140} The Senate Finance Committee report states: "Of course, the court will continue to have full authority to act under its general jurisdiction (section 7402) and will continue to possess the great latitude inherent in equity jurisdiction to fashion appropriate equitable relief." 1982 Senate Report, supra at 269, reprinted in 1982 U.S. Code Cong. & Ad. News at 1017.

\textsuperscript{141} See id. Compare Farrand, \textit{Ancillary Remedies in SEC Civil Enforcement Suits}, 89 Harv. L. Rev. 1779 (1976).

\textsuperscript{142} No 83-2307-N (D. Mass. 1983).


\begin{quote}
\begin{verbatim}
[I]f Richard Roberts organizes, assists in the organization of or participates in the sale of any tax shelter as defined in § 6661(b) of the Internal Revenue Code of 1954 (26 U.S.C.) and Regulations promulgated thereunder, Richard Roberts shall promptly notify the Internal Revenue Service (through the District Director of the Internal Revenue District wherein Richard Roberts resides) of his participation in the organization or sale of such tax shelter and provide the District Director with complete and true copies of all offering documents and other promotional material with respect to the tax shelter, and upon the request of the District Director, provide the Internal Revenue Service with the names, addresses and social security numbers of each person who acquires an interest in such tax shelter.
\end{verbatim}
\end{quote}

\textsuperscript{144} No. 84-1327 RMT (GX) (C.D. Calif. May 24, 1984) (injunction of shelter based on leasing of audio recording masters entered by consent, without admitting or denying the Government's allegations, of individual and corporate defendants). The judgment provides relevant part:

5. It is further ORDERED, ADJUDGED AND DECREEd that if any of the defendants, acting individually or through any corporation now in existence or hereafter formed, in which he or it is the controlling shareholder, or if any of the defendants acting indirectly in any other manner, organizes, assists in the organization of, or participates in the sale of any tax shelter, as defined in paragraph 6 below, such defendant shall:

A. Prominently disclose the existence and nature of this Order in any and all materials or media used to offer for sale such tax shelter; and shall promptly;

B. Notify the Internal Revenue Service (through the District Director of the Internal Revenue Service wherein the particular defendant resides) of his or its participation in the organization or sale of such tax shelter;
C. Provide the District Director with complete and true copies of all offering documents, appraisals, tax opinions, and other promotional material with respect to the tax shelter;

D. Wait a period of 30 days from the date such material is delivered to the District Director before beginning the sale of such tax shelter; and

E. Refrain from making any claim or statement that such notification or any failure by the Internal Revenue Service to comment or take action with respect to the material implies approval of the tax shelter by the Internal Revenue Service.

6. A “tax shelter,” as the term is used in paragraph 5, above, is an investment which has as a significant feature for Federal income or excise tax purposes either of the following attributes:

A. Deductions in excess of income from the investment being available in any year to reduce income from other sources in that year, or

B. Credits in excess of the tax attributable to the income from the investment being available in any year to offset taxes on income from other sources in that year.

7. It is further ORDERED, ADJUSTED AND DECREED that this Court shall retain jurisdiction of this action for the purpose of implementing and enforcing [sic] this Final Judgment and all additional decrees and orders necessary and appropriate to the public interest. The provisions of Paragraph 5 shall be in effect for a term of five years from the date entered, unless the United States files a notice no earlier than 180 days nor less than 60 days before expiration, stating the reasons why the best interests of the United States require an extension of these provisions. In such case, the Court may continue these provisions in accord with the public interest.

Definitions of “tax shelter” for purposes of notification to IRS of future offerings vary. In Packaging Industries, the definition was merely made with reference to Code Section 6661 while in Krupp the definition was made more specific and thus less limiting to the defendant. In other injunction actions the even more specific language has been used to define “tax shelter” for this purpose. See e.g. U.S. v. North American Investment Group, Ltd. et al., No. 04-C-3683-H (Government complaint filed April 30, 1984) (promoters and related accountant name defendants in injunction suit with respect tax shelter based on rehabilitation credit for real estate). In North American the Government prayer for relief seeking in part to require notification to the Service of future tax shelter offerings by defendants defines “tax shelter” for that purpose as:

[A]n investment which has as a significant feature for federal income or excise tax purposes either of the following attributes: (1) Deductions in excess of income from the investment being available in any year to reduce income from other sources in that year, or (2) credits in excess of the tax attributable to that income from the investment being available in any year to offset taxes on income from other sources in that year. Excluded from the term are: municipal bonds, annuities, qualified retirement plans, individual retirement accounts; stock option plans; securities issued in a corporate reorganization; and real estate where it is anticipated that deductions are unlikely to exceed gross income from the investment in any year, and that any tax credits are unlikely to exceed the tax on the income from that source in any year.

This definition substantially tracks the definition of “tax shelter” contained in Treas. Dept. Circular 230 for purposes of regulating the issuance of legal opinions in tax shelter investments. See note 33, supra.
In addition to relief requiring the enjoined parties to no longer engage in conduct subject to Section 6700 generally and requiring future notification to IRS of future tax shelter offerings the Government has sought other forms of ancillary relief including (i) agreement of the promoter to notify investors and salesmen of the injunction and provide IRS with names and addresses of investors and salesmen for both present and prior shelters,\(^\text{145}\) (ii) pay a penalty under Section 6700, (often specified in separate and undisclosed closing agreement)\(^\text{146}\) (iii) offering investors the opportunity to rescind their investment with the promoter\(^\text{147}\) and (iv) providing written notice of the injunction in all future investment offerings.\(^\text{148}\)

In one injunction suit lodged against a tax protest leader, the Government has requested relief in the form of requiring the defendant to halt publication of a newsletter.\(^\text{149}\) In addition, in some injunction suits brought by the United States under Section 7408, the government has also placed jurisdiction and sought injunctive and ancillary relief under Code Section 7407 relating to injunction of return preparers.\(^\text{150}\) In these cases the Government has also sought, in addition to other relief, to prohibit the defendant(s) from engaging


\(^{150}\) Code Section 7407. See *United States v. Ernst & Whinney, supra.*
in improper activities as tax return preparers\textsuperscript{151} and in some cases, primarily those best described as involving "tax protester" defendants, sought to enjoin the defendant(s) from engaging in future return preparation completely regardless of whether the activity would be legitimate or abusive.\textsuperscript{152}


\textsuperscript{152} United States v. Savoie, supra; United States v. Shugarman, supra; U.S. v. Oaks, supra.
C. Implementation of the TEFRA Abusive Tax Shelter Provisions

1. IRS Procedures for Identification and Examination of Abusive Tax Shelters

[A] Prior to TEFRA

Prior to TEFRA, the IRS had little if any effective capacity to monitor current tax shelter offerings. Investigatory resources and manpower focused almost exclusively on examination of taxpayer returns.\(^1\) Being return-based, the Service's institutional experience and knowledge was limited to prior year tax shelters. Any knowledge possessed by the Service of a promoter's current activities was purely coincidental and unspecific.

However, with the enactment of Sections 6700 and 7408 in TEFRA, the focus of enforcement has changed from audit of prior year(s) shelter at the investor level to interdiction of current offerings at the promoter level. The Service has instituted new procedures to implement the change in focus.\(^2\)


[i] Identification of Abusive Offerings

To implement the TEFRA tax shelter provisions, particularly the abusive tax shelter promoter penalty and injunction provisions, Code Sections 6700 and 7408, the Internal Revenue Service has instituted new procedures aimed at identifying and responding to abusive tax shelters before investing taxpayers file their returns. Revenue Procedure 83-78, 1983-2 C.B. 595, sets forth the new procedures and standards the Service will follow in identifying and reacting to abusive tax shelters.

