Caplin & Drysdale

taxAlert

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In this edition of TaxAlert, Caplin & Drysdale lawyers summarize a number of recent Government actions that may have significance for your own work on current tax issues. If you need additional information, please contact the attorneys mentioned at the bottom of each article.

Section 6700 – IRS's Newly Found Weapon Against Professionals

Recent actions by IRS agents to invoke section 6700 ("Promoting Abusive Tax Shelters, Etc.") portends a new area of concern for professionals who render tax advice. This penalty section was added to the Internal Revenue Code in 1982, primarily to provide the Service with an additional means of pursuing promoters of abusive tax shelters who make false or fraudulent statements regarding the tax consequences of their products. Recently, however, revenue agents are applying the section to lawyers and other professionals who provide tax or tax-related advice with which the Service disagrees or which it considers aggressive. In some cases, it appears that the Service's objective is not to win in court, but rather to create an *in terrorem* effect, with respect to both the professional whose advice is under examination and the profession as a whole.

Section 6700 imposes a penalty in the case of any person who assists in the organization of a plan or arrangement or participates in its sale and, in connection therewith, makes or furnishes a statement with respect to the allowability of a deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of participating in the plan or arrangement that "the person knows or has reason to know is false or fraudulent as to any material matter." The IRS has the burden of proof in a section 6700 case.

In order for a penalty under section 6700 to be applied against a professional who renders advice on the tax consequences of a transaction, the IRS must establish that the professional knew or had reason to know that the opinion or advice given was false or fraudulent. It is important to note that this test involves two parts: a "false or fraudulent" statement — not one that is merely erroneous or even negligent — that the author "knows or has reason to know" is false.

Under section 6700, a person must pay the *lesser* of $1,000 or his collected fees, with respect to each plan or arrangement activity. Initially, a conflict emerged in the courts over what constituted an "activity," but in 1989 Congress clarified that each individual sale of a single interest is a separately punishable activity. Thus, if a lawyer provides tax advice with respect to a limited partnership involving the sale of ten partnership interests at $5,000 apiece, the *maximum* penalty exposure is $10,000. Similarly, the Service apparently takes the position that if a lawyer provides advice with respect to the tax-exempt status of interest on a bond issue sold in $5,000 denominations, the maximum penalty exposure is $1,000 per bond, subject to the limitation on actual fees received.

The court cases under section 6700 typically involve frivolous, "tax protestor" positions, or representations regarding the tax benefits available from sham transactions lacking economic substance — in short, outlandish tax statements that no "reasonable person" could possibly believe to be true. However, in recent examinations, the Service is asserting or considering asserting the penalty in situations where it simply disagrees with, or views as aggressive, the tax analysis provided by a law or accounting firm. A recent example is in the municipal bond area, where the Service publicly acknowledged that it has begun using section 6700 against bond lawyers who render opinions on the tax-exempt status of interest on municipal bonds. The IRS recently confirmed that it reached a settlement with a bond lawyer in one such case and collected its first-ever section 6700 penalty in this context.

The IRS may be counting on the fact that professionals cannot endure the adverse business consequences of a pending section 6700 examination and will therefore rush to the settlement table. As the Service's expansive use of this penalty continues, however, there will be increased resistance. It is likely that, in the not-too-distant future, this new position will be tested through appeals to higher officials within the IRS and Treasury and in court.

For more information about the issues in this article, contact Daniel B. Rosenbaum at 202-862-5032 or dbr@capdale.com.

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How Safe Is Taxpayer Information In The Hands Of Congress?

Several recent Congressional investigations of tax shelters, the Advance Pricing Agreement program, and certain charitable organizations have raised questions in the minds of taxpayers concerning how to maintain the confidentiality of sensitive information once it is turned over to a Congressional committee so that it is not "redisclosed" to other third parties. Unfortunately, the short answer is, it depends.

As an initial matter, there is no doubt that the Congressional tax-writing committees can get otherwise confidential taxpayer information from the IRS. Section 6103(f)(1) of the Code authorizes the IRS to disclose any return or return information to the Chairmen of the House Ways and Means Committee, the Senate Finance Committee, and the Joint Committee on Taxation upon a proper written request. Paragraphs (f)(2) and (f)(4) of section 6103 permit such disclosures to the Joint Committee' Chief of Staff and to designated staff members of the tax-writing committees, respectively. The main restriction on the IRS is that, if the information is taxpayer-specific (*i.e.*, relates to or identifies, directly or indirectly, a particular taxpayer), the IRS must obtain the taxpayer's consent or make the disclosure to the committee or staff only in "closed executive session."

What happens once taxpayer-specific information produced by the IRS is in the hands of the committee or staff? There are two lines of potentially applicable authority preventing redisclosure to third parties. First, the general prohibition in section 6103(a)(1) against redisclosure of taxpayer returns or return information by any "officer or employee of the United States" is likely to apply. Although section 6103 does not contain a definition of "officer or employee of the United States," Congressional employees are often treated as "officers or employees" of the United States under various other statutes, such as personnel or employment laws. Members of Congress, by contrast, are not as clearly covered by the term, but the IRS reportedly takes the position that section 6103(a)(1) still applies to Members who receive taxpayer-specific information from it (although there is no public ruling to this effect). The Members of the tax-writing committees also have an historical practice of treating themselves as if they are subject to section 6103(a)(1)'s general prohibition against redisclosure of information.

