

PROMOTERS, PREPARERS, INJUNCTIONS, PENALTIES
Nicholas J. Richards, Esq.

INVESTIGATIONS

- A. Promoter and preparer investigations begin when an individual is referred to the Lead Development Center in Laguna Niguel, California for investigation.
- a. Some evidence that the promoter or preparer could be in violation of I.R.C. § 6700 or 6701
 - b. Deconfliction process with Criminal Investigation (CI) and other IRS functions
 - c. Preliminary research
 - d. Counsel review
 - e. Authorization to the field
- B. Authorized investigations are assigned to an Abusive Transactions Revenue Agent or Officer. Upon receiving the case, the RA/RO is informed if the case is a parallel investigation and coordination is necessary with Criminal Investigation. Because the primary objective is to enjoin the promoter/preparer from offering (ie. Speaking about) the product or services, the First Amendment must be considered.
- a. **Parallel Investigation** – begins with a “six way conference” involving the revenue agent, manager, special agent, supervisory special agent, criminal tax counsel and IRS counsel. Other necessary parties could include a DOJ Attorney, Fraud Technical Advisor and Revenue Officer.
 - i. The parties will agree on a process for the civil side to keep the special agent informed, provide information, evidence, and witness statements so to comply with the Federal Rules (i.e. FRCP 16, Brady v. Maryland, 373 U.S. 83 (1963); Giglio v. United States, 405 U.S. 150 (1972); 18 U.S.C. § 3500 “The Jencks Act”).
 - ii. Subject to the limitations as to Grand Jury Material, under FRCP 6(e), Civil will also request that CI share information, including any client list that has been secured.
 - iii. Other matters that need to be discussed are issuance of Summons, audit of participants, timing of investigative steps, and Tweel concerns. United States v. Tweel, 550 F.2d 297 (5th Cir. 1977)

- b. **First Amendment** - Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the government for a redress of grievances. Injunctions are classic “prior restraints” on the freedom of speech. Alexander v. U.S., 509 U.S. 544, 550 (1993); New York Times Co. v. U.S., 403 U.S. 713 (1971)¹. First Amendment protection, however, does not simply attach because the conduct the government seeks to prevent is carried out through written or spoken language. Giboney v. Empire Storage & Ice. Co., 336 U.S. 490 (1949). To qualify as “protected speech” and gain Constitutional protection, the speech must not be commercial, aid or abet a criminal act nor incite imminent lawlessness.
- i. Protected Speech – the First Amendment protects the expression of ideas irrespective of what they are or the medium by which they are expressed. United States v. Stewart, 336 F. Supp. 299, 302 (E.D. Pa. 1971). Protected speech includes statements and discussions about the tax laws whether or not they are true. New Orleans S.S. Ass’n v. General Long Shore Workers, 626 F.2d 455, 462 (5th Cir. 1980); Abdo v. IRS, 234 F. Supp. 2d 553, 567 (M.D.N.C. 2002)
1. Free Speech - The right to give a speech, publish a book, pamphlet, website or video tape promoting or explaining a particular point of view. Includes the right to promote a frivolous constitutional argument, regardless how ridiculous the argument might be. Virginia v. Black, 538 U.S. 343, 358 (2003); Griswold v. Connecticut, 381 U.S. 479, 482 (1965).
 2. Free Association - The right to gather together, publicly or privately, and discuss a promoter’s frivolous constitutional argument. Freeman v. City of Santa Ana, 68 F.3d 1180, 1188 (9th Cir. 1995).
 - a. The right of Free Association can prevent the IRS from issuing summonses for participants of promoters who are engaged in protected speech and are not promoting a plan or arrangement.