Under the guidelines outlined in Rev. Proc. 83-78, each of the 63 IRS Districts nationwide is to have a committee to review potentially abusive tax shelters being currently promoted in that district. The committee is to select those offerings which, based on the preliminary information available to the Committee, meet the criteria for imposition of any of the following: (1) the promoter penalty under Code Section 6700; (2) institution of an action for injunction under Section 7408; or (3) the sending of pre-filing notification letters to investors.\(^3\) The three main administrative branches of the IRS are represented on each district committee: District Counsel, Criminal Investigations Division and the Examination Division. A coordinator for the committee gathers information on potential targets from any source of opportunity

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\(^1\) See Slaughter, supra, at 5-8, 39.
\(^3\) Rev. Proc. 83-78, 1983-2 C.B. 595, Section 3.03. For elements needed to establish liability under Sections 6700 and 7408, see Sections II A. and B., supra. As to investor pre-filing notifications, see Section II D., infra. In addition, since conduct subject to penalty under Code Section 6701 has been added as actionable conduct under Section 7508, presumably the scope of investigations under Rev. Rule 83-78 will be expanded accordingly. Code Section 6701 imposes a penalty for aiding and abetting in the understatement of another's tax liability. See Section III B., infra.
including federal, state and local information agencies, other IRS investigations (civil or criminal), magazines and newspapers. In selecting current tax shelter offerings for examination, the committee is to consider such factors as the past involvement of the shelter’s promoter and other related persons in prior year shelters; the type of shelter involved; the number of investors involved, the potential revenue loss. Obviously, selection of a particular offering for examination will be more likely if the promoter is thought to have engaged in previous abusive promotions.

[ii] Examination of Targeted Offerings

Once the committee selects a shelter based on available preliminary information, a revenue agent then conducts a formal examination of the promoter. The stated purpose of the examination is not only to determine whether penalty for promotion of an abusive tax shelter under Code Section 6700 should be imposed or injunctive relief under Code Section 7408 sought but also merely whether “there is a basis for concluding that the investors will not be in compliance with the tax laws if they claim the tax benefits represented by the promoter to be available.” Thus, the examination is general in scope and not restricted only to whether the shelter comes with the scope of Sections 6700 and 7408 as an “abusive” tax shelter.

At commencement of the examination, a revenue agent is to contact the promoter of the selected shelter by letter informing the promoter of the examination and advising that the Service is considering possible penalties and injunctive action under Section 6700 and 7408 and pre-filing notification to investors. The letter may also request documents and records which the promoter has 10 days to make available for examination. The letter also is to inform the promoter that he will be afforded an opportunity to meet with the revenue agent and an IRS attorney to offer any facts and legal arguments to establish that the selected shelter’s claimed benefits comply with the tax laws.

With the records obtained from the promoter (either voluntarily or by summons) and any third party information available, the agent conducts the

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4 Rev. Proc. 83-78, Section 3.01. For example, though developed and litigated prior to promulgation of Rev. Proc. 83-78, the injunction in United States v. Buttorff, supra was obtained based in part on evidence supplied by the Texas State Bar which was conducting an investigation of Buttorff for unauthorized practice of law.

5 Rev. Proc. 83-78, Section 3.02.

6 Past history is particularly relevant when developing information for an action seeking injunctive relief under Section 7408 since an element and predicate to issuance of an injunction is that “injunctive relief is appropriate to prevent recurrence.” See Section II. B. [3], supra.

7 Rev. Proc. 83-78, Section 3.03.


9 Id. A 10-day return date may be woefully inadequate if the request for records is lengthy or technical issues are implicated. In the event the promoter fails to comply with the request, the agents may issue a summons for the records. Id.

10 Id.
examination. If in the course of the examination, the agent determines there are indications of fraud (e.g., backdating of documents), the case is to be referred to the Criminal Investigations Division for its review. In the event the Criminal Investigations Division finds evidence of criminal violations, the investigation will then be conducted from that point as a "joint" investigation by Criminal Investigations Division, represented by a special agent, and the Examination Division, represented by the assigned revenue agent. As a practical matter, this no doubt means a special agent would then lead any continued investigation and any criminal implications in the case would assume top priority.

The conference, between the IRS and the target promoter, is apparently held after the agent's examination is completed but before formal recommendations are made to the District Director. Besides providing the promoter the opportunity to present any defenses or mitigating facts, the conference may provide the promoter an opportunity to learn the Service's views on the shelter. It may also serve as the starting point for settlement negotiations. The conference procedure as outlined in the Revenue Procedure is very restrictive. Rev. Proc. 83-78 provides that, except in unusual circumstances, no extensions of time will be granted on the meeting date and only one meeting will be afforded. Thus, the promoter may have to defend his position to the IRS without any advance notice of the specific nature of the Service's concerns and no stated opportunity for additional meetings if clarification or follow-up is needed.

The limited nature of the conference opportunity at this stage emphasizes the importance of an orderly and competent presentation of views at the conference. The promoter, represented by counsel, should consider making...

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11 Rev. Proc. 83-78, Section 4.03.  
15 These requirements have been criticized as too strict. See Sanders, J. of Tax. of Investments 269, 273 (1984).  
16 See Section II. E., infra, discussing conference opportunities with the Department of Justice after referral of case to the Department by the Internal Revenue Service for institution of suit for injunction.  
17 Counsel for the promoter must consider whether they may themselves by a target in the investigation since penalty and injunctive relief under Sections 6700 and 7408 encompass attorneys as well as the direct promoter. Cf., Rev. Proc. 83-78, Section 8.02. See Sections II. A. [2], supra. For example, there is a clear conflict of interest where counsel in the enforcement controversy is also the author of target shelter's tax opinion. This raises the additional issue of whether other possible targets of in the examination (attorneys, accountants, appraisers, etc.) who might also be subject to penalty or injunction should also be afforded a conference opportunity with the Service. The guidelines of Rev. Proc. 83-78 refer only to the promoter. However, other parties, particularly those from which the Service obtained information in its investigation arguably come within the scope of Rev. Proc. 83-78 and should be afforded a conference opportunity as well.
a written presentation of defense and facts. A written submission makes a record for the promoter which may be helpful in presenting his case to the Service at higher levels of its review, particularly where difficult or technical issues are presented.

After completion of the examination and conference with the promoter, the agent and attorney working with the agent make their recommendations to the District Director based on the following options: (1) assertion of the Section 6700 penalty; (2) referral to the Department of Justice for institution of suit for injunctive relief under Section 7408; and (3) issuance of pre-filing notification letters to investors.

It is difficult to assess with any precision the impact of Rev. Proc. 83-78. However, a few instances of its application have been made public. In one instance, a syndicator of tax shelter private placements based on computer leasing was investigated by the Service under the new procedure. Though no details of the reason for selection of the syndicators were given by either it or the Service, a recent Tax Court decision had disallowed the tax benefits in prior year offering of the syndicator on the grounds that the lease arrangement at issue there had no business purpose. This decision may have triggered further investigation directed at current offerings of the syndicator. In a second publicized incident, another computer leasing syndicator announced that the Service had examined its activities but found no basis for further action. This latter instance is instructive because it demonstrates the Service's willingness to use the Rev. Proc. 83-78 guidelines to examine offerings which are not necessarily abusive.

