

M. APPLICATION OF IRC 6700 AND IRC 6701 TO CHARITABLE CONTRIBUTION DEDUCTIONS

by

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1. Introduction

Under the Tax Equity and Fiscal Responsibility Act of 1982, Congress enacted IRC 6700 and IRC 6701 as penalties for the abuse of tax shelters. IRC 6700 imposes a penalty on anyone -- promoters, salesmen and their assistants -- for organizing and selling abusive tax shelters. IRC 6701 is the aiding and abetting provision, and it imposes a penalty on those who aid and assist in the preparation of false or fraudulent tax documents that would result in an understatement of tax liability.

These two provisions are not limited to tax shelter situations, but could be applicable in the exempt organizations area. Charities often receive gifts of cash or property from contributors so that they may carry out their charitable endeavors. IRC 170(c) provides that such contributions are tax deductible for federal income tax purposes provided that certain requirements are met. One requirement, under IRC 170(f)(8)(A), is that a contribution of \$250 or more, whether in cash or property, is tax deductible only if that contributor has a contemporaneous written acknowledgment from the donee organization. If the contribution involves a "quid-pro-quo" contribution the acknowledgement must contain this information as well. (See 1997 CPE, Updates on Disclosure and Substantiation Rules, p. 67 for further discussion of this provision. A quid pro-quo contribution is a payment made partly as a contribution and partly as payment for goods or services provided to the contributor.)

Charities may negligently or intentionally provide inaccurate information to a contributor concerning the monetary value of gifts made. Charities in other instances may provide erroneous information to indicate that a quid pro quo contribution is fully tax deductible when in fact no full deduction would be permitted. Continued misrepresentations about these matters raise the possibility that the penalty provisions of IRC 6700 and IRC 6701 could come into play.

This article will discuss the application of IRC 6700 and 6701 to charities that provide erroneous information concerning the deductibility of charitable contributions. (For discussion of other situations where IRC 6700 and IRC 6701 may apply, see the Donor Directed Funds and VEBA articles in this CPE text). This article will begin with the background of IRC 6700 and IRC 6701. It will follow with an overview of the statutory elements thereof and the application of these provisions to specific situations.

2. Background of IRC 6700 and IRC 6701

Tax shelters are devices used by taxpayers to reduce or defer payment of taxes, such as deductions and credits against federal income tax liability. See Black's Law Dictionary (5th ed. 1979). IRC 6700 and IRC 6701 were enacted in an effort to curb perceived and actual abuses of tax shelters. The rationale was that the best way to end abuses was to go after the promoters, salesmen, and marketers who organize and sell abusive arrangements and those who assist them in carrying out such activities.

3. Basic Statutory Framework of IRC 6700

IRC 6700(a) provides that any person who

- (1) a. organizes (or assists in the organization of) a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, or

b. participates (directly or indirectly) in the sale of any interest in an entity or plan or arrangement referred to in a., and
- (2) makes or furnishes or causes another person to make or furnish (in connection with such organization or sale)--
 - a. a statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter, or
 - b. a gross valuation overstatement as to any material matter, shall pay, with respect to each activity described in paragraph (1), a penalty equal to the \$1,000 or, if the person establishes that it is lesser, 100 percent of the gross income derived (or to be derived) by such person from such activity.

Essentially, IRC 6700 is comprised of five elements, which must be demonstrated before a violation arises.

First, there must be a person (i.e. a promoter). Second, there must be a partnership, entity, investment plan, or arrangement (hereinafter "arrangement or plan") which is organized or sold. Third, the person (or his/her assistant) must make a false or fraudulent statement or a gross valuation overstatement of the tax benefit for which the arrangement or plan is designed to provide. Fourth, that person must know or have reason to know that the statement is false. Finally, the statement must be with respect to a material matter.

A. Definition of a Promoter

IRC 6700(a) provides that a promoter can be "any person." This includes individuals (such as organizers and sales persons), trusts, estates, partnerships, associations, companies, corporations and their officers, attorneys, accountants and financial advisors. See 7701(a)(1). Many organizational forms, such as an exempt organization fall within the meaning of "any person."