1. An injunction may issue without resort to the traditional equitable prerequisites requiring the court to balance the harms, likelihood of success on the merits, and public interest, if a statute expressly authorizes the injunction. Time Warner Entm’t/Advance-Newhouse P’ship v. Worldwide Elecs., L.C., 50 F. Supp 2d 1288 (S.D. Fla. 1999); Burlington N.R.R. Co. v. Department of Revenue, 934 F.2d 1064 (9th Cir. 1991). Because both Section 7407 and 7408 authorize injunctions, injunctive relief relies on the factors identified in each individual section. U.S. v. Ernst & Whinney, 735 F.2d 1296 (11th Cir. 1984).

ii. Unprotected Speech

1. Commercial Speech - The First Amendment permits the government to regulate expression “related solely to the economic interests of the speaker and its audience.” Central Hudson Gas & Elec. Corp. v. Public Serv. Comm’n of New York, 447 U.S. 557, 561 (1980). The factors used to determine whether speech is commercial include whether (1) the speech is an advertisement; (2) the speech refers to a specific product or service; and (3) the speaker has an economic motivation for the speech. U.S. v. Bell, 414 F.3d 474, 479 (3rd Cir. 2005). Most promoter investigations involve commercial speech.
 - a. The connection between the speech and commercial interest must be more than the mere sale of the speech itself.
 - b. The fact that false statements within a book, video, or speech, are sold, does not make them commercial speech.
 - c. Speech which includes a plan, arrangement, the formation of an entity, specific tax advice such as forms, instructions or sample court pleadings, constitutes commercial speech that may be banned. U.S. v. Estate Preservation Servs., 202 F.3d 1093 (2000).
2. Aiding and Abetting - Speech that aids or abets illegal conduct – for example, conspiracy or tax fraud – is not protected by the First Amendment. Village of Hoffman Estates v. Flipside, Hoffman Estates, Inc., 455 U.S. 489 (1982). Return preparers who prepare abusive returns are actually engaged in conduct which is unprotected by the First Amendment. Madigan v. Telemarketing Assocs., 123 S.Ct 1829 (2003).
 - a. Tax advice which includes instructions on tax evasion, falls into this context, if it aids or abets criminal activity. U.S. v. Buttorff, 572 F.2d 619 (8th Cir. 1978).
 - b. Most tax promotions which fall into this category are also commercial speech.

3. Imminent Lawlessness – Speech which is delivered in a way that incites others to *imminent* lawlessness. Brandenburg v. Ohio, 395 U.S. 444 (1969).
 - a. In the tax-law context, imminence can require that at the time of the speech the audience is actually fill out false forms.
 - b. Some courts might even require that the forms are filed at the same time under the imminence standard.
- iii. Mixed Speech “Cloaking” – if a promoter is using protected speech to promote tax products, the arrangement is commercial in nature and subject to an injunction. United States v. Schiff, 379 F.3d 621 (9th Cir. 2004), affirming 269 F. Supp 2d 1262 (D. Nev. 2003).
 1. If removal of the commercial element will change the protected speech, both are protected under the First Amendment. Riley v. National Federation of the Blind of North Carolina, Inc. 487 U.S. 781 (1988).
 2. If a promoter removes the false commercial speech from the protected speech, it can regain its status as protected speech even if it contained false tax theories. Schiff, at 629.
 3. Injunctions involving mixed speech must be carefully drafted so to avoid impacting protected speech. U.S. v. Kaun, 827 F.2d 1144 (7th Cir. 1987).
- c. **Client Lists** – the IRS will go to summons enforcement to obtain promoter materials and client lists and will put the clients under audit.
 - i. Section 7602(a)(1) authorizes the IRS “[t]o examine any books, papers, records, or other data which may be relevant or material” to “ascertaining the correctness of any return, making a return where none has been made, . . . or collecting any such liability.” I.R.C. § 7602(a)(1). To meet the test of relevancy, the IRS must show only that the information sought by summonses “might throw light upon the correctness of the return[s],” by demonstrating “in the particular circumstances an indication of a realistic expectation rather than an idle hope that something may be discovered.” United States v. Goldman, 637 F.2d 664, 667 (9th Cir. 1980) (quoting United States v. Harrington, 388 F.2d 520, 524 (2d Cir. 1968)); see United States v. Arthur Young & Co., 465 U.S. 805, 813-15 & n.11 (1984).