D. Pre-filing Notification of Investors

In addition to determining whether a selected shelter is an appropriate candidate for penalty or injunction under either (or both) Code Sections 6700 and 7408, Rev. Proc. 83-78 outlines a third option, pre-filing notification whereby the Service notifies the shelter investors that they will be audited if they claim the deductions or credits of the shelter on their returns.

In format, the written product should be similar to a ninety-day protest letter or a "Wells" submission used in SEC enforcement proceedings at the administrative level. However, counsel should be careful to set forth only facts which are accurate and, if possible, independently verify facts. See notes 32 and 33 supra.

The examining agent and assigned District Counsel attorney who make recommendations to the District Director may be the only IRS representative actually attending the conference. See Rev. Proc. 83-78, Section 4.04.


However, the opinion though disallowed the claimed tax benefits as lacking economic reality stopped short of describing the offering at issue as an "abusive tax shelter".


Pre-filing notification is an extremely effective tool for the Service. Unlike Sections 6700 and 7408, no judicial review or court order is required for its application. Further, it may apply to a wider range of shelters than those subject to penalty or injunction under Sections 6700 and 7408. Under Rev. Proc. 83-78, the Service may utilize pre-filing notification for any tax shelter that involves: "(1) overvaluation of assets, (2) false or fraudulent statements as to a material matter; (3) an aberrational use of technical positions." While the first two criteria roughly track the grounds under Section 6700, the Revenue Procedure cites only "Rules of 78's in time-sharing transactions" as an example of "aberrational use of technical positions." Rules of 78's and similarly abusive interest accrual devices have been the object to Government action for injunctive relief under Section 7408. The danger exists, however, that the Service may construe the "aberrational use" standard to reach beyond those abuses subject to sanction under Sections 6700 or 7408, and apply pre-filing notifications to merely aggressive shelters despite its draconian impact.

Despite the potentially disastrous consequences to a promoter of pre-filing notification by the Service to the promoter's investors, there is no provision for obtaining review of the Service's decision to issue pre-filing notification to investors of a targeted shelter under Rev. Proc. 83-78. Indeed, the Service may issue the letters without notice to the promoter. At least two promoters have sought to enjoin the Service from sending notification letters but both

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27 Rev. Proc. 83-78, Section 6.01
28 See Sections II. [A] [4], supra.
29 Rev. Proc. 83-78, Section 6.01. "Rules of 78's" interest accrual is a tax shelter technique used mostly in real estate shelters for inflating interest deductions. Calculating interest on long-term seller financing using the sum-of-the-year's-digits method (popularly known as "Rule of 78's"); coupled with a deferred balloon payment of accrued interest and principal, results in accrual of most of the loan's interest in the early years of the loan while the provision for balloon payment defers actual payment twenty or thirty years. An accrual method taxpayer's deduction of the accrued but unpaid interest creates great tax advantage. But cf., Rev. Rul. 83-84, 1983-1 C.B. 97 (Rule of 78's interest accrual not a proper method of accounting for interest in indebtedness); Rev. Rul. 84-5, C.B. (Rules of 78's interest accrual in context of real estate time-sharing tax shelter held improper method of calculating deductible interest).
31 See Note 25, supra and accompanying text.
32 Upon receipt of pre-filing notification, investors may refuse to make future scheduled capital contributions or bring suit for recision or damages against the promoter for violation of the securities law. The promoter also stands to lose future customers and suffer harm to reputation. See, e.g., Sanders, IRS New Attacks on Tax Shiter Syndications, J. Tax. Investments 269, 273-274 (1984).
34 Id.
have failed.\footnote{35 Mid-South Music Corp. v. United States, 83-2 U.S.T.C. 9710 (M.D. Tenn. Nov. 2, 1983) (appeal pending in the Sixth Circuit, No. 83-5867) (letters at issue were issued by District Director before Rev. Proc. 83-78 issued); Phillips v. Internal Revenue Service, No. 84-1700 W.M.B.C. (PX) (C.D. Calif.) (stay denied by the Ninth Circuit). But cf., South Carolina v. Regan, 52 A.F.T.R. 2d 84-732 (Sup. Ct. 1984). In South Carolina, the Supreme Court granted South Carolina leave to file a complaint invoking original jurisdiction of the court and seeking injunctive and other relief barring enforcement of certain provisions of TEFRA that impose restrictions on tax-exempt bearer bonds issued by state and local governments. Code Section 103(a), providing that interest earned on state obligations is not subject to the federal income tax, was amended by TEFRA to require that many state bonds be issued in registered, rather than bearer form in order to qualify for the tax exemption provided in Section 103(a). South Carolina maintains this Section is unconstitutional as violative of the Tenth Amendment and the doctrine of intergovernmental tax immunity. The Federal Government sought dismissal of the State's action on the ground that the proposed suit was barred by the Anti-Injunction Act, Code Section 7421(a), which prohibits the maintenance by any person of any suit seeking to restrain the assessment or collection of any tax.

The Supreme Court, in a divided opinion, held that the Anti-Injunction Act did not bar the State's suit reasoning that the Act could not bar injunctive suits brought by nontaxpayers such as the State here, when such third parties have no other recourse to obtain judicial review. See also Foodservice and Lodging Institute, Inc. v. Regan, F. Supp. (D.C. D.C. Feb. 29, 1984) (Government motion to dismiss plaintiff's injunction suit to enjoin regulations implementing tip income reporting requirements denied on the ground that plaintiff's members had no adequate remedy at law to contest the regulations). After South Carolina, it would appear a promoter may seek to enjoin the Service from issuing pre-filing notification letters to investors and not be bound by Code Section 7421 since the promoter has no other recourse to challenge the action. On the other hand, any such action must clear additional hurdles of standing, cf., Wright v. Regan, U.S. 535 (1980); Mid-South Music Corp. v. United States, 656 F. 2d 820 (D.C. Cir. 1981); and sovereign immunity, United State v. Mitchell, 445 U.S. 535 (1980); United States Sherwood, 312 U.S. 584 (1941); Rowe v. United States, 633 F. 2d 799 (9th Cir. 1980), Cert. denied 451 U.S. 970 (1981).

36 Cf. proposed legislation that will require promoters to maintain lists of shelter investors for use by the Internal Revenue Service on request.