Second, the rules of the respective houses and committees of Congress may apply to restrict further disclosure. Both the Senate and the House have rules permitting their committees (including the tax-writing committees) to conduct business in "executive session" not open to the public, although the conditions under which that can occur vary. Materials considered by the committees in executive session are generally confidential, subject to certain exceptions, and unauthorized disclosure of such materials can result in sanctions, including the termination of a staffer's employment or expulsion of a Member. Of course, those rules can be amended at any time by a majority of the legislative chamber in which they apply.

As a consequence of these restrictions and practices, it can generally be assumed that returns and taxpayer-specific return information that are disclosed by the IRS to Congressional bodies will remain confidential.

What about information disclosed to Congressional committees directly by taxpayers themselves or by persons doing business with the taxpayers? The answer here is less a legal one than a political one. Both houses of Congress and most committees have subpoena authority to obtain any materials relevant to an issue they are considering, and as a practical matter there are few restrictions on the Members of Congress once such materials are in their hands. Taxpayers frequently seek pledges of confidentiality from committees that have issued (or are threatening to issue) subpoenas, but the staff and Members ordinarily resist, so the best a taxpayer can ordinarily obtain is some agreement limiting the use of materials produced to the committees.

An example of how this process can go awry involves the recent Congressional investigations of Enron Corporation. Enron and the Congressional investigating committees entered into a written agreement of confidential information obtained from Enron to be disclosed only in the official meetings and reports of those committees. The committees also agreed to a similarly limited redisclosure policy with respect to information obtained from the IRS. However, the committees used the "report" exception to swallow up the rule. They ultimately issued a lengthy report containing detailed and specific information on Enron's business, accounting and tax activities. The political imperatives of issuing the Enron report overcame any Congressional qualms about redisclosing information that might have been considered confidential or proprietary. Copies of the agreements are actually reproduced in an Appendix to the Joint Committee's report on Enron's tax issues.

In sum, when Congress obtains information from the IRS, it is generally confidential and remains so. But information obtained by Congress from other sources can ordinarily be redisclosed barring an agreement to the contrary.

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The Impact of the Bipartisan Campaign Reform Act on Tax Exempt Organizations Still Evolving

President Bush signed the Bipartisan Campaign Reform Act ("BCRA") into law on March 27, 2002. BCRA represents the most significant changes to campaign finance laws since the reforms enacted after the Watergate scandal almost three decades ago. Not surprisingly, numerous lawsuits challenging the law's constitutionality were almost instantaneously filed.

On December 10, 2003, the Supreme Court issued its opinion in *McConnell v. FEC*, which upheld virtually the entire BCRA. In doing so, it recognized that soft money had corrupted our political system and noted that Congress should receive appropriate deference in dealing with that threat. The Court also found that the nexus between federal officeholders and party officials and six- (and even seven-) figure checks is inherently corrupting. Finally, the Court upheld a hundred years of federal laws and previous Supreme Court rulings prohibiting corporations and unions from directly intervening in federal elections.

The biggest development in the past couple of months resulting from the decision is the debate over "527 organizations" (groups that have voluntarily identified themselves for tax law benefits as "political organizations"). Certain of these organizations—thus far primarily on the Democratic side—have professed to be, in essence, shadow parties working to defeat the other party's presidential candidate. The controversy stems from their engagement in activities designed to influence federal elections, but that are arguably not covered by the federal election laws; thereby allowing them to raise money from sources and in large amounts otherwise prohibited. Even more controversial is whether organizations that are tax-exempt under sections such as 501(c)(3) and (c)(4) of the Internal Revenue Code should also be subject to further regulation to ensure that they do not become avenues for exploiting loopholes in the federal election laws. The Federal Election Commission is currently engaged in a rulemaking to settle these and other issues with a projected completion date set for mid-May.

Since interest in campaign finance reform is so universal and its impact on our nation's political landscape is so great, below we supplement this TaxAlert article with some additional general information on BCRA for our regular readers.

BCRA Provisions

BCRA was designed to combat a number of perceived loopholes in the Federal Election Campaign Act of 1971, as amended ("FECA"), that had allowed the source and dollar limits on contributions to political parties and other FECA rules to be easily circumvented. BCRA has two major provisions:

- **Electioneering Communications:** restrictions on who can pay for, and required disclosures for, certain issue advertisements referring to clearly identified candidates for federal office.
- **Soft Money:** a prohibition on the national political party committees raising or using "soft money" (*i.e.*, money that is not subject to FECA's limits on sources and amounts of contributions), accompanied by various restrictions on the raising and use of "soft money" by state, district and local political party committees, federal officeholders and candidates, and state and local officeholders and candidates to prevent circumvention of this prohibition.

