NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on Application of Section 6700 Penalties to Lawyers:

The "Reason to Know" Standard

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I. Introduction

This report[1] requests guidance from the Government on the circumstances under which lawyers will be considered to be subject to penalties imposed under Section 6700 of the Internal Revenue Code of 1986, as amended (the "Code"). While a lawyer who knowingly makes a false or fraudulent statement certainly would be subject to penalties, issues arise in discerning the circumstances under which the lawyer is considered to have "reason to know" that statements he made or furnished, or caused another person to make or furnish, in connection with the sale of an "investment plan or arrangement" described in Section 6700[2] (including the issuance of a tax-exempt bond) are false as to any material matter. As the report indicates, the guidance requested should follow the legislative history of the statute, as well as case law that articulates general legal principles interpreting the concept of having "reason to know." Although the report requests guidance on the application of Section 6700 penalties to all lawyers, it discusses the application of Section 6700 penalties to tax-exempt bond lawyers at some length for two reasons: first, what limited authority there is concerning the application of Section 6700 penalties to lawyers is found in the legislative history of Section 6700, which focuses on tax-exempt bond transaction participants, including lawyers; and, second, as discussed below, the Service is making extensive use of Section 6700 penalties with respect to tax-exempt bond transaction participants, including lawyers.

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[1] The principal author of this report is Margaret C. Henry. Others who gave helpful comments include Stuart Rosow, Lewis Steinberg, Kimberley Blanchard, Michael Schler, Edward Gonzales, Joe Forrester, James Malone, Alexander Deland, and Bruce Serchuk.

[2] Unless otherwise noted, all section references are to sections of the Code.

II. Why This Report Now?

With the increased focus on enhancement of the Service's ability to combat abusive transactions, we are concerned that the remedies available to the Service be employed appropriately. In general, that means that punitive action should be taken against participants in transactions under the circumstances in which Congress intended such action to be taken. The current climate of vigorous challenge to aggressive transactions should not provide the basis to extend penalty provisions beyond their intent and convert them into audit tools. We are concerned, in particular, that Section 6700 penalties have become an increasingly important element in the Internal Revenue Service's enforcement efforts against what it perceives to be abusive tax-exempt bond transactions. *The Bond Buyer* reports that, in 2003, Section 6700 investigations and proceedings represented at least 25% of the Service's budget for tax-exempt bond enforcement. Yet express guidance on how Section 6700 should be applied to participants in tax-exempt bond transactions is very limited.

The current debate between the Service and tax-exempt bond lawyers focuses on the meaning of the "has reason to know [that a statement] is false" language of the statute, specifically whether the Service may impose Section 6700 penalties on tax-exempt bond lawyers for failure to conduct due diligence or conduct that is otherwise negligent, but not fraudulent. Given the lack of published guidance in this area and the confidentiality provisions to which the Service is subject, press reports are the principal source on the Service's thinking on the type of conduct that may be sanctioned under Section 6700. A recent report clearly indicates the Service's intention to pursue aggressively cases in which it concludes that tax-exempt bond lawyers have reason to know that statements on which they rely are false.

September 10, 2004[3]: Mark Scott (director of the Service's tax-exempt bonds division), in a speech to the National Association of Bond Lawyers, stated that the Service would hold all bond lawyers to the same standard of conduct to which other lawyers are held and would not tolerate blind reliance on certificates that include "unreasonable assumptions or unreasonable factual representations." Scott was quoted as saying: "The IRS can and will assert tax promoters penalties on lawyers and law firms that provide opinions on abusive arbitrage-driven transactions."

May 28, 2004[4]: "IRS officials" said that they planned to refer the names of two attorneys and six law firms under investigation for Section 6700 violations to the Office of Professional Responsibility. Charles Anderson (manager of field operations for the Service's tax-exempt bond division) was quoted as follows: "They clearly either knew what was going on and issued opinions or relied on certifications of other people when, with a minimum amount of investigating, they could have found information that would have caused them to not issue an opinion."

April 29, 2004[5]: A law firm settled with the Service under Section 6700. Charles Anderson was quoted as follows: "Many 6700 cases that we see involving law firms are

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[3] *The Bond Buyer.*
[4] *The Bond Buyer.*
[5] *The Bond Buyer.*

situations where the attorney relied on the blind certification[6] of another party. They could have known the other parties were making false statements if they had done adequate diligence."

October 23, 2003[7]: A lawyer who was a "fairly well-known" member of NABL agreed to pay a Section 6700 penalty. "The IRS plans to focus future 6700 investigations on cases where bond counsel took large fees in return for opinions in which they did little or no due diligence, according to [Charles] Anderson."

October 29, 2002[8]: In an article addressing contrary views on whether Section 6700 is a fraud statute, Charles Anderson was quoted as follows: "I think fraud is too strong a word. If you look at the statute, it talks about misrepresentation or misinformation. It's a penalty for an abusive or very negligent transaction. I never use the words 'fraud' and '6700' in the same sentence, because it really is not a fraud section."

Although the foregoing comments have been taken from statements made in the context of tax-exempt bond offerings and involve the application of Section 6700 to tax-exempt bond lawyers, we believe that the principles at issue are applicable to all lawyers.[9]

III. Summary of Recommendations

We recommend that the Government issue published guidance adopting the following standard: Section 6700 penalties should be imposed on a lawyer on the ground that the lawyer had reason to know that a statement material to the tax treatment of the transaction (including the exclusion from gross income of the interest on tax-exempt bonds) is false only if a reasonable person in the lawyer's position in the transaction would have discovered the problem using a minimum level of ordinary care. This minimum level of ordinary care standard would require the lawyer to make an effort to determine the facts upon which the lawyer's opinion or statement as to the tax consequences of the transaction is based. The exercise of a minimum level of ordinary care should be able to be accomplished through obtaining statements of the relevant facts from clients or others (including experts) with knowledge of the facts. Under this approach, the lawyer generally would be able to rely upon those statements or certificates. However, the minimum level of ordinary care standard would also require that the lawyer question or make further inquiry when the statements or certificates received were unreasonable or not believable or the lawyer otherwise had knowledge that the statements or certificates might not be accurate.

We also recommend that the published guidance provide that whether Section 6700 penalties are appropriate in these circumstances is a fact-specific, case-by-case analysis, in which the following criteria should be considered:

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[6] Mr. Anderson seems to have meant that the attorney relied blindly on the certification.

[7] *The Bond Buyer.*

[8] *The Bond Buyer.*

[9] The conduct of tax-exempt bond lawyers should be subject to the same standards under Section 6700 as those applied to the conduct of other lawyers. Although some have argued that special rules should govern the application of Section 6700 to tax-exempt bond lawyers, we find no principled basis for treating tax-exempt bond lawyers differently than other lawyers. Our view is consistent with the preamble to the revisions to Circular 230 published in the December 20, 2004 Federal Register.

1. the lawyer's role in the transaction (*e.g.*, in the case of a tax-exempt bond transaction, whether the lawyer was bond counsel, underwriters' counsel, credit enhancer's counsel, conduit borrower's counsel);

2. whether the lawyer reasonably relied on statements by a reputed "expert" or another participant in the transaction (including the issuer) that were credible and reasonable on their face;

3. whether the lawyer was on notice that there might be a problem with the federal tax law analysis underlying the investment plan or arrangement (*e.g.*, because certificates as to the facts underlying the opinion contained inconsistencies);

4. whether the lawyer was deceived or misled by other participants in the transaction or was the recipient of misleading information;

5. the complexity of the transaction; and

6. whether the lawyer conducted due diligence designed to elicit facts that might be material to the federal tax law analysis.