- ii. United States v. Powell, 379 U.S. 48 (1964). Under Powell, the Service need only show (1) that the investigation is being conducted pursuant to a legitimate purpose; (2) that the summoned materials are relevant to that investigation; (3) that the information sought is not already within the Service's possession; and (4) that the administrative steps required by the Internal Revenue Code have been followed. *Id.* at 57-58.
 1. The Powell requirements are generally met by the submission of affidavits by Service agents involved in the investigation asserting that the requirements are met and showing proper purpose, relevance and compliance with the administrative steps. Liberty Financial Services, Inc. v. United States, 778 F.2d 1390, 1392 (9th Cir. 1985).
- iii. First Amendment – as mentioned above, a request for a client list, in the absence of a plan or arrangement (commercial speech), can “chill” the clients right to free association and could be in violation of the First Amendment. U.S. v. Fox, 721 F.2d 32, 40 n.6 (2nd Cir. 1983); U.S. v. Traders State Bank, 695 F.2d 1132 (9th Cir. 1983); U.S. v. Citizens State Bank, 612 F.2d 1091 (8th Cir. 1980).

INJUNCTIONS

When an investigation is initiated, the primary objective is to stop the abuse through a Section 7407 or 7408 injunction.

- A. **Section 7408** - empowers a district court to grant an injunction if a promoter or preparer has (1) engaged in conduct subject to penalty under IRC § 6700, 6701, 6707 or 6708 and (2) injunctive relief is appropriate to prevent recurrence of such conduct. U.S. v. Gleason, 432 F.3d 678 (6th Cir. 2005). The government bears the burden of proving each element by a preponderance of the evidence. Franklet v. U.S., 578 F. Supp. 1552 (N.D. Cal. 1984).
 - a. Section 6700 – to enjoin a promoter the government must prove the promoter (1) organized or sold, or participated in the organization or sale of, an entity, plan, or arrangement; (2) made or caused to be made, false or fraudulent statements concerning the tax benefits derived from the entity, plan, or arrangement; (3) knew or had reason to know the statements were false or fraudulent; (4) the false or fraudulent statements pertained to a material matter; and (5) an injunction is necessary to prevent recurrence of this conduct.
 1. The penalty amount is \$1000 or the lesser of 100% of the gross income derived (or to be derived) from the activity.

- i. Participated in the organization or sale - any direct or indirect participation in a plan or arrangement having some connection to taxes satisfies this element. U.S. v. Raymond, 228 F.3d 804, 811 (7th Cir. 2000); Gates v. U.S., 874 F.2d 584 (8th Cir. 1989).
 - ii. False Statement – whether the statement directly addresses the availability of tax benefits or concern factual matters relevant to the availability of benefits, this element is satisfied if the court determines they are impermissible. U.S. v. Campbell, 897 F.2d 1317, 1320 (5th Cir. 1990).
 - iii. Knew or had reason to know – actual knowledge or what a reasonable person in the promoter’s subjective position would have known so long as it is commensurate with the level of comprehension required by the speaker's role in the transaction. Sanders v. U.S., 509 F.2d 162 (5th Cir. 1975).
 - iv. Material matter – A matter is considered material if its veracity, and thus the potential for future conflict with the IRS, would have a substantial impact on the decision-making process of a reasonably prudent investor. U.S. v. White, 769 F.2d 511 (8th Cir. 1985).
 - v. Necessary to prevent recurrence - factors used to determine the likelihood of recurrence include: (1) the gravity of the harm caused by the offense; (2) the extent of the promoter's participation; (3) the degree of scienter; (4) the isolated or recurrent nature of the infraction; (5) the promoter's recognition (or non-recognition) of his own culpability; and (6) the likelihood of future violations. U.S. v. Estate Preservation Servs., 202 F.3d at 1105.
- b. Section 6701 – to enjoin a preparer the government must prove the preparer (1) aided or assisted, procured, or advised in (2) the preparation or presentation of any portion of a return, affidavit, claim or other document (3) knew, or had reason to know, that such portion would be used in connection with a material matter arising under the internal revenue laws and (4) if so used would result in an understatement of the liability for tax of another. U.S. v. Baxter, 372 F. Supp. 2d 1326 (M.D.Ala. 2005).
1. The penalty amount is \$1000 in the case of a return pertaining to an individual and \$10,000 for a return pertaining to a corporation.