BCRA also contains a number of additional provisions, including increased contribution limits for "hard money" (*i.e.*, money subject to FECA's limits on sources and amounts of contributions), and new rules for what constitutes impermissible "coordination" with a federal candidate. The various provisions of BCRA generally became effective immediately after the November 2002 election.

Supreme Court Decision

Most of the rulings were decided on a 5-4 vote; however, a 7-2 majority upheld the prohibition on soft money fundraising by federal officeholders and candidates, and an 8-1 majority upheld the principal disclosure provisions.

Soft Money Upheld. The Court upheld the Act's soft money provisions:

- the prohibition on the national parties' raising or spending soft money;
- the regulation of state parties' spending soft money on federal election activity;
- the ban on federal officeholders or candidates' raising or spending soft money;
- the prohibition on political parties' transferring or soliciting soft money for politically active, tax-exempt groups (construing this provision to apply only to soft money); and
- the ban on state candidates' spending soft money on public communications that promote or attack federal candidates.

Electioneering Communications Upheld. The Court also upheld the Act's "electioneering communications" and other provisions:

- the definition of "electioneering communication" as a broadcast advertisement mentioning a federal candidate, targeted at their electorate, and aired within 30 days of a primary or 60 days of a general election;
- the requirement that corporations and unions use only hard money—PAC funds, instead of "soft money" treasury funds—to pay for electioneering communications;
- the requirement that individuals disclose their spending on electioneering communications to the FEC;
- the requirement that coordinated electioneering communications be treated as

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contributions to candidates and parties;

- the statutory definition of "coordination"; and
- the new FCC requirements for candidate disclosure.

Provisions Ruled Nonjusticiable or Struck Down. The Court held the following provisions "nonjusticiable" (*i.e.*, the justices declined to rule on the merits of the issue, generally because the issue was not yet ripe for judgment and/or because the plaintiffs lacked standing to sue):

- the increase in "hard money" contribution limits for individuals (lack of standing);
- the "millionaires amendment" (lack of standing); and
- the challenge to the FEC's coordination regulations (not ripe for adjudication).

The Court struck down:

- the provision prohibiting minors 17 years and younger from making political contributions; and
- the provision requiring parties to choose between making independent expenditures or coordinated expenditures on behalf of candidates.

The bottom line is that because the Supreme Court upheld BCRA almost in its entirety, there is no need to learn a new body of law as we have all been operating under BCRA for more than a year and will continue to do so. Nevertheless, as the furor over tax-exempt organizations' ability to participate in influencing public opinion and elections makes clear, we must pay attention to how the strategy, compliance, and regulation of political activities evolve.

For more information about the issues discussed in this article, contact Kirk L. Jowers at 202-862-5057 or klj@capdale.com.

UPCOMING TAX LAW EVENTS

The following is a partial list of upcoming events at which Caplin & Drysdale attorneys will be speaking. If you would like additional information on any of these events or the topics covered, please contact any of the attorneys listed below.

April 7, 2004
Washington Grantmakers Skill-Building Institute
Location: Washington, DC
Speakers: ***Lloyd Mayer, Marcus Owens***
Topic: "Legal Requirements and Regulatory Issues Affecting Foundations"

April 26 – 29, 2004
Christian Management Association Annual Conference
Location: Gaylord Texan Resort and Convention Center, Grapevine, TX
Speaker: ***Lloyd Mayer***
Topics: "Politics and the Pulpit;" "Money Laundering, International Activities and Terrorism;" and "Legal Update for Churches"

April 28, 2004
Georgetown University Law Center's Primer on Representing and Managing Private Foundations
Location: Georgetown University Law Center, Washington, DC
Speaker: ***Douglas Varley***
Topic: "Section 4942: Distribution Requirements, Private Operating Foundations"

April 29 – 30, 2004
Georgetown University Law Center's 21st Annual Representing and Managing Tax-Exempt Organizations
Location: Hyatt Regency Washington, Washington, DC
Speakers: ***Marcus Owens, Christopher Rizek***
Topic: "Anatomy of the IRS Audit: Practitioners' Perspective"

May 19, 2004
Law and Faith: Giving to Religious Organizations
Location: Wesley Theological Seminary, Washington, DC
Speaker: ***Beth Kaufman***
Topic: "Deferred Giving and Funding an Endowment"

May 20, 2004
Law and Faith: Legal Issues Facing Today's Religious Organizations
Location: American University Washington College of Law, Washington, DC
Co-chairs: ***Milton Cerny, Lloyd Mayer***
Speakers: ***Jason Bortz, Kirk Jowers***
Topics: "Compensation, Benefits and Other Employment Issues" and "Political Activity and Lobbying"
Other Topics Covered: Tort Liability; Tax Exemption; Government Funding; Human Resources; International Activities

June 3 – 4, 2004
56th Anniversary Virginia Conference on Federal Taxation
Location: Charlottesville, VA
Co-chair: ***Mortimer M. Caplin***
Speakers: ***Richard E. Timbie, Scott D. Michel***
Topics: "Update on IRS Compliance, Audits, Appeals and Collections" and "Survey of Current Ethical Issues Facing the Tax Practitioner"