38 Id.

39 There is an intercircuit conflict which the Supreme Court will resolve on the issue of whether the "John Doe" summons procedures of Section 7609 (requiring court approval for issuance of the summons) must be complied with when the IRS seeks information from a person such as a tax shelter promoter when that information will be used in examining not only the served party (the promoter) but third parties (the investors) as well. Tiffany Fine Arts v. United States, 718 F. 2d 7 (2d Cir. 1983), cert. granted 52 U.S.L.W. 3713 (April 3, 1984). Section 7609(f) provides that no John Doe summonses, used to determine the liability of unknown taxpayers, may be issued prior to an ex parte judicial proceeding and approval by the district

On the other hand, pre-filing notification is subject to an important practical limitation in that the Service must have the names and addresses of the investors in order to notify them.\footnote{36} It may obtain such information a number of ways. It may be available as matter of public record as in the case of a certificate or amended certificate of partnership recorded under state law, or it may be made available voluntarily by the promoter cooperating with the Service in a Rev. Proc. 83-78 examination.\footnote{37} In the event the names are not obtained from the promoter voluntarily or by other means, the Service may issue a summons to the promoter,\footnote{38} though in issuing a summons for this purpose, it is unclear whether the summons must comply with the special "John Doe" procedures requiring court approval to issue the summons.\footnote{39}
An investor in receipt of a pre-filing notification letter should be aware that not only will deductions and credits of the targeted shelter be disallowed if claimed, but the notification process opens up other items on his return for review since under Rev. Proc. 83-78 the investor return will be handled by normal audit procedures. It is unclear whether the investor's return will still be singled out for audit on other items if the questioned shelter items are not claimed. Since the IRS must check the investor's return to determine whether the shelter items appear, the opportunity to review items unrelated to the shelter presents itself.

In addition, though the notification procedure is described as "pre-filing," the Revenue Procedure indicates that letters may be issued after the filing of returns by investors. Investors may file amended returns, but are still subject to any applicable penalties, such as the understatement penalty, based on their original return.

Lastly, a fourth option in addition to penalty or injunction under Sections 6700 and 7408 and pre-filing notification is merely audit of the shelter investor without pre-filing notification. Under this option, the promoter avoids the hazards and harm caused by pre-filing notification while the Service is able to develop its examination at the promoter level in accordance with the procedures under Rev. Proc. 83-78 which it can then disseminate to various districts for use in the individual investor audits.

E. Litigation of Penalty or Injunction Actions

1. Generally

When the Internal Revenue Service in accordance with guidelines announced in Rev. Proc. 83-78, determines to seek injunctive relief under Section 7408 with respect to an offering or promoter, it refers the actions to the Tax Division of the Department of Justice for institution of suit. The Tax court. In Tiffany Fine Arts, the Second circuit held that a "dual purpose" summons need not satisfy the statutory conditions imposed by Section 7609(f) of the Internal Revenue Code with respect to the issuance of "John Doe" summonses. In that case, the IRS issued ordinary (non-John Doe) summonses under Code Section 7602 to Tiffany, a promoter of tax shelters, indicating that the Service was investigating Tiffany's own tax liabilities, but conceding that the information requested could also serve to identify its clients. Accord, United States v. Gottlieb, 712 F. 2d 1363 (11th Cir. 1983); United States v. Barter Systems, Inc., 694 F. 2d 163 (8th Cir. 1982). Contra, United States v. Thompson, 701 F. 2d 1175 (6th Cir. 1983).

Rev. Proc. 83-78, Section 7.02. In addition the investor's decision to claim the disputed shelter deductions exposes not only the investor to the full range of penalties (civil fraud, negligence, substantial understatement) but may also expose his tax return preparer to penalty under 6694 or 6701. See Section III. B., infra.

Rev. Proc. 83-78, Sections 7.01 and 8.01.


Id.

Nationwide dissemination of audit materials gained from audit of a promoter for use in investor audits has been challenged but upheld by the courts. First Western Government Securities, Inc. v. United States, 578 F. Supp. 212 (D. Colo. 1984) (court held no claim under Section 6103, barring disclosure of tax return information, stated by disclosure of IRS audit report of promoters to the investors in disallowing their tax benefits).
Division then holds responsibility for the conduct of the litigation. Similarly, Tax Division attorneys would defend any penalty imposed by the Service under Section 6700 or 6701 since these penalties may only be contested in federal district court.  

2. Conference Opportunities with the Department of Justice

It appears that prospective section 7408 defendants will not be afforded a conference with the Department of Justice as a matter of right. This is in contrast to the conference opportunity described in discretionary terms but virtually always granted in criminal tax cases.

The Justice Department discretionary approach in the injunction area appears motivated by the concern that any mandatory conference procedures would present prospective defendants with an opportunity to delay investigation and institute of suit. The same considerations resulted in the conference policy now followed by the SEC in its civil enforcement actions including injunction actions. The SEC policy is that the Commission staff, "in its discretion, may advise prospective defendants or respondents of the general nature of its investigation, including the indicated violations as they pertain to them, and the amount of time that may be available for preparing a [Wells] submission."

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45 The Department of Justice Tax Division represents the Internal Revenue Service and the Department of Treasury in all litigation other than that before the United States Tax Court. See 28 U.S.C. §§ 515-19 (1976); 28 C.F.R. § 0.70 (1982).

46 Code Section 6703. See Section II. A. [5], supra.

47 See Remarks of B. John Williams, Jr., Deputy Assistant Attorney General, Tax Division, U.S. Department of Justice, before Philadelphia Bar Assn., Section of Taxation, Annual Meeting (Nov. 7, 1983), reported in Daily Tax Rep. (BNA) No. 216, 6-5 (Nov. 7, 1983). Mr. Williams stated:

Because the Service will have afforded the promoter a conference and an opportunity to present evidence that the Service's suspicions are unfounded, the Tax Division will not as a matter of course permit a conference with its attorneys [in § 7408 injunction cases], except to negotiate a consent decree. If we believe that no useful purpose would be served by holding a conference, none will be held.


48 The Criminal Section of the Tax Division may grant a conference request after referral of a criminal case to the Department of Justice for prosecution. At the conference held in criminal cases, the taxpayer and counsel generally are informed of the alleged statutory violations, the years involved, the unreported income and tax deficiencies under consideration and the method of proof employed by the government. See United States Attorney Manual §6-2.140.


50 Securities Act Release, supra (emphasis added). A "Wells submission" is a letter or memorandum to the SEC setting forth the defendant's position as to the facts, the law or both. See generally Handling an SEC Investigation 1980 (No. 357 P.L.I. 1980); Mathews, Effective Defense of SEC Investigations: Laying the Foundation for Successful Disposition of Subsequent
In practice, a prospective § 7408 injunction defendant will almost always be granted a conference with the assigned Department of Justice attorney prior to institution of suit if it is clear that the defendant is acting in good faith and not using the conference opportunity to delay or hinder the Government's consideration of the injunction suit. In rare instances, compelling circumstances may make a conference impossible, as for example, if the Service has requested and provided adequate factual foundation for seeking a temporary restraining order. In this circumstance timing would dictate that any contact between the Department and defendant(s) be limited. In any event, for the same reasons detailed as to mandatory conferences with the IRS in its initial investigation, the prospective defendant and counsel should seek a conference with the Department of Justice.

3. Entry of Injunction by Consent

The overwhelming majority of actions brought under Section 7408 have resulted in consent judgments prior to trial. This is not surprising in light of SEC experience. The SEC has long used consent judgments to obtain injunctions on negotiated terms. Indeed, the majority of SEC injunction actions are

_Civil, Administrative and Criminal Proceedings, 24 Emory L. J. 567, 618-28 (1975). In the early 1970's, an SEC advisory group, the "Wells Committee," named for its chairman, John A. Wells, proposed that the SEC establish a formal conference procedure which would, except in limited circumstances, afford persons under investigation two mandatory procedural rights prior to the institution of any injunctive proceeding. A prospective defendant would have the right to be notified of the probable charges facing him and the right to be heard by the SEC. See SEC Advisory Committee, Report on Enforcement Policies and Practice (June 1, 1972) reprinted in A. Mathews, B. Finkelstein & H. Milstein, Enforcement and Litigation Under the Federal Securities Laws—1973, 275, 279 (No. 116 P.L.I. 1973). The Commission, however, declined to adopt any procedure that would impede its flexibility in responding to violations. The Commission's formal response to the Committee's recommendation stated:

[The SEC] cannot place itself in a position where, as a result of the establishment of formal procedural requirements, it would lose its ability to respond to violative activities in a timely fashion.