- c. Section 6707 – a material advisor is subject to an injunction if the government proves the individual (a) provided advice regarding a reportable transaction and (b) failed to disclose the appropriate information on a filed return.
 - i. Material Advisor – any person who aids, assists or advises with respect to managing, promoting, selling, implementing, insuring or carrying out any reportable transaction and (2) directly or indirectly derives income in excess of applicable thresholds.
 - ii. Required disclosure – the return must set forth (1) the information identifying and describing the transaction (2) information describing any potential tax benefits expected to result from the transaction, and (3) such other information as the Secretary may prescribe.
 - iii. Reportable transaction – one which the Secretary determined, or is substantially similar to one the secretary determined, as having a potential for tax avoidance or evasion.
 - iv. Penalty amount - \$50,000 or if the reportable transaction is a listed transaction the greater of \$200,000 or 50% of the gross income derived by the person failing to disclose (75% if intentional failure).

- d. Section 6708 – a material advisor is also subject to injunction if he fails to provide the list required under Section 6112(a) to the IRS within 20 days after a written request.
 - i. 6112(a) requires a material advisor to maintain a list identifying each person with respect to whom such advise was given. The list must include:
 - 1. The name of each reportable transaction and the reportable transaction number obtained under IRC § 6111.
 - 2. The name, address, and TIN of each participant.
 - 3. The date on which each participant entered into the transaction.
 - 4. The amount invested in the transaction by each participant.
 - 5. A summary of the tax treatment that each participant is intended or expected to derive from participation in the transaction.
 - 6. The names of other material advisors to the transaction.

7. A copy of any designation agreement to which the material advisor is a party.
 8. Copies of written materials, including tax analyses or opinions, relating to the transaction that are material to an understanding of the purported tax treatment or tax structure of the transaction that have been shown or provided to any person who acquired or may acquire an interest in the transaction (or to that person's representatives, tax advisors, or agents) by the material advisor or any related party or agent of the material advisor.
- ii. Penalty amount - \$10,000 per day, with no maximum penalty, if the person required to maintain a list under IRC § 6112 does not provide it within 20 business days upon written request of the IRS. The penalty (post AJCA) is applicable to requests made after October 22, 2004, the date of enactment.
 - iii. Reasonable cause provides an exception from imposition of the penalty.

B. **Section 7407** - empowers a district court to grant an injunction if a preparer has (1) engaged in conduct subject to penalty under Section 6694 or 6695; (2) engaged in conduct subject to criminal penalty (3) misrepresented his eligibility to practice before the IRS (3) guaranteed the payment of a tax refund; or (4) engaged in fraudulent or deceptive conduct which substantially interferes with the proper administration of the Internal Revenue Code.

- a. Section 6694 - subjects a tax return preparer to penalty for knowingly asserting frivolous positions that do not have a realistic possibility for being sustained on the merits. Under this statute, the United States has to prove that (1) there was an unrealistic position taken in respect to any return or claim for refund; (2) defendant knew or reasonably should have known about this position; and (3) such position was frivolous. See U.S. v. Bailey, 789 F. Supp. 788 (N.D. Tex., 1992). Abdo v. U.S., 234 F.Supp.2d 553 (M.D.N.C. 2002).
- b. Section 6695 - penalizes a tax return preparer for failing to comply with Section 6107(b) requiring return preparers to maintain client returns for three years after the close of the return period and to allow the government to inspect them upon request.

C. **Section 7402** – “Catch All” - In addition to the summons enforcement authority granted to the District Courts, Section 7402 also grants the authority to issue in civil actions, writs and orders of injunction..., and such other orders, and

processes, and to render such judgments and decrees as may be necessary of appropriate for the enforcement of the internal revenue laws.

