RESOLUTION

RESOLVED that the American Bar Association recommends to the Congress that the Internal Revenue Code of 1986 be amended to clarify that the purpose of the penalty authorized by Section 6701 is to penalize conduct that results in the submission of a false or fraudulent return or other document to the Internal Revenue Service, that there is no statute of limitations regarding the assessment of this penalty, and that the standard of proof necessary to support the assessment of the penalty is "clear and convincing evidence."

REPORT

In the Tax Reform Act of 1976, Pub. L. No. 455, Congress enacted a host of new measures aimed at the comprehensive regulation of the commercial income tax return preparer industry. Among the new provisions was a civil penalty to sanction income tax return preparers whose conduct, with respect to a return or a claim, resulted in the understatement of a taxpayer's liability. As originally enacted, Code Section 6694(a) imposed a penalty of $100 on a preparer who understated a taxpayer's liability by negligently or intentionally disregarding revenue rules or regulations, and Code Section 6694(b) imposed a penalty of $500 when the preparer willfully understated a taxpayer's liability. In the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 239, Congress raised the civil penalty stakes for income tax return preparers by increasing the amounts to $250 and $1000, respectively.

As part of TEFRA, Congress also added a new penalty structure for persons who actively assisted taxpayers in understating their tax obligations through the organization or promotion of abusive tax shelters. Under Code Section 6700, persons who, in connection with tax shelter, make a false or fraudulent statement, or a gross valuation overstatement, as to any material matter are subject to a penalty equal to the greater of $1,000 or 10% of the gross income derived from the penalized activity. Code Section 6701 was added to the Internal Revenue Code in 1982, along with the shelter promoter penalty of Code Section 6700, as part of TEFRA's attack on actual and perceived abuses by "tax advisors" who were not necessarily tax preparers. In essence, the purpose of Code Section 6701 was to fill the compliance gap between the more difficult criminal prosecution of the advisor and the fairly minimal civil penalty then applicable only to return preparers under Code Section 6694. Indeed, fairly read, the legislative history of Section 6701 demonstrates that the 97th Congress intended to create a civil counterpart to 26 U.S.C. Section 7206(2), the criminal provision for aiding or assisting in the preparation of a false return or other document, for the target of both statutes is a false or fraudulent return or other document that is used to understate tax liability. H.R. Conf. Rep. No. 760, 97th Cong., 2d Sess. 576, reprinted in 1982 U.S. Code Cong. & Admin. News 1190, 1348; S. Rep. No. 494, 97th Cong., 2d Sess. 275-276, reprinted in 1982 U.S. Code Cong. & Ad News 781, 1021-1023.

Section 6701 was amended as part of the Improved Penalty Administration and Compliance Tax Act (IMPACT) of 1989. Prior to the amendment, Section 6701 applied only if the person who aided or assisted knew that the document would be used in connection with a material matter arising under the internal revenue laws. As amended in 1989, the penalty applies if the person knows or has reason to believe that the document will be used in connection with material tax matters. The legislative history does not explain the reason for this

It appears, however, that the 1989 amendment may have been in response to cases such as Sansom v. United States, 703 F. Supp. 1505, 1509-1511 (N.D. Fla. 1988), which refused to equate the "knowledge" requirement of the original version of Section 6701 with the traditional "willfulness" standard, thereby imposing a more stringent standard of scienter than that believed to be appropriate by the Service. See Mattingly v. United States, 924 F.2d 785, 791 (8th Cir. 1991). This conclusion is also suggested by recently adopted Internal Revenue Manual Penalty Handbook provisions for Code Section 6701 ("OBRA '89 expanded the scope of the penalty to individuals 'who have reason to know' that they are aiding and abetting in the understatement of a tax liability of another person.").

The courts have been less than consistent in construing this section, and indeed, on occasion, have strained the original congressional purpose in enacting Code Section 6701 when attempting to fill some of the interstices in the existing statutory scheme. Compare Mattingly v. United States, 924 F.2d 785, 787-789 (8th Cir. 1991) (rejecting clear and convincing evidence standard of proof because a violation of Section 6701 does not require proof of fraud with intent to evade tax) with Mullikin v. United States, 952 F.2d 920, 928 (6th Cir. 1991) ("Congress was interested in combating fraud by imposing penalties on individuals who aid in the fraudulent underpayment of taxes.") (the court held that no period of limitations applied because 6701 was an antifraud statute and unlimited periods apply to other "antifraud" provisions in the Code). In addition, absent amendment, the Code Section 6701 penalty is being, and will continue to be, used by the Service against return preparers nearly interchangeably with the penalty provided for by Code Section 6694(b). See, e.g., Rodrigues v. United States, 797 F. Supp. 122 (D.R.I. 1992); Warner v. United States, 726 F. Supp. 1287 (S.D. Fla. 1989); I RM Section (20)(11)64.4(1) (September 20, 1993). See also Bailey Vaught Robertson & Co. v. United States, 828 F. Supp. 442 (N.D. Tex. 1993). Accordingly, amendments to Code Section 6701 are being proposed to clarify the circumstances under which its use is appropriate. It is recommended that the proposed amendments be considered and enacted together.

Respectfully submitted,

M. Carr Ferguson, Jr.
Chair

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EXECUTIVE SUMMARY

1. **Summary of the recommendation(s).**

   To amend the Internal Revenue Code of 1986 to clarify that the purpose of the penalty authorized by Section 6701 is to penalize conduct that results in the submission of a false or fraudulent return or other document to the Internal Revenue Service, that there is no statute of limitations regarding the assessment of this penalty, and that the standard of proof necessary to support the assessment of the penalty is "clear and convincing evidence."

2. **Summary of the issue which the recommendation addresses.**

   The resolution proposes amendments to the Internal Revenue Code to clarify that "clear and convincing evidence" is required to sustain the burden of proof in civil fraud penalty proceedings in the U.S. Tax Court, U.S. Court of Federal Claims and the U.S. District Court and that there is no statute of limitations on the penalty. The courts have not been consistent in construing section 6701 rejecting the "clear and convincing evidence" standard of proof because a violation of section 6701 does not require proof of fraud with intent to evade.

3. **Please explain how the proposed policy position will address the issue.**

   The recommendation contemplates amendment of two sections of the Internal Revenue Code to achieve the result by codifying existing principals of law so that the burden of proof shall be upon the Secretary and the burden shall be carried by "clear and convincing evidence."

4. **Summary of any minority views or opposition which have been identified.**

   No known minority views or opposition.