As explained in more detail below, the foregoing is consistent with the legislative history of Section 6700 as well as the case law interpreting the phrase "reason to know". Thus, while there is no generalized duty of inquiry imposed by Section 6700, a tax lawyer's role in the transaction carries with it certain due diligence obligations. As explained more fully below, there should be a duty to ask enough pointed questions to ensure that all of the transaction participants upon whose efforts the opinion relies are up to the task. In the ordinary case, requesting and receiving certificates from other professionals or from the issuer or other participants should be sufficient, absent some indication that one or more certificate is not accurate. If such indication of inaccuracy were present, the lawyer should make further inquiry. If some aspect of due diligence seems insufficient, tax counsel should ask more questions until he or she is satisfied that a reasonable person would be entitled to assume the facts upon which his or her firm's opinion is based.

The legislative history also make clear that the imposition of penalties under Section 6700 was intended to apply to those persons who are most culpable in promoting the abusive transaction through the making of false statements as to tax consequences. As a penalty statute, Section 6700 should be applied in limited circumstances in which conduct fails to meet clearly articulated standards. The threat of the imposition of Section 6700 penalties should not be a routine tool in the examination of transactions, including tax-exempt bond transactions. In addition, any standard interpreting the phrase "reason to know" should not impose either an undue burden or impracticable obligations on the lawyer or the transaction.

We also recommend that the Service clarify that a false statement within the scope of Section 6700 includes a legal opinion that is erroneous because it is based on a statement that is false or fraudulent, which the person rendering the opinion knows or has reason to know is false or fraudulent. However, given the limited intended scope of Section 6700, a legal conclusion that represents a mere difference of opinion with the Service over an uncertain legal issue should

not result in Section 6700 penalties. This report only addresses situations in which tax counsel would not have delivered opinions had they, in fact, known of certain adverse facts. Finally, we recommend against the adoption of a negligence standard, because negligence is a state law concept, subject to differing interpretations from state to state. Thus, a determination that a lawyer was negligent in a transaction, and liable for damages, would not support the automatic imposition of penalties, although the lawyer's conduct constituting negligence would be considered under all of the facts and circumstances. Similarly, violations of Circular 230 or civil violations of the federal securities laws should not result automatically in Section 6700 penalties, although the offensive conduct certainly should be taken into account.

IV. Section 6700 Legislative History

Section 6700 of the Code, entitled "Promoting Abusive Tax Shelters, Etc.," imposes a penalty on "any person who organizes or assists in the organization of . . . any investment plan or arrangement . . . or any other plan or arrangement . . . or . . . participates (directly or indirectly) in the sale of [such] . . . interest in an entity or plan or arrangement . . . and makes or furnishes or causes another person to make or furnish (in connection with such organization or sale) . . . a statement with respect to 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 . . . . (emphasis supplied)."

The Conference Committee Report to the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") [10], with respect to the enactment of Section 6700, explains the purpose of the "reason to know" language. It provides that "[t]he 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 materials which are furnished to him by the promoter. The 'reason to know standard' is not, however, intended by the conferees to be used to impute knowledge to a person beyond the level of comprehension required by his role in the transaction. Thus, this standard does not carry with it a duty of inquiry concerning the transaction." The Joint Committee Explanation of TEFRA makes clear that the duty of inquiry is limited to the duty "implied by a person's role in the transaction."

The foregoing legislative history is applicable to all persons involved in the transaction, including the tax lawyers involved in rendering opinions or making statements as to the tax consequences of the transaction. While the language is quite explicit that there is no generalized duty of inquiry, there is a requirement to inquire as to the facts implied by the person's role in the transaction. Thus we believe that the person advising as to the tax consequences of the transaction should undertake sufficient diligence to become familiar with the facts of the transaction, even if there is no overarching duty to insure that the facts are as described to the lawyer (*i.e.*, no duty to audit facts that appear reasonable upon their face).

[10] H. Conf. Rep. No. 760, 97th Cong., 2d Sess. 572 (1982).

Further support for this view is found in the legislative history[11] to the Omnibus Budget Reconciliation Act of 1989 (the "1989 Act" and the "1989 Legislative History", respectively), which is the principal guidance[12] on the application of Section 6700 penalties to participants in tax-exempt bond transactions. The 1989 Legislative History makes clear that Section 6700 penalties may be imposed upon participants in tax-exempt bond transactions (*e.g.*, bond counsel, investment bankers and their counsel, issuers, conduit borrowers and their counsel, financial advisors, feasibility consultants, and engineers). The statute and the 1989 Legislative History are clear that the Service need only show that the transaction participant had "reason to know" that he was making, furnishing, or causing another person to make or furnish a false statement in connection with the "organization or sale" of a bond. Neither fraud nor actual knowledge need be demonstrated.

The 1989 Legislative History described certain situations in which participants in tax-exempt bond transactions would be considered to "have reason to know" that their opinions, offering documents, reports, or other statements (or material on which they relied in making such statements) were false or fraudulent as to any matter material to the tax exemption of interest on the bonds due to their roles in the transaction. This is accomplished primarily by the use of examples, rather than the enunciation of specific factors.

> For example, bond counsel, issuer's counsel, and underwriters' counsel would be entitled to rely upon a feasibility study conducted by an engineering firm reputed to be expert in the subject matter and area of the study, unless such counsel independently knew or had reason to know information bringing into question the results of that study. Absent that, counsel would not be required to question the assumptions underlying, or results reached by, the study. Similarly, bond counsel would be able to rely, as to matters of fact or expectation relevant to his or her opinion, on information provided by other parties (including the issuer) absent actual knowledge or a reason to know of its inaccuracy or the use of statements not credible or reasonable on their face. . . . Similarly, an investment banking firm organizing or assisting in the organization of the bonds holding itself out as expert in the particular subject area of the financing would have reason to question the conclusion of a feasibility consultant if that consultant's report omitted consideration of a principal factor typically discussed in feasibility reports used in such financings (*e.g.*, competition for a project's source of supply of materials).[13]

This legislative history would seem to set a high bar for the Service before the imposition of penalties under Section 6700 on tax-exempt bond lawyers. In general, justifiable reliance on certificates of experts or statements of others having knowledge of the facts is clearly contemplated and would not subject the lawyer to penalties. The exception to this general rule is where there is some indication that information in such certificates or statement was inaccurate. Such indications could include the absence of information typically found in those types of

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[11] H. Conf. Rep. No. 101-247, 101st Cong., 1st Sess. 1397.

[12] FSA 200129011 (July 20, 2001) is the only guidance ever issued by the Service on the application of Section 6700 to tax-exempt bond transaction participants. Discussion of this FSA follows this report's discussion of the case law and legislative history on which it relies.

[13] *Id.*

statements or certificates or statements or certificates that on their face that are not credible or reasonable.

V. Section 6700 Cases

What limited authority there is concerning the application of Section 6700 penalties to lawyers is found in the 1989 Legislative History concerning tax-exempt bond lawyers. However, the "knew or had reason to know" requirement has been interpreted by the courts in Section 6700 cases and in cases involving other provisions of the Code that contain a "knew or had reason to know" requirement. Some have suggested that the case law described in this report is inapposite to the application of Section 6700 to lawyers and to tax-exempt bond lawyers in particular. To be sure, none of the cases considered situations involving a lawyer who had not himself organized a tax shelter, and the cases need to be interpreted in this light. However, we see no reason why a court applying Section 6700 to the conduct of a tax lawyer who had not organized a tax shelter would ignore other Section 6700 case law or, in fact, other case law interpreting the identical "reason to know" language. A discussion follows of the legal standards set forth in the cases and what factors the courts found to be key to their decisions.