The Commission believes that the adoption of formal requirements could seriously limit the scope and timeliness of its possible action and inappropriately inject into actions it brings issues, irrelevant to the merits of such proceedings, with respect to whether or not the defendant or respondent had been afforded an opportunity to be heard prior to the institution of proceedings against him and the nature and extent of such opportunity.

For example, the exception for egregious cases—"where the nature of the case precludes"—would create definitional problems through which defense counsel might delay enforcement action to the detriment of the SEC and the public interest.


52 See Section II. C. [1][B][ii], supra.

53 With few exceptions, e.g., United States v. Buttorff, supra (preliminary injunction entered after evidentiary hearing), United States White, supra (preliminary injunction entered after hearing) and United States v. Your Heritage Protection Society No. 84-0643-R (C.D. Calif. April 17, 1984) (injunction entered on Government's motion for summary judgment), the overwhelming
settled by consent.54

Entering into a consent judgment offers several advantages for a defendant or prospective defendant in a Section 7408 injunction action. Besides avoiding the cost of litigation entry of the injunction by consent, without admitting or denying the allegations of the Government's complaint, allows the defendant the opportunity to negotiate with the Government on the scope and terms of the Government's complaint and the terms of the final judgment to be entered.55 For example, allegations of false or fraudulent statements which may expose the defendant to subsequent litigation by investors, might be deleted in favor of allegations only of gross valuation overstatement if appropriate.56 The defendant or counsel may also be very interested in min-


54 See, Steinburg, supra, at 27 n. 2 See generally Rowe, Settlement of an SEC Enforcement Action, 1980 Sec. Reg. Guide (P-H) § 1121, reprinted in Handling an SEC Investigation—1980 at 925 (No. 357 P.L.I. 1980). Settlement negotiations with the SEC leading to consent judgments generally encompass the following issues: (i) discussion and provision of information concerning violations to be alleged; (ii) discussion and provision of information concerning the language and factual allegations to be contained in the complaint; (iii) ascertainment of the language and scope of the defendant's consent (e.g., inclusion of "without admitting or denying" phrase, exclusion of the "any other securities" phrase); (iv) ascertainment of the individuals and entities which will or will not be named as defendants; (v) negotiation of simultaneous, companion settlements such as broker-dealer, investment advisor or 1940 Act disciplinary actions; and (vi) coordination and determination of the content of press announcements. See Mathews, supra, at 623-24; Rowe, supra, at 927-31. See also Marrifield, Investigations by the Securities and Exchange Commission, Bus. Law. 2583, 1626-29 (1977).


56 See Comments of Carolyn M. Parr, Special Counsel/Acting Chief, Office of Special Litiga-
imizing the number of defendants name in the action. In the consent process, counsel may persuade the government to name only corporate defendants or name only those persons directly involved in promotion of the offerings at issue and not name tax professionals potentially subject to liability as having aided or participated in the promotion. Consideration should also be given to settling any liability for Section 6700 or Section 6701 penalties and determining the amount of such penalties. The *quid pro quo* for Government concessions on these points could be entry of ancillary relief of satisfactory impact to the government and acceptable in scope to the defendants.

Pleadings filed in the consent judgment generally include (1) the Government's complaint, (2) the consent of defendant(s) and (3) an order of final judgment entering the injunction and granting ancillary relief. In drafting or proposing language for inclusion in the Government's complaint and the court's final judgment entering the injunction, careful attention must be paid to avoid any possibility of raising collateral estoppel against the defendant(s) in subsequent proceedings.

Counsel should also consider taking steps to minimize adverse publicity that may be created by entry of an injunction. As a matter of general practice, the Department of Justice, often in conjunction with the Internal Revenue Service, issues a press release when it files a complaint seeking injunctive relief under Section 7408 and when the injunction is entered. It may be desirable to negotiate with the government to limit its announcement of any injunction order or at least review with counsel the proposed language and timing of any press announcement being contemplated in order to minimize adverse publicity.
III. Other TEFRA Tax Shelter Compliance Provisions

A. The Substantial Understatement Penalty

1. Generally

The substantial understatement penalty, Code Section 6661, imposes a penalty on taxpayers for any understatement of tax not meeting the exceptions specified by the statute.\(^1\) The penalty applies to any understatement of tax but the statutory exceptions to avoid the penalty are made stricter in the case of understatements due to a "tax shelter", as defined by the statute.

\(^1\) SEC. 6661. SUBSTANTIAL UNDERSTATEMENT OF LIABILITY

(a) ADDITION TO TAX—If there is a substantial understatement of income tax for any taxable year, there shall be added to the tax an amount equal to 10 percent of the amount of any underpayment attributable to such understatement.

(b) DEFINITION AND SPECIAL RULE—

(1) SUBSTANTIAL UNDERSTATEMENT—

(A) IN GENERAL—For purposes of this section, there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of—

(i) 10 percent of the tax required to be shown on the return for the taxable year, or

(ii) $5,000.

(B) SPECIAL RULE FOR CORPORATIONS—In the case of a corporation other than an S corporation or a personal holding company (as defined in section 542), paragraph (1) shall be applied by substituting "$10,000" for "$5,000".

(2) UNDERSTATEMENT—

(A) IN GENERAL—For purposes of paragraph (1), the term "Understatement" means the excess of—

(i) the amount of the tax required to be shown on the return for the taxable year, over

(ii) the amount of the tax imposed which is shown on the return.

(B) REDUCTION FOR UNDERSTATEMENT DUE TO POSITION OF TAXPAYER OR DISCLOSED ITEM—The amount of the understatement under subparagraph (A) shall be reduced by that portion of the understatement which is attributable to—

(i) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or

(ii) any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return.

(C) SPECIAL RULES IN CASES INVOLVING TAX SHELTERS—

(i) IN GENERAL—In the case of any item attributable to a tax shelter—

(I) subparagraph (b)(ii) shall not apply, and

(II) subparagraph (B)(i) shall not apply unless (in addition to meeting the requirements of such subparagraphs) the taxpayer reasonably believed that the tax treatment of such item by the taxpayer was more likely than not the proper treatment.

(ii) TAX SHELTER—For purposes of clause (i), the term "tax shelter" means—

(I) a partnership or other entity,

(II) any investment plan or arrangement, or

(III) any other plan or arrangement.

if the principal purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.
The penalty is equal to 10 percent of the underpayment of income tax attributable to any "substantial understatement" of tax,\(^2\) defined as any understatement of tax due in a taxable year that exceeds the greater of $5,000 or 10 percent of the tax due.\(^3\)

Prior to enactment of the substantial understatement penalty in TEFRA, a taxpayer including a tax shelter investor could rely on "reasonable basis" support for a disallowed position to insulate himself from any penalty for overly aggressive positions.\(^4\) After TEFRA every taxpayer must consider the impact of the penalty when taking an aggressive position as to tax liability which if disallowed on audit would result in a "substantial understatement" of tax.