B. Definition of an Arrangement or Plan

IRC 6700 does not define "tax shelters" but specifies items subject to the provision: arrangements, plans, entities or partnerships. It does not provide definitions of these items. These items can include activities such as the sale of mail order ministries or the promotion of family trusts. (See General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982, Joint Committee on Taxation, 97th Cong., 2d Sess., p. 211 (1982)(hereinafter "General Explanation") and Tweeddale v. Commissioner, 501 U.T.C. 499 (1989)). For the promotion and sale of business trusts and alleged tax-exempt corporations, see U.S. v. Noske, 117 F.3d 1053 (8th Cir. 1997). For the lease of artwork, see U.S. v. Petrelli, 706 F. Supp. 122 (D.C. OH 1986). Many activities can be an arrangement or plan. With this broad intent of the statute, the issuance of acknowledgement statements by charities for receipt of contributions could be classified as an arrangement or plan.

C. Conduct Penalized Under IRC 6700

There are two distinct types of conduct to which IRC 6700 applies: (1) making a false or fraudulent statement; and (2) making a gross valuation overstatement. A statement can be oral as well as written. See, e.g. U.S. v. Buttorff, 563 F. Supp. 450 (N.D. Tex. 1983). A charity's acknowledgement statement would fall within the meaning of a statement under IRC 6700.

(1) False Statement

Under IRC 6700(a)(2)(A), a statement is false or fraudulent if it contains incorrect information that relates to the allowability of any deduction or credit, the excludability of any income, or the securing of any other types of tax benefit. A statement can be false as

to factual matters and/or the law or conclusions of the law -- specifically, the availability of benefits under the tax laws for such arrangement or plan.

a. Knowledge Requirement

Even if the information in a statement is false or fraudulent, the Service must show that a person (i.e. a promoter) has such knowledge. The Service may rely on objective and subjective evidence to show that the person knows or has reason to know that a statement is false. For example, a person's role in the organization, their educational level, and their work experience may indicate knowledge. See General Explanation, at p. 211.

b. No Reliance Requirement

The recipient of an acknowledgement statement (as well as participants, purchasers or investors of a tax shelter) need not rely on the information in the false statement for IRC 6700 to apply. See S. Rep. No. 97-494, Vol. 1, 97th Cong., 2d Sess., p. 267 (1982)(hereinafter "1982 Senate Report").

(2) Gross Valuation Overstatement

There are two requirements for a gross valuation overstatement. First, the stated value of a property or service must exceed twice the amount determined to be the correct valuation (fair market value). Second, the value of such property or service is directly related to the amount of the income tax deduction or credit allowable to a participant. The valuation must directly affect the amount of the tax deduction or credit allowable to the participant under the internal revenue laws.

a. No Knowledge Requirement

Note that, unlike a false or fraudulent statement, a person furnishing the gross valuation overstatement need not have knowledge that the valuation is overvalued. See 1982 Senate Report, at p. 266.

b. Waiver of Penalty

The Service can waive all or any part of the penalty for a gross valuation overstatement if there is a reasonable basis for the valuation and if the valuation is made in good faith. See IRC 6700(b)(2). However, the mere existence of an appraisal is not sufficient, by itself, to show either reasonable basis or good faith. Rather, the Service may examine the basis for the appraisal, the manner in which it was obtained, and the appraiser's relationship to the investment or promoter. See 1982 Senate Report, at p. 267.

D. Materiality

Both the false or fraudulent statement and gross valuation overstatement must relate to a material matter. A matter is material if it would have a substantial impact on the decision-making process of a reasonable, prudent person or investor. See 1982 Senate Report, at 267. An acknowledgement statement that contains false or fraudulent information as to the deductibility of contributions is material because such information would influence a person to take such a deduction.