As to the Section 6700 cases, the "knew or had reason to know" requirement has been interpreted in particular detail by the 5th, 7th, and 9th Circuits.

A. 5th Circuit. The leading 5th Circuit case is *United States v. Campbell*, 897 F.2d 1317 (5th Cir. 1990). The standard it applied was "what a reasonable person in the [defendant's] . . . subjective position would have discovered." Factors considered important by the court were: (1) the degree of the defendant's involvement in the structuring of the tax shelter (the defendant was the architect of the shelter); (2) the level of the defendant's education (the defendant was an attorney with a master's in business administration); and (3) whether the defendant had been put on notice of a problem with the shelter (an expert had notified the defendant that the notes were worthless).

The court noted that, when Section 6700 was enacted, the Code already contained the "reason to know" standard. It had been interpreted by the 5th Circuit to include "what a reasonable person in the [defendant's] . . . subjective position would have discovered." *Sanders v. United States*, 509 F.2d 162, 166 (5th Cir. 1975) (interpreting the "innocent spouse" rule of Section 6013(e) of the Code). The court found it reasonable to presume that Congress was aware of that construction when it included the "reason to know" standard in Section 6700. The court noted that the Conference Report accompanying TEFRA, while clarifying[14] that the standard did not carry a duty of inquiry, indicated that the reason to know standard allowed imputation of knowledge so long as it was commensurate with the level of comprehension required by the speaker's role in the transaction. The court also cited with favor the *Kaun* case discussed *infra* for the "should have known" test.

B. 7th Circuit. The two leading 7th Circuit cases are *United States v. Kaun*, 827 F.2d 1144 (7th Cir. 1987), and *United States v. Raymond*, 228 F.3d 804 (7th Cir. 2000). Both cases

[14] While the "reason to know" standard was added in conference, the Senate Report (No. 97-530, 97th Cong., 2d Sess., at 572 (1982) (the "1982 S. Rep."), provided that the Service could rely on objective knowledge of the transaction. The conference agreement followed the Senate amendment. Together, they are referred to in this report as the "1982 Legislative History."

involved tax protestors who sought to convince others that payment of federal income taxes was voluntary. The 7th Circuit seems to equate "had reason to know" with "should have known," and considered the following factors to be relevant to its analysis: (1) degree of intelligence (one defendant was a law school graduate; another had run his own business for 20 years; another was an accountant); (2) knowledge of the law (one defendant was the U.S. Taxpayers Party's candidate for the U.S. Senate; another demonstrated knowledge of the tax system); and (3) whether defendants had been put on notice that there were legal problems with their shelters (each defendant was a tax protestor).

C. 9th Circuit. The leading 9th Circuit case is *United States v. Estate Preservation Services*, 202 F.2d 1093 (9th Cir. 2000). The standard applied in that case was "what a reasonable person in the [defendant's] subjective position would have discovered." Factors considered important by the 9th Circuit were: (1) extent of reliance on knowledgeable professionals (defendant ignored the advice of professionals who disagreed with him); (2) level of sophistication and education (defendant held an advanced degree in physics, had completed course work for an advanced degree in computer science, and had training at USC in the field of taxation); and (3) familiarity with tax matters (defendant's testimony demonstrated "his facility" with various elements of the Code).

The court noted that the 1982 Legislative History indicates that the "reason to know" standard of Section 6700(a)(2)(A) "allows imputation of knowledge so long as it is commensurate with the level of comprehension required by the speaker's role in the transaction." The court also cited *United States v. Campbell* and *Sanders v. United States* for the interpretation of the "knew or had reason to know" standard that it includes "what a reasonable person in the [defendant's] subjective position would have discovered."

D. Other Significant Section 6700 Cases. While not a circuit court case, *Weir v. United States*, 716 F. Supp. 574 (N.D. Ala. 1989), is a frequently cited case. The court applied a subjective analysis to conclude that the defendant "lacked the intent to misstate the tax consequences" of the shelter he was marketing. Factors considered important by the court were: (1) the degree of the defendant's involvement in the structuring of the tax shelter (defendant did not structure the shelter; he only marketed it); (2) degree of intelligence (defendant was "naïve, perhaps stupid"); (3) extent of reliance on knowledgeable professionals (defendant believed the "lengthy and weighty" tax opinion on the shelter); and (4) whether the defendant had been put on notice of a problem with the shelter (the shelter "had a semi-logical basis in the then tax laws, which permitted, even encouraged, schemes not unlike this one").

See also United States v. Fisher, 2004 U.S. Dist. LEXIS 2222 (N.D. Texas 2004) (because "schemes" similar to defendants' partnership agreement had been consistently rejected by the courts, defendants knew or should have known that their statements regarding the tax benefits of the scheme were false or fraudulent); *United States v. Buttorff*, 761 F.2d 1056 (5th Cir. 1985 (virtually identical arrangement to that in *Fisher*, but involving trusts rather than partnerships); *Kersting v. United States*, 206 F.3d 817 (9th Cir. 2000) (court applied *Estate Preservation* standards; promoter knew prior version of tax shelter had been disallowed by 9th Circuit); and *United States v. Schiff*, 269 F. Supp.2d 1262 (D. Nev. 2003), aff'd __ F.3d __ (9th Cir. 2004) (promoter of scheme based on premise that payment of federal income taxes was voluntary had reason to know that promotional materials were false based on previous case law).

VI. Section 6013(e) ("Innocent Spouse") Cases

In view of the analogy drawn to the innocent spouse cases by the 5th Circuit (*United States v. Campbell*, *supra*) and the 9th Circuit (*United States v. Estate Preservation Services*, *supra*), we believe that the leading cases that interpret the "no reason to know" requirement of Section 6013(e) are also instructive.

A. 2d Circuit. The leading 2d Circuit case is *Hayman v. Commissioner*, 992 F.2d 1256 (2d Cir. 1993). The standard adopted by the court was: Whether "a reasonably prudent taxpayer in her position at the time she signed the return could be expected to know that the return contained the substantial understatement." Factors considered important by the 2d Circuit were: (1) the spouse's level of education and degree of business sophistication (plaintiff had a B.S. in retailing and was vice president and merchandising director of the Ann Taylor chain of stores); (2) the spouse's involvement in the family's business and financial affairs (plaintiff was very involved, signed large checks and many documents, and received private placement memoranda); (3) the presence of expenditures that appear lavish or unusual when compared to the family's past levels of income, standard of living, and spending patterns; and (d) the culpable spouse's evasiveness and deceit concerning their finances (the court did not believe the plaintiff was deceived, given that the losses from the shelters exceeded the income she and her husband recorded; instead, the court found that she "turned a blind eye;" plaintiff was troubled enough to ask her husband whether the investments "were legal.")

B. 5th Circuit. The leading 5th Circuit case is *Sanders v. United States*, 509 F.2d 162 (5th Cir. 1975). The standard adopted by the court was "what a reasonable person in the taxpayer's subjective position would have discovered," although the court did not think that test precluded the setting of "judicially defined *minima* of reasonable prudence" for individual taxpayers or classes of taxpayers. Facts considered important to the court were: (1) unusual or lavish expenditures (house and condominium were heavily mortgaged); (2) participation in business affairs or bookkeeping (very reliant on accountant; although taxpayer balanced their joint account, their affairs were so complex that it took the Service over 100 hours to deduce the omissions from those checkbooks); (3) the "guilty" spouse's refusal to be forthright about the couple's income (taxpayer's husband rarely confided in her concerning his financial affairs); (4) the claimant spouse's emotional condition during the period in question (during the period in question, taxpayer was having severe emotional problems heightened by heavy alcohol consumption); (5) the complexity of the financial transactions that produced the funds (extremely complex); and (6) the complexity of the method used by the Service to deduce the omissions.