The statute's safe harbor exceptions to the imposition of the penalty allow taxpayers to assert aggressive positions which might otherwise result in penalty if the requirements of the applicable exceptions are not met. The statute also grants the Service authority to waive the penalty upon a showing by the taxpayer of reasonable cause and good faith.\(^5\) Generally, the penalty may be avoided if there is "substantial authority" for the disallowed position giving rise to the understatement of tax,\(^6\) or if facts relevant to the disallowed position were "adequately disclosed" on the tax return or in a statement attached to the return.\(^7\) However, in the case of a substantial understatement attributable to "tax shelter" items a stricter standard applies. In that case the

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\(^{(3)}\) COORDINATION WITH PENALTY IMPOSED BY SECTION 6659—For purposes of determining the amount of the addition to tax assessed under subsection (a), there shall not be taken into account that portion of the substantial understatement on which a penalty is imposed under section 6659 (relating to addition to tax in the case of valuation overstatements).

(c) AUTHORITY TO WAIVE—The Secretary may waive all or any part of the addition to tax provided by this section on a showing by the taxpayer that there was reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith.

\(^2\) The ten percent penalty is twice the 5 percent negligence penalty provided for in Code Section 6653 or the equivalent of raising the marginal tax to 55 percent for a 50 percent tax bracket taxpayer. See Stuart E. Siegel, New Penalty Provisions - Some Practical Considerations, 61 Taxes at 788, at 789 (Dec. 1983).

\(^3\) Code Section 6661(b) (1). For corporations other than Sub-chapter S corporations and personal holding companies, the minimum is $10,000 instead of $5,000. Code Section 6661(b) (1) (B).

\(^4\) The negligence penalty (5 percent of the tax underpaid) and civil fraud penalty (50 percent of the underpayment) cannot be successfully imposed by the IRS if the taxpayer has a "reasonable basis" for the claimed but disallowed deduction or credit. Code Section 6653. See, e.g., Durovic v. Commissioner, 54 T.C. 1364 (1970), aff'd 487 F. 2d 36 (7th Cir. 1973), cert. denied, 417 U.S. 915 (1974); M. Saltzman, IRS Practice and Procedure, 7-73 to 7-75 (1981). With "reasonable basis" providing defense to any penalty coupled with the favorable interest rate on any tax deficiency, taxpayers had little inducement to take conservative positions on their returns or settle tax disputes with the Service if detected, and every reason to take aggressive postures. See note Section I., supra.

\(^5\) Code Section 6661(c).

\(^6\) Code Section 6661(b) (2) (B) (i).

\(^7\) Code Section 6661(b) (2) (B) (ii). Of course, while the fact that a position is adequately disclosed may insulate the taxpayer from the understatement penalty in the absence of substantial authority, liability may still be imposed for negligence or civil fraud unless there is a "reasonable basis" for the position. See note 4, supra.
penalty is avoided only by a showing of substantial authority coupled with
the additional requirement that the taxpayer have "reasonably believed" that
the tax treatment in question was "more likely than not" the proper
treatment.8

1. Substantial Authority

While the statute itself does not define "substantial authority," the legisla-
tive history gives the following definition: "when the relevant facts and
authorities are analyzed with respect to the taxpayer's case, the weight of the
authorities that support the taxpayer's position should be substantial com-
pared with those supporting other positions."9 The legislative history and
proposed regulations both discuss what may be deemed reliable authority for
purposes of establishing "substantial authority." Such authorities include case
law, statutes, regulations and revenue rulings and exclude opinions of coun-
sel, private letter rulings issued to third parties and legal treaties.10

3. Adequate Disclosure

The "adequate disclosure" alternative to substantial authority is essentially
flagging a questionable position on the return for review by the Service in the
event the taxpayer's return is audited.11 Adequate disclosure is described as
disclosure of "facts sufficient to enable the Service to identify the potential
controversy, if it analyzed that information."12 The proposed regulations set
forth specific form requirements as to what constitutes in the Service's view
acceptable "adequate disclosure" and reference should be made to those pro-
visions in attempting to formulate an adequate disclosure for purposes of
avoiding the understatement penalty.13 However, adequate disclosure is not a
permissible safe harbor to avoid the penalty in the case of a substantial

Prop. Treas. Reg. § 1.6661-2(b) (1). The legislative history indicated that Congress settled on
"substantial authority" as the standard for the somewhat curious reason that "substantial author-
ity" had not yet been subject to interpretation in any other context. Id. The author would suggest
that improving taxpayer compliance with the internal revenue laws is better pursued by enact-
ment of laws that allow taxpayers to arrange their affairs with relative certainty, rather than
relaying on interpretation of vague and unspecific standards which inevitably engender contro-
versies between taxpayers and the Service. Compare the TEFRA amendments to Code Section
7602, REFRA Section 333 (enactment of a "bright-line" test to replace the vague and much
litigated standard for determining proper purpose of IRS summons).
9 1982 Conf. Rep. at 575; Prop. Treas. Reg. § 1.6661-2(b) (2). Interestingly, the proposed
regulations do not accord a taxpayer substantial authority if the taxpayer relies on favorable case
law in his own jurisdiction when the weight of authority generally is to the contrary. Prop. Treas.
Reg. § 1.6661-3(b) (4) (ii). See Code Section 6661(b) (2) (B) (ii). See generally, Siegel, supra.
10 1982 S. Rep. at 274.
11 Prop. Treas. Reg. § 1.6661-4 (general requirements of adequate disclosure). See also Prop.
Treas. Reg. § 1.6661-6(b) (2) (automatic waiver for partners in the cases of disclosure made by
partners individually as to partnership items).
understatement attributable to a "tax shelter" item.  

4. "Tax Shelter" Understatements

A stricter standard of justification applies in the case of a substantial understatement caused by a "tax shelter". In that case, the taxpayer may avoid the penalty only on a showing that there was both substantial authority for the tax shelter benefits and that the taxpayer reasonably believed the benefits were more likely than not proper.

The statute defines "tax shelter" broadly. Code Section 6661(b) (2) (C) (ii) provides:

(i) TAX SHELTER—For purposes of clause (i), the term "tax shelter" means—

(ii) a partnership or other entity,

(iii) any investment plan or arrangement, or

(iv) any other plan or arrangement, if the principal purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.

Since any plan or arrangement whose principal purpose is the avoidance or evasion of tax constitutes a tax shelter for purposes of the penalty, the stated definition reaches far beyond what most practitioners and laymen would consider tax shelter investments. The definition would include not only limited partnerships and other ventures which "shelter" otherwise taxable income by creation of tax deductions and credits in excess of cash invested or income derived, but also any transaction or arrangement in which the tax benefits can be characterized as the principal purpose of the transaction or arrangement exceeding any other purposes. Thus "tax shelter" for purposes of the understatement penalty would include such transactions as corporate reorganizations, sales of property, and charitable contributions if the underlying tax motivations in these transactions can be characterized as their principal purpose.

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14 Cf., Code Section 6661(b) (2) (C) (i) (I). 1982 S. Rep. at 274.


16 Code Section 6661(b) (2) (C) (i). The proposed regulations quantify "more likely than not" as a conclusion that "there is a greater than 50 percent likelihood that the tax treatment will be upheld in litigation if challenged by the Internal Revenue Service." Prop. Treas. Reg. § 1.6661-5(d).