4. Burden of Proof

The Service bears the burden of proving that a promoter made a false or fraudulent statement or a gross valuation overstatement. See IRC 6703(a). This burden must be sustained by a preponderance of the evidence. See Barr v. United States, 76 AFTR2d 95-550 (1995); Weir v. United States, 716 F. Supp. 574, 577 (N.D. Ala. 1989).

5. Penalty

The IRC 6700 penalty is to be applied per arrangement or per plan. See H.R. Rep. No. 247, 101st Cong. 1st Sess., 1397-98 (1989)(hereinafter "1989 House Report"). The amount of the penalty for activities that occurred on January 1, 1990, and thereafter is an amount equal to \$1,000 for each sale of an arrangement or plan. For example, a charity is subject to a penalty of \$1,000 for each false acknowledgement statement. However, if the charity (or promoter) can show it to be less, the amount would be 100 percent of the gross income derived or to be derived by the promoter (or sales person) from the activity. The burden of proving the dollar amount of the penalty is on the violator of IRC 6700. See In re Tax Refund Litigation, 766 F. Supp. 1248, 1264 (E.D.N.Y. 1991), aff'd in part and rev'd in part, 989 F.2d 1290 (2d Cir. 1993).

In calculating the amount of a penalty, each plan or sale, and not the overall activity of promoting such plan or sales, is subject to the penalty. If the promoter is entitled to a flat fee or commission, the penalty is easily computed. If the gross income is contingent or speculative, the Service may compute the penalty on the amounts which the promoter can reasonably be expected to realize. For the purpose of calculating the penalty on income "to be derived," a prospectus or other source of projected income may be used, but only if it is reasonably likely that the income would be received.

A. Coordination with IRC 6701

The penalty imposed by IRC 6700 is in addition to any other penalty provided by law, except the penalty under IRC 6701, aiding and abetting understatement of tax liability. If the Service assesses a penalty on a charity (or person) under IRC 6700, it cannot assess a penalty under IRC 6701 (or vice versa). See IRC 6701(f)(3).

6. Injunction

Where the Service wants to prevent the marketing or selling of arrangements or plans that are abusive tax shelters, an injunction under IRC 7408(a) is an effective tool to prohibit a promoter (and his/her sales persons) from further engaging in any conduct which is subject to IRC 6700. To get the injunction, the Service need only show that conduct falls within IRC 6700. See IRC 7408(a). If the court finds that the promoter has engaged in conduct that is actionable under IRC 6700 and that injunctive relief is appropriate to prevent the recurrence of that conduct, the court can enjoin the promoter from engaging in such conduct. An injunction is separate and apart from any other action the Service may bring against a promoter. See IRC 7408(a) and IRC 6700(a)(2).

7. Statute of Limitations

There is no statute of limitations for the assessment of the IRC 6700 penalty. Once an assessment is made, the ten year statute of limitations on collections applies in each case. See IRC 6502(a).

8. Assessment and Collection

The rules for assessment and collection are governed by and described in IRC 6703(b) & (c).

9. Specific Situations

These illustrations describe the application of IRC 6700 to situations involving charitable contribution deductions. Section 15 below contains illustrations that describe the application of IRC 6701.

A. Situation 1

Charity X is exempt from federal income tax under IRC 501(c)(3) and is a publicly supported organization described in IRC 509(a)(1) and IRC 170(b)(1)(A)(vi). It is engaged in a fund raising campaign of soliciting donations of used automobiles. If Charity X's written acknowledgments to contributors do not state the monetary value of the donated automobiles (and all other information contained therein is accurate), there are no IRC 6700 issues. However, if each written acknowledgement states that the value of the donated automobile is the contributor's purchase price and several years have passed since its purchase, Charity X would likely be subject to an IRC 6700 penalty if all other elements of IRC 6700 are satisfied (see section 3, above).

First, assuming a "normal" situation, there is no doubt that Charity X falls within the meaning of "any person" under IRC 6700(a), for it includes any form of organization (see section 3A. above). Second, each written acknowledgement is a false statement, because, even assuming "normal" improvements have been made, the value of a used automobile is not its original purchase price. Third, such false information is material because it relates to the amount of charitable deduction the contributor may take.