- a. The language of Section 7402(a) encompasses a broad range of powers necessary to compel compliance with the tax laws and, therefore, it can be used to enjoin interference with tax enforcement even when such interference does not violate any particular tax statute. United States v. Ernst & Whinney, 735 F.2d 1296, 1300 (11th Cir.1984).
- b. Section 7402 has historically been used to prevent individuals from harassing IRS employees by filing liens, etc., against them. United States v. Ekblad, 732 F.2d 562 (7th Cir.1984); United States v. Hart, 701 F.2d 749 (8th Cir.1983); Ryan v. Bilby, 764 F.2d 1325, 1327 (9th Cir.1985).
- c. Section 7402 is also used to impose additional requirements on individuals found subject to injunction under Section 7408. Examples include posting a copy of the injunction on the individual's website. Schiff, 379 F.3d at 630-631 (9th Cir.2004).
 - i. The government may impose reasonable regulations on content to prevent future deception. Zauderer v. Office of Disciplinary Counsel of the Supreme Ct. of Ohio, 471 U.S. 626, 650-51, 105 S.Ct. 2265, 85 L.Ed.2d 652 (1985).
- d. A mandatory disclosure of factual, commercial information does not offend the First Amendment. Highmark, Inc. v. UPMC Health Plan, Inc., 276 F.3d 160, 165 (3d Cir.2001).

PENALTIES ONLY

Some investigations are not appropriate for an injunction but are appropriate for imposition of an IRC § 6700 or 6701 penalty. Examples include situations where the promoter is no longer engaged in prohibited conduct; there are an insufficient number of participants to show a significant tax loss to the government, legislative changes have occurred resulting in the cessation of the promotion, etc.

OTHER TOOLS THE IRS MAY CONSIDER

- A. **Extended Statute of Limitations** under IRC § 6501(c)(10) – Non-Disclosed Listed Transactions. SOL for assessing tax against a participant with respect to the listed transaction extended for one year after disclosure if SOL was open as of October 22, 2004. See Rev. Proc. 2005-26.
- B. **Reportable Transaction Understatement Penalty** under IRC § 6662A – Assessed against participants. 20% of the understatement due to a reportable

transaction with a significant tax avoidance purpose if disclosed, and 30% of the understatement if not disclosed.

C. **IRC § 6707A Penalty** for Failure to Include Reportable Transaction Information with Return - Assessed against participants.

a. Taxpayers who fail to disclose reportable transactions in which they participated are subject to a penalty of \$10,000. If the taxpayer who fails to report is not a natural person, the penalty is increased to \$50,000.

i. If the failure was to report a Listed Transaction, the penalties increase to \$50,000 and \$200,000, respectively.

D. **Circular 230** sanctions and referrals to OPR. Sanctions now include censure, suspension, disbarment and monetary penalties.

E. **E-filing Privileges**, sanctions and revocation of privileges.

a. Revenue Procedure 2007-40 and Pub. 3112 (11/2004) govern current e-filing procedures and potential sanctions for all return preparers who are authorized e-file providers.

b. Reasons for sanctions are listed in Pub. 3112, pp 15, 27.

c. Sanctions include written reprimand, suspension, and expulsion.

d. Levels of infraction – sanctions are determined by reference to the level of abuse. Level 1 results in a reprimand; level 2 results in a limitation on authorized use or suspension for the current year and one year; level 3 results in a suspension for two years plus the remainder of the current year or permanent expulsion from the program (see Pub. 3112, page 28).

e. Preparers who are sanctioned may seek administrative appeal of any sanction determination (see Rev. Proc. 2007-40, sec. 8).

f. Preparers who are enjoined from preparing returns may be sanctioned. The LDC will recommend the appropriate sanction to the Andover Service Center.

g. Revocation of e-filing privileges (Rev. Proc. 2007-40, sec. 9).

i. Preparers who have been enjoined from filing returns may be denied an e-filing application or may have their e-filing privileges revoked.

- ii. A preparer who has been enjoined and who is subsequently subject to the revocation process does not have a right to appeal the revocation decision, unlike preparers who are sanctioned.
- iii. If an injunction expires at a later date or is overturned on reconsideration or appeal, the preparer may reapply for e-filing privileges at that time.