The court said that different considerations would apply where the evidence permitted the inference that the spouse intentionally turned a blind eye upon the financial activities of his or her spouse. Furthermore, the Section 6013(e)(1)(B) "no reason to know" requirement is not satisfied when lack of knowledge is "predicated on mere ignorance of the legal tax consequences of transactions, the facts of which are either in the possession of the spouse or reasonably within his or her reach.

In *Reser v. Commissioner*, 112 F.3d 1258 (5th Cir. 1997), the 5th Circuit distinguished innocent spouse cases concerning erroneous deductions from those concerning income omissions. The court held that, in an erroneous deduction case, the "innocent" spouse could prevail even if she had knowledge of the transaction that triggered the erroneous deduction, as

long as she did not understand that the deductions in question gave rise to a substantial understatement of income. Factors considered relevant by the court to whether the taxpayer knew or had reason to know that the erroneous deductions gave rise to a substantial understatement were: (1) the spouse's level of education (although taxpayer was a lawyer, she was a personal injury lawyer, with no special knowledge of complex tax law issues); (2) the spouse's involvement with the family business and financial affairs (taxpayer was not personally involved in husband's S corporation to any significant degree); (3) the presence of expenditures that appear lavish or unusual when compared with past levels of income, standard of living, and spending patterns (income invested in husband's S corporation or consumed on family living expenses); and (4) the culpable spouse's evasiveness and deceit concerning the couple's finances (taxpayer could not be blamed for husband's efforts to recast transaction in tax-favorable light). The court found that the Tax Court had erred in its determination that the taxpayer had a duty to inquire as to the propriety of the deductions. The deductions were not "dramatic"; nor would have a cursory review have revealed them to be illegitimate. The case turned on a "hypertechnical determination" whether the husband had borrowed funds and loaned them to the S corporation (in which case his basis would increase dollar for dollar) or the S corporation was the borrower (in which case the husband's basis would not be increased).

C. 8th Circuit. The leading 8th Circuit case is *Erdahl v. Commissioner*, 930 F.2d 585 (8th Cir. 1991). The standard adopted by the court was "whether a reasonably prudent taxpayer under the circumstances of the spouse at the time of signing the return could be expected to know that the tax liability stated was erroneous or that further investigation was warranted." Factors considered important by the 8th Circuit were: (1) the spouse's level of education (plaintiff had a high school education, while her husband had a medical degree); (2) her involvement in family financial affairs (plaintiff was given a $1,500/month budget to maintain a household with two children; plaintiff was the trustee of her husband's pension plan, but thought that the shelter was an investment of the plan's); (3) the evasiveness or deceit of the culpable spouse (her husband deceived her personally and financially); and (4) any unusual or lavish expenditures inconsistent with the family's ordinary standard of living (twice her husband deserted her and their children; once he told them to live in public housing).

D. 9th Circuit. The leading 9th Circuit case is *Price v. Commissioner*, 887 F.2d 959 (9th Cir. 1989). The standard adopted by the 9th Circuit was that, "A spouse has 'reason to know' of the substantial understatement if a reasonably prudent taxpayer in her position at the time she signed the return could be expected to know that the return contained the substantial understatement." Factors considered important by the 9th Circuit were: (1) the spouse's level of education (taxpayer had two years of junior college as a sociology major and was branch manager of a car pooling agency); (2) the spouse's involvement in the family's business and financial affairs (taxpayer's husband handled all of the family's investment decisions and maintained a separate checking account for those expenditures; she was kept on a budget); (3) the presence of expenditures that appear lavish or unusual when compared to the family's past levels of income, standard of living, and spending patterns (there were none compared with past practice); and (4) the culpable spouse's evasiveness and deceit concerning the couple's finances (taxpayer's husband was a tax shelter promoter and lied to her about the value of the investment in a Colombian mining operation; when questioned by her about the deduction for losses from the mining operation, her husband said that the CPA would never have prepared the return if there had been a problem with the shelter).

The court noted that ignorance of the attendant legal or tax consequences of an item that gives rise to a deficiency is no defense for one seeking to obtain innocent spouse relief. "If a spouse knows virtually all of the facts pertaining to the transaction that underlies the substantial understatement, her defense in essence is premised solely on ignorance of the law. In such a scenario, regardless of whether the spouse possesses knowledge of the tax consequences of the item at issue, she is considered as a matter of law to have reason to know of the substantial understatement and thereby is effectively precluded from establishing to the contrary."

The court agreed with the Commissioner that the size of the deduction vis-a-vis their joint income, when considered in light of her knowledge of the investment and its rather unusual nature, was enough to put taxpayer on notice. The court found that, once she was on notice, she had a duty of inquiry, but that she had satisfied that duty by her questioning of her husband.

VII. Section 6715(a)(2) Fuel Excise Tax

Consolidated Edison Company of New York, Inc. v. United States, 221 F.3d 364 (2d Cir. 2000). Section 6715(a)(2) of the Code imposes a penalty when "any dyed fuel is held for use or used by any person for a use other than a nontaxable use and such person knew, or had reason to know, that such fuel was so dyed." The standard adopted by the 2d Circuit was the same "reasonably prudent taxpayer" standard that it had adopted in *Hayman*, *supra*. The 2d Circuit cited with favor *Campbell*, *supra,* and *Estate Preservation*, *supra*. The case was remanded to the District Court for further proceedings consistent with that standard (*e.g.*, whether plaintiff's employee should have known of the error from the fuel delivery ticket).

VIII. Section 6015 Equitable Relief

Two Tax Court cases have interpreted the "no reason to know" requirement for equitable relief from a penalty for underpayment of tax by a spouse. In *Hopkins v. Commissioner*, 121 T.C. 73 (2003), the court applied the same standard as has been applied in the Section 6013 "innocent spouse" cases[15], (*i.e.*, whether "a reasonably prudent taxpayer in her position at the time she signed the return could be expected to know that the return contained the understatement"). Factors the court considered important were: (1) whether plaintiff had been put on notice of the deductions that gave rise to the understatement penalty (the partnership loss deductions were readily apparent from the face of the tax return and were substantial in amount); and (2) her knowledge of tax law (she had actively participated in previous audits and Tax Court litigation). The court noted that "an individual cannot rely solely on ignorance of the attendant tax or legal consequences of an item giving rise to a deficiency to satisfy his or her burden under Section 6015(b)(1)(C)".[16]

In *Ewing v. Commissioner*, 118 T.C. 494 (2004), the Tax Court followed *Hopkins* and found the following factors important: (1) taxpayer's level of education relative to her husband (one a licensed clinical laboratory scientist, the other the sole proprietor of a financial services company; (2) knowledge about the spouse's business (taxpayer did not know how much her husband earned); (3) whether taxpayer's husband deceived her (her husband concealed outstanding tax liabilities from before their marriage, promised to make payments under an

[15] Citing *Price v. Commissioner, supra.*
[16] *Id.*

installment agreement, and failed to do so); and (4) whether taxpayer and her spouse kept their finances separate (they did).