On the fourth element, proving Charity X knows or has reason to know the falsity of the acknowledgement statements depends upon the specific facts and circumstances. The Service may look at the information that Charity X used to make such claims and the sophistication and experience of the officers or persons in charge of the fundraiser.

Assume that Charity X does not have reason to know that the values of the used automobiles are not their original purchase prices. Also, an independent appraisal shows that the fair market value of a particular donated automobile is \$2,500 and the original purchase price is \$18,000. Whether Charity X has knowledge of the falsity of its acknowledgement statement or not, it has made a gross valuation overstatement because the stated value exceeds 200 percent of the correct value, and the value of the used automobile is directly related to the amount of an allowable deduction.

The final element to satisfy is whether the false statements or gross valuation overstatements constitute an arrangement or plan. Charity X's solicitation of used automobiles is an "arrangement or plan" because it is designed to raise funds and allows the contributors to take charitable contribution deductions under IRC 170(c). (See section 3B. above, for discussion of the definition of an "arrangement or plan"). Where any of the above elements are lacking, an alternative penalty to pursue against Charity X would be IRC 6701 (see situation 1, section 15A, below).

B. Situation 2

Charity Y was formed to raise funds by soliciting donations from the general public, but is not exempt from federal income tax under IRC 501(c)(3). It conducts little or no charitable activities. Its acknowledgement statements state that all contributions are tax deductible for federal income tax purposes. Charity Y is a tax shelter disguised as a charity and could be penalized under IRC 6700 for making false statements in claiming that contributions are tax deductible.

10. Basic Statutory Framework of IRC 6701

IRC 6701 imposes a civil penalty on any person

- (1) who aids, assists in, procures, or advises with respect to, the preparation or presentation of any portion of a return, affidavit, claim, or other document,

- (2) who knows (or has to reason to know) 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) would result in an understatement of the liability for tax of another person.

Essentially, IRC 6701 requires that the following elements be demonstrated before a violation arises. First, there must be a person. Second, that person must assist in the creation of a document. Third, the person must know that such document would result in an understatement of tax liability. Each of these elements will be discussed below.

A. Who is a Person?

The first element requires that a person violate IRC 6701. The definition of a person includes individuals, trusts, estates, partnerships, associations, and companies. See IRC 6701(b)(2) & IRC 7701(a)(1). It includes exempt organizations and their officers, attorneys, accountants and financial advisors.

B. Assistance in Document Preparation or Presentation

The second element requires that the person assists in or provides advice in the preparation of a return, an affidavit, a claim for refund, or any other tax documents. The person does not have to be the actual preparer of the document. It is sufficient that the person helps or advises in the preparation or presentation of these documents. For example, a charity may assist in preparation of a tax document every time it issues an acknowledgement statement substantiating a contribution made. Typing, reproducing, or other mechanical assistance does not constitute aid or assistance. See IRC 6701(e).

If a person procures a subordinate to help or assist in document preparation or presentation, actions by the subordinate are treated for IRC 6701 purposes as undertaken by that person. See 1982 Senate Report, at p. 267. "Procure" is defined to include ordering or causing. Also, knowing of a subordinate's participation in an act and not attempting to stop it is also included in the definition of procure. See IRC 6701(c)(1).

A subordinate is anyone over whom the person has direct and immediate direction, supervision or control. A subordinate's status is irrelevant, for he or she can be anyone within an organization -- a director, officer, employee, or agent. See IRC 6701(c)(2). A financial officer or other key officers of an exempt organization would fall within the definition of subordinates.

C. Definition of Document

The third element requires that there be a document used to understate liability of tax. A document can be a return, an affidavit, a claim for refund, or any other document used in connection with a matter under the internal revenue laws. See IRC 6701(a)(1). A charity's acknowledgement statement that substantiates a gift from a donor relates to the charitable contribution deduction under IRC 170(c) and falls within the definition of document. The definition would also include items such as schedules attached to a return and any statements prepared for presentation to the Service.