17 See generally 1983 Joint Com. Staff Report, supra. Cf., Rev. Proc. 74-17, 1974-1 C.B. 43 (IRS will not rule on classification of limited partnerships as partnerships for tax purposes if aggregate deductions to be claimed by the partners over the first two years exceed the amount of equity capital invested in the partnership). Another generally accepted definition of "tax shelter" is that contained in Treas. Dept. Circular 230, supra.

In any case where there has been a disallowance of a deduction or credit for overvaluation as is often the case in tax shelter cases, the Service may also consider imposition of the valuation overstatement penalty under Section 6659. However, the valuation overstatement penalty and the substantial understatement penalty are mutually exclusive in that the Service may not

that if any person acquires control of a corporation and "the principal purpose" of such acquisition is avoidance of federal tax by securing the benefit of a deduction, credit or other allowance which such person would otherwise not enjoy, then the Service may disallow such deduction, credit or allowance. Reg. § 1.269-3(a) provides that: "If the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose." Under Section 269, the issue of principal purpose is one of fact with the burden on the taxpayer to prove some other principal purpose, e.g., a business purpose, other than tax avoidance. See e.g., Capril, Inc. v. Commissioner, 65 T.C. 162, 178 (1975); Brumley-Donaldson Company v. Commissioner, 443 F. 2d 501 (5th Cir. 1970).

The "principal purpose" test of tax shelter under Code Section 6661 is also limited in one sense. The proposed regulations provide that a legitimate utilization of tax benefits provided under the Code which might otherwise be characterized as a tax shelter by reference to the principal purpose test will not be a "tax shelter" for purposes of the understatement penalty if the tax shelter benefits are "consistent with Congressional purpose." Prop. Treas. Reg. § 1.6661-5(b)(2). For example, a plan or arrangement will not be considered to have as its principal purpose the avoidance or evasion of federal income tax merely as a result of the following uses of tax benefits provided by the Internal Revenue Code: the claiming of the investment tax credit under Code Section 38; the purchase or holding of an obligation bearing interest which is excluded from gross income under Code Section 103; entering into a safe harbor lease transaction under Code Section 168(f)(8); taking an accelerated cost recovery system (ACRS) allowance under Code Section 168; taking the percentage depletion allowance under Code Section 613 or Code Section 613A; or deducting intangible drilling and development costs as expenses under Code Section 263(c).

Thus a partnership, plan, or arrangement which legitimately provides some "sheltering" of income by reference to one of the foregoing sections would not be a "tax shelter" for purposes of the understatement penalty. On the other hand the qualification may be a distinction without a difference since any utilization of tax benefits "consistent with Congressional purpose" would seem to necessarily presuppose that the tax benefits claimed are legitimate and therefore would not be disallowed on audit and not give rise to any understatement of tax subject to the penalty.

See, e.g., Estate of Franklin v. Commissioner, supra; Brannen v. Commissioner, supra; Anselmo v. Commissioner, supra. See Rev. Rul. 82-224, 1982-2 C.B. 5. In Revenue Ruling 82-224, a tax shelter investor was held subject to a § 6659 penalty for underpayment of tax attributable to valuation overstatement on the ground that the cost basis of the tax shelter asset, as stated in the shelter's promotional literature, exceeded 250% of the amount determined to be the correct value. Relying on § 483 which deals with allocation between interest and principal of promissory notes bearing no stated interest, the ruling arrived at the correct value by discounting to present value the principal-only recourse indebtedness financing the asset. See id. Cf., Caruth v. United States, 566 F. 2d 901 (5th Cir. 1978) noninterest-bearing notes on sale of property were "indefinite" and thus not subject to valuation by use of simple discounting procedures).

Code Section 6659 provides:

SEC. 6659. ADDITION TO TAX IN THE CASE OF VALUATION OVERSTATEMENTS FOR PURPOSES OF THE INCOME TAX

(a) ADDITION TO THE TAX-IF-

(1) an individual, or

(2) a closely held corporation or a personal corporation,

has an underpayment of the tax imposed by Chapter 1 for the taxable year which is attributable to valuation overstatement, then there shall be added to the tax an amount equal to the applicable percentage of the underpayment so attributable.

(b) APPLICABLE PERCENTAGE DEFINED—For purposes of subsection (a), the applicable percentage shall be determined under the following table:
impose both penalties for the same overvaluation.\textsuperscript{21}

Section 6659 is a no fault penalty in the sense that it cannot be avoided by a showing of substantial authority, adequate disclosure or other safe harbor as with the substantial understatement penalty though the Service has a discretion to waive the penalty in cash where the taxpayer had a reasonable basis for the valuation claimed and acted in good faith.\textsuperscript{22} It is also a more onerous penalty rising to as much as 30\% depending on the degree of overvaluation.\textsuperscript{23} On the other hand, the penalty is also somewhat limited in that it does not apply in cases of property held by a taxpayer for more than five years.\textsuperscript{24}

### B. Aiding and Abetting Penalty

The aiding and abetting penalty was enacted by TEFRA in Code Section 6701\textsuperscript{25} to provide a "civil counterpart" to the criminal aiding and abetting

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<tr>
<th>If the valuation claimed is</th>
<th>The applicable percentage is:</th>
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<tbody>
<tr>
<td>the following percentage of</td>
<td></td>
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<tr>
<td>the correct valuation—</td>
<td></td>
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<tr>
<td>150 percent or more but not more than 200 percent</td>
<td>10</td>
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<tr>
<td>More than 200 percent but not more than 250 percent</td>
<td>20</td>
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<tr>
<td>More than 250 percent</td>
<td>30</td>
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(c) VALUATION OVERSTATEMENT DEFINED—

(1) IN GENERAL—For purposes of this section, there is a valuation overstatement if the value of the property, or the adjusted basis of any property, claimed on any return is 150\% or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be).

(2) PROPERTY MUST HAVE BEEN ACQUIRED WITHIN LAST 5 YEARS—This section shall not apply to any property which, as of the close of the taxable year for which there is a valuation overstatement, has been held by the taxpayer for more than 5 years.

(d) UNDERPAYMENT MUST BE AT LEAST $1,000—This section shall not apply if the underpayment for the taxable year attributable to valuation overstatements is less than $1,000.

(e) AUTHORITY TO WAIVE—The Secretary may waive all or any part of the addition to the tax provided by this section on a showing by the taxpayer that there was a reasonable basis for the valuation or adjusted basis claimed on the return and that such claim was made in good faith.

(f) OTHER DEFINITIONS—For purposes of this section—

(1) UNPERPAYMENT—The term "underpayment" has the meaning given to such term by section 6653(c) (1).

(2) CLOSELY HELD CORPORATION—The term "closely held corporation" means any corporation described in section 465(a) (1) (C).

(3) PERSONAL SERVICE CORPORATION—The term "personal service corporation" means any corporation which is a service organization (within the meaning of section 414(m) (3). See generally Siegel, supra.

\textsuperscript{21} Code Section 6661(b) (3).

\textsuperscript{22} Code Section 6659(e).

\textsuperscript{23} It is equal to the understatement penalty (10\% of underpayment) for any overvaluation of 150\% to 200\% of the correct value, but rises to 20\% for overvaluations between 200\% and 250\% and 30\% for any overvaluation in excess of 250\% of the correct valuation. Code Section 6659(b).

\textsuperscript{24} Code Section 6659(c) (2).