IX. Section 6701 Aiding and Abetting

In *Gard v. United States*, 92-1 U.S. Tax Cases (CCH) (N.D. Ga. 1992), the Tax Court interpreted the actual knowledge requirement of Section 6701(a)(3) of the Code. There is also dicta concerning the "knows (or has reason to believe)" requirement of Section 6701(a)(2). The government argued that "willful disregard" could reach a level that illustrated actual knowledge. Plaintiff said that he possessed no actual knowledge of any misrepresented, false, or fraudulent assertion within the document in issue. He asserted that he had no training or experience in valuing the software in issue. The government argued that "Plaintiff's failure to question the terms by which the [security offering] was acquired and his failure to conduct any due diligence investigation into [its] [actual] value allows the inference that he had actual knowledge of the overvaluation and choose not to take any action." The court said that the government's evidence suggested that plaintiff "should have known" that the document at issue would result in an understatement of the liability for the tax of another. The court found "inapposite" the government's citation of *Mattingly v. United States*, 924 F.2d 785 (8th Cir. 1991), for the proposition that evidence of willful disregard of facts is evidence from which actual knowledge can be inferred. The court stated that "[t]he only reasonable inference that can be drawn from plaintiff's conduct is that plaintiff should have taken additional steps to investigate the value of the software. That reasonable inference stands in vivid contrast to an inference that plaintiff performed no investigation because he knew that such investigation would reveal an overvaluation of the software."

X. Section 4945 Private Foundation Excise Tax

While Section 4945 of the Code requires a showing that a foundation manager made a taxable expenditure "knowing" that it was taxable, the regulations interpreting the term "knowing" come close to a "reason to know" test, because they take into account whether the foundation manager "negligently fails to make reasonable attempts to ascertain whether the expenditure is a taxable expenditure . . . ." Treasury Regulations § 53.4945-1(a)(2)(iii).

In *Thorne v. Commissioner*, 99 T.C. 67 (1992), the Tax Court said that the term "knowing" did not mean "having reason to know." However, it found that evidence tending to show that a foundation manager has reason to know of a particular fact or particular rule is relevant in determining whether he had actual knowledge of a particular fact or rule. For example, if a foundation manager has knowledge of sufficient facts concerning a grant to enable him to determine that it would be a taxable expenditure, and if he agrees to the making of the grant in a voluntary, conscious, and intentional manner, then he has done so willfully. Nevertheless, the court said that having "actual knowledge of sufficient facts" regarding the expenditures is different from "having reason to know" that the expenditures were taxable expenditures. The facts of the case were that it was the foundation manager's practice to request 501(c)(3) determination letters before making grants, but he did not question the failure of the organizations in question to provide the requested letters. Taxpayer was a lawyer who was well-informed that grants had to conform to certain criteria under the Code and knew what the requirements were.

XI. Section 4941 Self-Dealing Excise Tax

Section 4941(a)(2) of the Code imposes an excise tax "on the participation of any foundation manager in an act of self-dealing between a disqualified person and a private foundation, knowing that it is such an act . . . ." The regulations interpreting the term "knowing"[17] are virtually the same as the regulations under Section 4945, discussed *supra*. One factor to be considered is whether the foundation manager "negligently fails to make reasonable efforts to ascertain whether the transaction is an act of self-dealing . . . ."

In *Madden v. Commissioner*, T.C. Memo 1997-395, 74 T.C.M. (1997), the Tax Court stated that the term "knowing" does not mean "having reason to know," but that "evidence tending to show that a person has reason to know of a particular fact or particular rule is relevant in determining whether he has actual knowledge of such facts. Having found no cases interpreting Section 4941(a)(2), the court looked to its decision in *Thorne v. Commissioner*. It noted that Sections 4941 and 4945 were enacted at the same time and that the regulations under those respective statutes were virtually identical. Therefore, it considered its analysis in *Thorne* to be "highly probative." The facts of the case were that taxpayer was the founder and manager of a private foundation that hired a maintenance company of which he was a 75% owner. The court found that taxpayer was aware that the maintenance company was a "disqualified person vis-à-vis the foundation" and that some transactions between a private foundation and a disqualified person are consider "self-dealing" under Section 4941(d).

XII. Application of the Foregoing Standards to Lawyers

A. FSA 200129011. In FSA 200129011 (the "FSA"), the Office of Chief Counsel first addressed the appropriate standards for the imposition of Section 6700 penalties on participants in tax-exempt bond transactions. The FSA was requested in a situation in which the Service sought to impose Section 6700 penalties on the bond counsel for an issue that it had previously audited. The bonds in question had purportedly been issued to finance the acquisition and construction of a multi-family housing project. They were sold to the underwriter on December 31, 1985 (the date before more restrictive income targeting rules took effect[18]), but not offered to the public until a later date. The FSA suggests that the Service did not consider the bonds to have been issued before the stricter rules took effect and that, because the project failed to satisfy the more restrictive rules, the bonds were taxable. The FSA stated that subsequent significant modifications had been made to the bonds and that the bonds had been remarketed. In response to a preliminary adverse determination letter, the issuer had redeemed the bonds and the audit had been closed. The Service subsequently asserted Section 6700 penalties against the bond counsel. Although the FSA was requested because of a question about whether Section 6700 penalties could be applied to conduct that occurred prior to enactment of the 1989 Act, the

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[17] Treas. Regs. § 53.4941(e)-1.

[18] Prior to the effective date of the Tax Reform Act of 1986, the definition of "low and moderate income" for purposes of "residential rental property" (*i.e.*, multi-family housing) bond financings, meant no more than 80% of median gross income. Beginning January 1, 1986, a "qualified residential rental project" was required to have either: (a) at least 20% of its units occupied by individuals whose income is no more than 50% of area median gross income, or (b) at least 40% of its units occupied by individuals whose income is no more than 60% of area median gross income.

FSA represents the Service's first guidance on the standards of behavior of participants in tax-exempt bond transactions that may be sanctioned under Section 6700.

As to the "knew or had reason to know" test, the FSA cited *Campbell, supra*, and the 1982 Legislative History as support for the statement that the Service was permitted to rely on objective evidence of bond counsel's knowledge of the transaction, although it was precluded from imputing knowledge to bond counsel beyond the level of comprehension required by bond counsel's role in the transaction. It cited the 1989 Legislative History for the statement that bond counsel could rely (as to matters of fact or expectation) on information provided by others (including the issuer) absent actual knowledge or reason to know of its inaccuracy or the use of statements not credible or reasonable on their face. On the other hand, bond counsel was required to draw his own conclusions from that information. Consequently, whether bond counsel knew or had reason to know that statements contained in the bond documents were false or fraudulent depended upon bond counsel's role. The greater bond counsel's knowledge of the project and involvement in the issuance, marketing, and sale of the bonds, the more likely it was that bond counsel knew or should have known that the bonds would not meet the requirements of Section 103(a) of the Code. Note that Chief Counsel recommended not only that bond counsel's participation in the issuance and initial sale of the bonds be investigated, but that the Service also investigate bond counsel's participation in the subsequent amendments and remarketings of the bonds.