D. Knowledge of Materiality

The fourth element requires that a person knows or has reason to believe that the document will be used in connection with any material matter under the tax law. The language of "reason to believe" permits a finding of knowledge in situations where a person deliberately remains ignorant of what would otherwise have been obvious to him or her. See Mattingly v. U.S., 924 F.2d 785 (8th Cir. 1991). A finding of knowledge is based on all facts and circumstances of a particular case. For example, Charity Z issues acknowledgement letters to many contributors for receipt of contributions. In its acknowledgement letter to contributor A, it deliberately overstates by 100 percent the dollar value of a property. Charity Z knows that many contributors use the information in its letters for their tax return purposes. Although Charity Z does not actually know that contributor A used the information for charitable contribution deduction purpose, it nevertheless has reason to believe that its statement would be used for that purpose.

Materiality Requirement

A document must relate to a material matter arising under the tax law. Although "material matter" is not defined under IRC 6701, materiality, for purposes of this provision, is where a document effects the understatement of tax liability. See General Explanation, at p. 221.

E. Understatement of Tax Liability

The fifth requirement is that the person knows that, if so used, the document would result in an understatement of the tax liability of another person. See IRC 6701(a)(3). Actual knowledge is required in order to prove a violation. See, e.g. Gard v. U.S., 92-1 USTC 50,159 (N.D. Ga. 1992); Mattingly v. U.S., 924 F.2d 785 (8th Cir. 1991).

No Reliance Requirement

A 6701 violation may occur even if the taxpayer that receives the assistance or advice in the preparation of a document does not actually rely on that document. Also, there is no requirement that the taxpayer must actually have understated his tax liability. See

Golletz v. United States 91-1 USTC 50233 (N.D. Fla. 1988); Kuchan v. United States, 679 F. Supp. 764 (N.D. Ill. 1988).

11. Statute of Limitations

It is the Service's position that there is no statute of limitations for the assessment of penalties under IRC 6701. See, e.g. Mullikin v. U.S., 952 F.2d 920 (6th Cir. 1991), cert. denied, 506 U.S. 827 (1992); Sage v. U.S., 908 F.2d 18 (5 Cir. 1990); Lea v. U.S., F. Supp. 687 (W.D. Tenn. 1995); Emanuel v. U.S., 705 F. Supp. 764 (N.D. Ill. 1988); Agbanc Ltd. v. U.S., 707 F. Supp. 423 (D. Ariz. 1988).

12. Burden of Proof

The Service bears the burden of proving by preponderance of evidence that a person is liable for the IRC 6701 penalty. See IRC 6703 and General Explanation, at p. 220-21.

13. Penalty

The amount of the penalty is \$1,000 for any tax period (or taxable event if there is no tax period). See 6701(b)(3). If the document relates to the tax liability of a corporation, the dollar amount is \$10,000.

If a person is subject to IRC 6701(a), only one penalty can be imposed on that person with respect to a particular document relating to a taxpayer for any tax event or period. For example, a charity is subject to a penalty of \$1,000 for each false acknowledgement statement. However, additional IRC 6701 penalties can be imposed on that person for other documents. If there are various persons who helped prepare or advised in preparation of that document, each may be subject to the penalty.

A. Coordination with IRC 6700

The Service may impose any other penalties provided under the law. See IRC 6701(f)(1). However, if the Service assesses a penalty under IRC 6701, it cannot assess any penalty under IRC 6700 (and IRC 6694(a) and (b), Understatement of Taxpayer's Liability by Income Tax Return Preparer). See IRC 6701(f)(3).

14. Injunction

The Service may seek an injunction under IRC 7408(a) to prohibit a person from further engaging in any conduct, which is subject to IRC 6701. For further discussion, see section 6, above.

15. Assessment and Collection

Like IRC 6700, the rules for assessment and collection of a penalty under IRC 6701 are described in IRC 6703.