\textsuperscript{25} Sec. 6701. Penalties for Aiding and Abetting Understatement of Tax Liability.

(a) Imposition of Penalty - Any person—
statute, Code Section 7206(2).\textsuperscript{26} It provides more flexibility in the penalty structure by enacting a penalty applicable to those who are not themselves the taxpayer but who nonetheless assisted taxpayers in noncompliance.\textsuperscript{27} The penalty is $1,000 or $5,000 in the case of tax liability of a corporation and is

(1) who aids or assist in, procures, or advises with respect to, the preparation or presentation of any portion of a return, affidavit, claim, or other document in connection with any matter arising under the internal revenue laws,

(2) who knows that such portion will be used in connection with any material matter arising under the internal revenue laws, and

(3) who knows that such portion (if so used) will result in an understatement of the liability for tax of another person,

shall pay a penalty with respect to each such document in the amount determined under subsection (b).

(b) Amount of Penalty—

(1) IN GENERAL—Except as provided in paragraph (2), the amount of the penalty imposed by subsection (a) shall be $1,000.

(2) CORPORATIONS—If the return, affidavit, claim, or other document relates to the tax liability of a corporation, the amount of the penalty imposed by subsection (a) shall be $10,000.

(3) ONLY 1 PENALTY PER PERSON PER PERIOD—If any person is subject to a penalty under subsection (a) with respect to any document relating to any taxpayer for any taxable period (or where there is no taxable period, any taxable event), such person shall not be subject to an penalty under subsection (a) with respect to any other document relating to such taxpayer for such taxable period (or event).

(c) ACTIVITIES OF SUBORDINATES—

(1) IN GENERAL—For purposes of subsection (a), the term “procures” includes—

(A) ordering (or otherwise causing) a subordinate to do an act, and

(B) knowing of, and not attempting to prevent, participation by a subordinate in an act.

(2) SUBORDINATE—For purposes of paragraph (1), the term “Subordinate” means any other person (whether or not a director, officer, employee, or agent of the taxpayer involved) over whose activities the person has direction, supervision, or control.

(d) TAXPAYER NOT REQUIRED TO HAVE KNOWLEDGE—Subsection (a) shall apply whether or not the understatement is with the knowledge or consent of the persons authorized or required to present the return, affidavit, claim, or other document.

(e) CERTAIN ACTIONS NOT TREATED AS AID OR ASSISTANCE—For purposes of subsection (a) (1), a person furnishing typing, reproducing, or other mechanical assistance with respect to a document shall not be treated as having aided or assisted in the preparation of such document by reason of such assistance.

(f) PENALTY IN ADDITION TO OTHER PENALTIES—

(1) IN GENERAL—Except as provided by paragraph (2), the penalty imposed by this section shall be in addition to any other penalty provided by law.

(2) COORDINATION WITH RETURN PREPARER PENALTIES—No penalty shall be assessed under subsection (a) or (b) of section 6694 on any person with respect to any document for which a penalty is assessed on such person under subsection (a).

\textsuperscript{26} 1982 S. Rep. at 275. Under the criminal statute it is a felony punishable by imprisonment or fine (up to $100,000) for any person to willfully aid, assist, procure, counsel or advise as to the preparation of a false or fraudulent return, affidavit, claim or other document under the internal revenue laws. Code Section 7206(2). See, e.g., United States v. Crum, 529 F. 2d 1380 (9th Cir. 1972); United States v. Williams, 644 F. 2d 696 (8th Cir. 1981).

\textsuperscript{27} 1982 S. Rep. at 275. Prior to enactment of Code Section 6701, the only civil penalty applicable to third parties were the penalties under Section 6694 providing penalties applicable to tax return “preparers”. Since the penalties are concurrent in scope as to return preparers, the penalty under Section 6701 may not be applied to any preparer who has been assessed a penalty under Section 6694. Code Section 6701(f) (2).
contested in federal district court in accordance with the provisions of Code Section 6703.28

The penalty applies to "any person who aids or assists in, procures, or advises with respect to, the preparation or presentation of any portion of a return, affidavit, claim or other document in connection with any matter arising under the internal revenue law."29 Thus, the penalty would reach advisors such as attorneys, accountants and appraisers who prepare valuation reports for use in determining a taxpayer's tax liability.30

On the other hand, the penalty is limited in application by the requirements that the person charged with aiding and abetting (1) "actually know" that the document as to which he advised or aided in preparation will be used in connection with a material matter under the internal revenue laws, and (2) "actually know" that the subject document, if used, will result in the understatement of tax.31 However, note that a third-party advisor who may escape liability for penalty under Section 6701 because of the scienter requirement may nonetheless be subject to the abusive tax shelter promoter penalty under Section 6700.32

The Tax Reform Act of 1984 amended Code Section 7408 to make conduct subject to penalty under Section 6701 a ground for injunction under Section 7408.33 The amendment was intended to make clear that actionable conduct for purposes of injunctive relief under Section 7408 should not be limited to only acts during the organization and sale phase of an abusive tax shelter but should include actions by the promoter after the organization and sale as well (E.G., filing false partnership returns).34 The legislative history points out that the amendment to include Section 6701 as actionable conduct under Section 7408 should not be viewed as restricting the scope of 7408 to "promoter activities alone".35 By including within the scope of actionable conduct under Section 7408 aiding and abetting under Section 6701 the amendment expands the scope of Section 7408 beyond the promoters and others who directly make or furnish actionable statements for purposes of 6700 to include those who indirectly participate by aiding and abetting in the

28 Code Section 6701(b). See Code Section 6703. Section II A. [5], supra.
29 Code Section 6701(a) (1).
30 See Joint Com. Explanation, at 221. Moreover, the penalty is not limited in application to only assistance in filing a return. Rather, it reaches assistance in connection with "any matter arising under the internal revenue laws." It therefore could be construed to reach assistance to a taxpayer rendered in the audit process or in litigation. Id.
32 Under Code Section 6700 anyone assisting in the organization or sale of "any plan or arrangement" who makes or furnishes one of the two types of prohibited statements would be liable for the penalty. See Section II. A., supra. The false or fraudulent statement under Section 6700 requires only proof that the person have "reason to know" rather than actual knowledge as required under Section 6701, and there is no requirement of knowledge as to a gross valuation overstatement under Section 6701. See Section , supra.
33 Tax Reform Act of 1984 § 143.
abusive tax shelter. Indeed, the inclusion of Section 6701 conduct in Section 7408 expands the scope of injunctive relief under Section 7408 to reach any conduct resulting in understatement of tax whether or not related to a "tax shelter".

On the other hand, this amendment may be of limited effect given the strict scienter requirement under Section 6701. With the burden of proof on the government to establish actual knowledge, liability under Section 6701 will be in many cases difficult to establish where reliance on others or other defenses can be demonstrated to negate knowledge or specific intent.

36 Id. Compare the scope of liability under Section 6700 discussed above at Section II. A. [4] [a].
37 Id. Cf. Code Section 7407 (injunction authority for abusive activities of return preparers).
38 See United States v. Ernst & Whinney, F. 2d (11th Cir. 1984).
39 Compare Section 6700. The false or fraudulent statement under Section 6700 requires only proof that the person have "reason to know" rather than actual knowledge as required under Section 6701, and there is no requirement of knowledge as to a gross valuation overstatement under Section 6700. See Section II. A. [4] [a], supra.