B. Recommended Standards for Imposition of Section 6700 Penalties on Lawyers. We recommend that the standard for whether Section 6700 penalties should be imposed on a lawyer on the ground that the lawyer had "reason to know" that a statement material to the tax treatment of the transaction (including the exclusion from gross income of the interest on tax-exempt bonds) is false should be whether a reasonable person in the lawyer's position in the transaction would have discovered the problem using a minimum level of ordinary care.[19] As Chief Counsel recognized in the FSA and the authorities cited above make clear, this should be a largely subjective, case-by-case analysis. Nevertheless, there are some limits to this subjectivity. Somewhat overlapping factors found important to the application of that standard in the legislative history and case law discussed *supra*, which we recommend be applied to lawyers, are:

1. the lawyer's role in the transaction (*e.g.*, in the case of a tax-exempt bond transaction, whether the lawyer was bond counsel, underwriters' counsel, credit enhancer's counsel, conduit borrower's counsel);

2. whether the lawyer reasonably relied on statements by a reputed "expert" or another transaction participant (including the issuer) that were credible and reasonable on their face;

3. whether the lawyer was on notice that there might be a problem with the federal tax law analysis underlying investment plan or arrangement (*e.g.*, because certificates as to the facts underlying the opinion contained inconsistencies);

[19] 1982 Legislative History; *United States v. Campbell, supra* (emphasis supplied); *United States v. Estate Preservation, supra; Sanders v. United States, supra; Weir v. United States; supra.*

4. whether the lawyer was deceived by other participants in the transaction or was unknowingly the recipient of misleading information;

5. the complexity of the transaction; and

6. whether the lawyer conducted due diligence designed to elicit facts that might be material to the federal tax law analysis.

C. Discussion of the Proposed Criteria.

1. Role in the Transaction. The 1982 Legislative History, the 1989 Legislative History, and the case law interpreting Section 6700 are clear that a person's role in a transaction is relevant to whether Section 6700 penalties may appropriately be imposed. The Section 6700 cases distinguish between the tax shelter architects and the unwitting promoter.[20] The innocent spouse cases distinguish between the spouses that are involved in the financial affairs in question and those that are not.[21] In many transactions, the knowledge of the various participants frequently varies considerably depending upon their roles and the responsibilities associated with those roles. For example, in the case of a tax-exempt bond transaction, quite fairly, much more is expected of bond counsel than is expected, for example, of an official of an infrequent governmental issuer, at least with respect to an understanding of the law and the facts that are relevant to the opinion that the interest on the bonds is tax-exempt.

Within the ranks of the lawyers who are frequent participants in tax-exempt bond transactions, the roles and responsibilities differ as well. Bond counsel is responsible for the opinion that the interest on the bonds is tax-exempt. Underwriters' counsel must advise the underwriters that they may reasonably rely on that opinion. A conduit borrower's counsel is himself a conduit between bond counsel and the conduit borrower as to the facts that are relevant to bond counsel's opinion. Counsel to a credit enhancer (such as a bond insurance company or letter of credit bank) is principally concerned with the adequacy of the security that the transaction structure affords his client and more indirectly concerned that the credit enhancer is not unintentionally becoming involved in a taxable bond transaction with all the liabilities that might entail. Enforcement of Section 6700 should recognize those differing roles and responsibilities by imposing the strictest standards upon bond counsel, while not permitting the other lawyers to abdicate any responsibility for a bad tax opinion. The recognition of different standards for different roles is also discussed in some of the federal securities authorities discussed *infra* under "Failure to Conduct Due Diligence."

However, while it is generally appropriate to impose the strictest standards on bond counsel, it may well be an issuer's or conduit borrower's counsel (especially if in-house) who may be most aware of facts that are essential to bond counsel's ability to deliver an informed opinion. The fact that they are not rendering the tax opinion should not excuse conduit borrower's counsel or issuer's counsel of Section 6700 penalties if their involvement in the transaction is such that they have reason to know of a tax problem with the transaction and by

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[20] *Campbell, supra; Weir, supra.*
[21] *Sanders, supra; Reser, supra; Price, supra.*

their action or inaction caused another person to make a false statement. Even "credit enhancer's counsel" could be found to have reason to know that a structure in which credit risk had not been substantively shifted to his client might preclude tax exemption.

2. Reasonable Reliance. The only criterion for the application of Section 6700 to lawyers discussed in detail in the legislative history or case law is reasonable reliance upon a reputed expert or another transaction participant, such as the issuer of tax-exempt bonds. One example from the 1989 Legislative History provides that bond counsel may rely on the facts or expectations set forth in a feasibility report prepared by an engineering firm reputed to be expert in the subject matter and area of the study, unless bond counsel knew or had reason to know information bringing into question the results of the study. Nevertheless, as is true of other lawyers as well, bond counsel must draw their own legal conclusions from that information. Reasonable reliance upon the opinions of others is also permitted by Treasury Circular 230 under certain circumstances, as discussed *infra* under "Failure to Conduct Due Diligence."

3. Notice of a Problem. The case law and legislative history are uniform that, once a person is on notice of a potential tax problem with the transaction, a duty of further inquiry is required.[22] It is unacceptable to "turn a blind eye" on a potential problem.[23] Similarly, if a tax lawyer has been put on notice that the Service considers certain fact patterns to be indicative of abusive transactions, the lawyer's due diligence (discussed below) should address the possible existence of such or similar adverse facts.

4. Deceit. If a lawyer has been deceived by another party to the transaction as to the facts relevant to his opinion, despite the exercise of due diligence by the lawyer, Section 6700 penalties should not be imposed on the lawyer. This concept of deceit as a defense to Section 6700, while it should be self-evident, is also supported by the innocent spouse cases. While the lack of reason to know test as applied in the innocent spouse cases is a high hurdle, courts have found the defense applicable in cases of deceit.[24]

5. Complexity. While many transactions entail a certain degree of complexity, clearly some are much more complex than others. For example, in a tax-exempt bond context, a school district financing or water and sewer financing is unlikely to achieve the same degree of complexity as a public power debt restructuring or resource recovery project financing. Certain corporate reorganizations entail a greater degree of complexity than others. While all tax lawyers should be held to compliance with certain minimum professional standards of conduct, there may be matters of fact that are very difficult to discover. Absent lack of due diligence or evidence of conduct that crosses over the line between incompetence and recklessness or other evidence that the lawyer has reason to know of a tax problem with the transaction, the imposition of Section 6700 penalties is inappropriate. The innocent spouse cases support the position that the complexity of a transaction is relevant to whether a reasonable person would have discovered the facts that are relevant to tax exemption.[25]

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[22] *Campbell, supra; Kaun, supra; Raymond, supra; Weir, supra; Price, supra; Hopkins v. Commissioner, supra.*
[23] *Hayman, supra; Sanders, supra.*
[24] *Sanders, supra; Reser, supra; Erdahl, supra; Price, supra; Ewing v. Commissioner, supra.*
[25] *Sanders, supra; Reser, supra.*

6. Failure to Conduct Due Diligence. The concept of failure to conduct due diligence differs only slightly from the concept of turning a blind eye once put on notice of a possible problem, which has been employed in the innocent spouse cases.[26] It might also be referred to as a "don't ask, don't tell" policy. If tax counsel does not ask questions designed to elicit the facts relevant to his or her opinion, he or she will never know whether adverse facts exist and whether the existence of those adverse facts might adversely affect his or her ability to render an opinion. The failure to conduct due diligence is virtually the same as "willful disregard"[27] and permits the conclusion that tax counsel had reason to know of a problem with the transaction.[28]

Some have suggested that lawyers may find comfort in the statement in the 1982 Legislative History that Section 6700 imposes no duty of inquiry. However, that same legislative history also stated that the reason to know standard allowed imputation of knowledge so long as it was commensurate with the level of comprehension required by the speaker's role in the transaction. The only case that found for the defendant on the basis of no duty of inquiry was *Weir*, and the court in *Weir* said the defendant had relied on knowledgeable professionals and was himself "naïve, perhaps stupid." The case law does not support the extension of a broad no duty of inquiry rule to individuals who purport to be knowledgeable professionals. As applied to tax lawyers, the no duty of inquiry rule is more appropriately interpreted to mean that the lawyers are not required independently to verify statements of facts or reports if they appear reasonable on their face.