16. Specific Situations

A. Situation 1

Charity X is exempt from federal income tax under IRC 501(c)(3) and is a publicly supported organization described in IRC 509(a)(1) and IRC 170(b)(1)(A)(vi). It is engaged in a fund raising campaign of soliciting donations of used automobiles. Charity X's written acknowledgments to all contributors do not state the monetary value of the donated automobiles except the acknowledgement that was issued to Contributor A. The written acknowledgment to Contributor A states that the value of the donated automobile is \$20,000. Charity X's president issued the said statement. There is evidence that A pressured X to include the valuation in the statement. The fair market value of the automobile is \$5,000. The Service may seek to impose penalties under IRC 6700 or IRC 6701. Assume that the Service has difficulty demonstrating that this one instance constitutes an "arrangement or plan" under IRC 6700(a); Charity X and its president may be subject to IRC 6701 penalties, provided all the elements are demonstrated.

First, Charity X falls within the meaning of "person" under IRC 6701(a), for it includes any form of organization (see section 9A, above). Second, assistance in creation of a document requirement is demonstrated when Charity X issued the acknowledgement statement to the Contributor A. Third, the acknowledgement statement is a document within the meaning of IRC 6701 because it is used by Contributor A to substantiate his charitable contribution deductions. Fourth, proving Charity X had knowledge or had reason to believe that the written acknowledgment is material to the tax law depends upon the specific facts and circumstances. For example, the Service may look at Charity X's or its president's knowledge of tax law or financial matters, and his sophistication and work experience. Certainly, the fact that A pressured X to include the valuation in the statement bears on materiality. The final element to satisfy is whether Charity X or its president actually knew that Contributor A would use the written acknowledgement to substantiate a charitable contribution deduction and, if used, would understate his tax liability. Whether Charity X or its president has such actual knowledge or reason to believe would depend on the facts and circumstances. All the facts in a particular case must be reviewed closely to ensure that actual knowledge exists.

B. Situation 2

Charity Y is exempt from federal income tax under IRC 501(c)(3) and is a publicly supported organization described in IRC 509(a)(1) and IRC 170(b)(1)(A)(vi). It conducts many charitable activities and is engaging in a fund raising campaign. Any contributor

who makes a \$1000 contribution receives a wireless telephone whose fair market value is \$100. Charity Y and its officers are financially sophisticated and knowledgeable. Charity Y purposely states in its written acknowledgement to Contributor B, a frequent supporter, that the entire payment is tax deductible. Contributor B told Charity Y's president that he would include that contribution as a charitable contribution deduction on his income tax return. Charity Y and its president are subject to an IRC 6701 penalty for the written acknowledgement made if the Service can demonstrate each element of IRC 6701 (see section 9 above).

There is no doubt that Charity Y is a "person" under IRC 6701(a). Second, Charity Y assisted in preparation of a federal tax document when it issued the acknowledgement statement to Contributor B. Third, the acknowledgement statement is a document for purposes of IRC 6701 because it could be used to substantiate a charitable contribution deduction. Fourth, Charity Y and its officers can be shown to have knowledge by their financial sophistication that the acknowledgment statements are material. Finally, Charity Y has actual knowledge that the acknowledgement statement would be used by a contributor B.

C. Situation 3

A offers to donate a sculpture to museum Z in February 1, 1998. B, the curator of the museum, agrees to accept the sculpture. B offers to backdate an acknowledgment statement for the donation to December 29, 1997. B intends that the statement to be used to substantiate A's charitable deduction. A uses the backdated acknowledgement statement to claim a charitable deduction for 1997. B has aided in the preparation of a federal tax document knowing that it will be used in connection with a material tax matter and that it will result in an understatement of tax. All the statutory elements are satisfied and, thus, B is liable for the IRC 6701 penalty.

17. Conclusion

This is a new and evolving area, and because IRC 6700 and IRC 6701 have not been applied with frequency to the area of charitable deduction contributions, each situation must be reviewed carefully to ensure that there are sufficient facts to demonstrate each statutory requirement and to sustain the burden of proof.