Tax counsel should review all of the documents relevant to the transaction and should be charged with knowledge of facts generally arising in connection with such transactions, by reason of such counsel's expertise and experience in acting on such matters. While there is no generalized duty of inquiry, there should be and must be a duty to ask enough pointed questions to ensure that all of the transaction participants upon whose efforts the opinion or statements rely are up to the task. If some aspect of due diligence seems insufficient, tax counsel should ask more questions until he or she is satisfied that a reasonable person would be entitled to assume the facts upon which his or her firm's opinion or statements are based. On the other hand, tax counsel is ordinarily not involved with or expert in certain matters relating to a transaction, such as, in the context of tax-exempt bond financings, matters of engineering feasibility and construction methods. As to such matters, tax counsel should be able to rely on the statements of other parties having apparent expertise in or knowledge of such matters, unless counsel has reason to know of the inaccuracy of such statements or they are not credible or reasonable on their face. Similarly, although tax counsel should review the underwriter's financial calculations to assure that, on their face, the calculations comply with applicable tax rules, he should not be required to replicate the calculations themselves.

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[26] *Hayman, supra; Sanders, supra.*
[27] *Gard v. United States, supra.*
[28] Treas. Regs. § 53.4945-1(a)(2)(iii); *Thorne v. Commissioner, supra*; Treas. Regs. § 53.4941(e)-1; *Madden v. Commissioner, supra.*

Treasury Circular 230 imposes a duty of due diligence upon practitioners before the Service.[29] Section 10.22 provides that "[a] practitioner must exercise due diligence -- (1) [i]n preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to Internal Revenue Service matters; (2) [i]n determining the correctness of oral or written representations made by the practitioner to the Department of the Treasury; and (3) [i]n determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the Internal Revenue Service."

Section 10.33(a) of existing Treasury Circular 230 also imposes due diligence obligations on practitioners -- in that case with respect to tax shelter opinions. It provides in pertinent part:

> (i) The practitioner must make inquiry as to all relevant facts, be satisfied that the material facts are accurately and completely described in the offering materials, and assure that any representations as to future activities are clearly identified, reasonable and complete.
>
> (ii) A practitioner may not accept as true asserted facts pertaining to the tax shelter which he/she should not, based on his/her background and knowledge, reasonably believe to be true. However, a practitioner need not conduct an audit or independent verification of the asserted facts, or assume that a client's statement of the facts cannot be relied upon, unless he/she has reason to believe that any relevant facts asserted to him/her are untrue.

Section 10.35(c)(1) of the December 20, 2004 revisions to Treasury Circular 230 similarly provides in pertinent part: "The practitioner must use reasonable efforts to identify and ascertain the facts . . . . The opinion must identify and consider all facts that the practitioner determines to be relevant." Circular 230 also provides that a lawyer may not rely upon a representation of a third party if, among other things, the practitioner "knows or should know" that the representation is incorrect or incomplete. We note also that the new Circular 230 penalty imposed by the American Jobs Creation Act of 2004 may be imposed on an employer, firm, or other entity for conduct on behalf of a representative acting on their behalf if the employer, firm, or entity "knew, or reasonably should have known, of [the offending] conduct," thus strengthening the argument, made by this report, that the same standards should apply.

Furthermore, "due diligence" is a concept as to which there is extensive guidance under the federal securities laws.[30] Under the general antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934, a broker-dealer may not recommend a security unless there is an adequate and reasonable basis for such recommendation. In Release No. 34-26100, which proposed the adoption of Rule 15c2-12 (concerning municipal securities disclosure), the Staff of

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[29] We refer to Circular 230 only to note that it represents federal tax law recognition of the federal securities law concept of "due diligence." We do not intend to suggest that a violation of Circular 230 would necessarily result in the imposition of a Section 6700 penalty.

[30] We note that the requirement of Section 6700 that a misstatement must be "material" was interpreted by Congress in the 1982 Legislative History with reference to a federal securities law-type definition. A matter is material to the arrangement "if it would have a substantial impact on the decision making process of a reasonably prudent investor." 1982 S. Rep. at 267.

the SEC summarized the cases interpreting the "due diligence" defense to a securities fraud action.

> In recognition of their responsibilities under the general antifraud provisions of the federal securities laws . . ., for some time underwriters generally have undertaken an investigation of the issuer's disclosure in negotiated offerings of municipal securities . . . . Among other things, depending upon the nature of the issuer, this has included meetings with municipal officials, visits to physical facilities, and an examination of the issuer's records and current economic trends and forecasts that bear upon the ability of the issuer to repay its debt. In addition, underwriters usually require so-called "Rule 10b-5" letters from their counsel with respect to municipal offerings [footnote 80].

Footnote 80 provides:

> Rule 10b-5 letters are obtained by underwriters from their counsel to provide negative assurance concerning the disclosure document (*e.g.*, "nothing has come to our attention that would indicate that the disclosure document contains any untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading") (citation omitted). Such letters generally provide a description of the investigation undertaken by the counsel on behalf of the underwriter which serves as a basis for those assurances.

It would certainly be a curious result in the context of a tax-exempt bond financing, for example, if the underwriters' counsel's due diligence procedures disclosed the existence of a nonqualified management contract (because, for example, it requested copies of all contracts involving financial obligations on the part of the issuer that exceeded a certain threshold), while tax counsel was not required to do the due diligence that would have revealed the existence of the contract.[31]

D. Recommended Application of Criteria to Hypothetical Situations.

Hypothetical #1: Tax counsel's corporate partner advises him that the firm has been retained as counsel to the acquiring corporation in a reorganization entailing the acquisition of the assets of the acquired corporation in exchange for stock of the acquiring corporation. Tax counsel is assured by his corporate partner that none of the consideration for the acquisition will be cash. Based upon that conversation, tax counsel renders an opinion that the exchange is a tax-free reorganization pursuant to Section 368(a)(1)(C). Had tax counsel inquired further as to the

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[31] It should be noted that, in discussing the concept of due diligence, the federal securities laws distinguish among underwriters according to their role in the transaction (*e.g.*, manager, syndicate member, or selected dealer). Release 34-26100.

> Generally, a participating underwriter in an offering of municipal securities need not duplicate the efforts of the managing underwriter, but must satisfy itself that the managing underwriter reviewed the accuracy of the information in the official statement in a professional manner and therefore had a reasonable basis for its recommendation. *Id.* at footnote 87.

consideration for the acquisition, he would have discovered that, in addition to the stock, the acquiring corporation was assuming debt of the acquired corporation and that the amount of the debt was equal to 30% of the fair market value of the acquired assets. The Service audits the transaction and concludes that the transaction was not a tax-free reorganization.

Recommendation: The imposition of Section 6700 penalties on tax counsel is appropriate, because tax counsel failed to conduct adequate due diligence as to the consideration for the acquisition. Whether an asset acquisition entails the assumption of debt of the acquired corporation is a threshold question that needs to be considered in any purported reorganization.

Hypothetical #2. Tax counsel's law firm frequently represents an industrial development agency (the "IDA"). Some of the conduit borrowers for which the IDA issues bonds are sophisticated 501(c)(3) organizations with their own tax counsel. Others are small 501(c)(3) organizations or manufacturers, which lack familiarity with the federal tax laws governing tax-exempt bonds. It is tax counsel's practice to send each conduit borrower a tax questionnaire, with the questions varying depending upon whether the conduit borrower is a 501(c)(3) organization or a manufacturer. Tax counsel sends conduit borrower X (a small 501(c)(3) organization that operates a nursing home) a tax questionnaire that asks, among other things, whether any of conduit borrower's facilities are operated by private, non-501(c)(3) entities pursuant to contracts that do not satisfy certain guidelines that are enumerated in the tax questionnaire (*i.e.*, non-qualified management contracts) and requests copies of those that do not. One of the clearly stated guidelines is that the contracts not entail a sharing of net profits. Conduit borrower X has a contract for the operation of its gift shop and cafeteria with a private management company. The contract provides that the management company is to collect all the revenues from the operation of the gift shop and cafeteria, deduct its operating expenses, and remit a share of the differential to conduit borrower X. The contract does not characterize this arrangement as profit-sharing. There is no overlap between the boards of conduit borrower X and the management company. Neither the management company nor anyone related to the management company has any relationship with the nursing home (*e.g.*, as the developer). Conduit borrower X does not submit the contract to tax counsel for review, and signs a tax certificate stating that there is no private business use of the nursing home within the meaning of Section 141. The Service subsequently audits the bonds, discovers the management contract, concludes that the management contract caused more than 5% of the net proceeds of the bonds to be subject to private business use, determines that interest on the bonds is subject to tax, and asserts Section 6700 penalties against bond counsel, alleging that bond counsel had reason to know that the statement in its opinion and in the official statement for the bonds that interest on the bonds was tax-exempt was false.

Recommendation: Absent circumstances that should alert tax counsel to the existence of the contract, tax counsel's conduct is not a proper subject for the imposition of Section 6700 penalties. Tax counsel conducted due diligence by sending a tax questionnaire that was reasonably calculated to uncover impermissible arrangements, including profit-sharing arrangements. Tax counsel should not be required to review every management or service agreement that each 501(c)(3) conduit borrower of the IDA's bonds may have executed to determine whether it satisfies clear guidelines for permissible contracts.

Hypothetical #3: The facts are the same as in hypothetical #2 except that the 501(c)(3) conduit borrower is a large hospital, which is represented in the transaction by both outside and inside counsel. Neither is an expert in the provisions of the Code governing the tax exemption of certain 501(c)(3) bonds. The outside and inside counsel for the hospital briefly discuss the tax questionnaire prepared by bond counsel. Neither has any actual knowledge of any hospital management contracts that do not satisfy the criteria in the questionnaire for qualified management contracts. Inside counsel does not make reasonable efforts to discover the existence of such contracts through a review of his files and consultation with knowledgeable hospital officials as to the existence of such contracts yet advises outside counsel that no nonqualified contracts exist. The hospital's contract with a physicians group that has general responsibility for the care of its inpatients is later found by the Service to entail profit-sharing, upon its review of the contract's formula for the computation of compensation to the physicians group and, as a result, the interest on the bonds is found to be taxable.

Recommendation: The inside counsel should be the subject of a Section 6700 penalty, because he failed to conduct due diligence with respect to the existence of such contracts. Given the size of the organization, he should not have relied simply on his own knowledge in answering the questionnaire. However, no Section 6700 penalties should be imposed on the hospital's outside counsel. His role in the transaction does not require him to contest the representation of the inside counsel, because in this situation he had no reason to know that it was false.

Hypothetical #4: Tax counsel has participated in the structuring of over 15 resource recovery financings utilizing tax-exempt bonds, including transactions in which he served as issuer's counsel during service contract negotiations, underwriters' counsel, as well as bond counsel. In 1987, he is asked to deliver the tax opinion that will permit the remarketing of a large variable rate tax-exempt bond issue, which was issued in 1984 and is, accordingly, not subject to the arbitrage rebate provisions of the Code. It should be assumed for purposes of this hypothetical that enough changes to the terms of the bonds will be made in connection with the remarketing that the bonds will be considered to be reissued on the date of the remarketing. Although the bonds were issued to finance the construction of a resource recovery facility, the proceeds of the bonds have not been expended on the project, but instead have been invested in Treasury securities with a yield exceeding the yield on the bonds. Tax counsel is told by his bond partner that he should rely on the financial advisor's certificate that the project is feasible and that it is reasonable to expect that the project will, in fact, be constructed. None of the principals in the financial advisory company has experience with successfully completed resource recovery facility projects. The underwriter is a firm known not for its resource recovery or other project finance experience, but for its expertise in marketing Treasury securities, so it cannot provide assistance to tax counsel in his analysis of the project.

Because of his experience with resource recovery transactions, tax counsel knows that the following factors, among others, are relevant to successful completion of the financed facility: (1) an assured, adequate, and affordable supply of fuel; (2) lack of strong local opposition to the location of the facility; (3) ability to secure air and water permits; (4) use of a qualified contractor, with the financial wherewithal to satisfy its obligations under the construction contract; and (5) qualified management. The financial advisor has not prepared a detailed

feasibility report for the project. Nor is he qualified to do so. His certificate concerning feasibility does not address the foregoing factors.

Tax counsel does not conduct his own due diligence regarding the proposed project. Had he done so, he would have discovered the following facts: (1) the cities upon which the facility is reliant for its supply of fuel are not committed to dispose of their garbage at the facility and, in fact, think that it might be cheaper to landfill it; (2) the brewing company located across the highway from the proposed facility has threatened to sue to stop construction of the facility, and there is a strong competitor for the site; (3) the site for the proposed facility is extremely smoggy, and the state air permitting agency is unlikely to grant an air permit for the facility; (4) the proposed contractor, although well-reputed, has not committed to construct the facility; and (5) no manager has even been selected, much less committed by contract. Tax counsel follows the advice of his bond partner and delivers the desired favorable tax opinion that permits the remarketing, stating that he is relying upon the financial advisor's representations concerning feasibility. The Service subsequently audits the bond issue, determines that it was never reasonable to expect that the facility would be constructed, and concludes that the bonds are arbitrage bonds.

Recommendation: Section 6700 penalties should be imposed on tax counsel and his bond partner, because: (a) it was not reasonable for them to rely on the financial advisor's certificate concerning feasibility, as (i) the financial advisor had no experience with successfully completed resource recovery facilities, and (ii) the financial advisor's certificate did not address the factors that tax counsel knew to be key to the successful completion of a resource recovery facility, and (b) they failed to conduct their own due diligence concerning the feasibility of the project. In light of tax counsel's particular expertise in the financing of resource recovery facilities, tax counsel had reason to know that there was at least a potential problem with the project's feasibility. The absence of a detailed feasibility report by a well-reputed consulting firm addressing the facts that were generally considered relevant to a determination of feasibility put him on notice of the problem and he turned a blind eye.

Hypothetical #5: During a final documents meeting on a financing, a tax issue is identified and discussed by the working group. Tax counsel proposes a novel modification to the financing plan as to which he is "comfortable" and willing to opine. The senior investment banker (himself, a former tax lawyer), upon reflection, is distinctly "uncomfortable," but is unwilling to "rock the boat" at such a late stage in the financing. The investment banker discusses the situation with his underwriters' counsel's tax expert, who in turn confers with tax counsel to understand tax counsel's reasoning behind the opinion. While underwriters' counsel tells the investment banker that he would be unwilling to give the same tax opinion on an unqualified basis, he nevertheless advises the investment banker that it is reasonable to rely on tax counsel's opinion. There has been no guidance on this legal issue from the Service, and tax counsel's opinion is not contrary to the language of the statute or what little legislative history there is. Tax counsel's solution is challenged by the Service, and the bonds are held to be taxable.

Recommendation: Neither the investment banker, nor underwriters' counsel should be the subject of Section 6700 penalties. The investment banker is not functioning as a tax lawyer

in the transaction, but rather as an investment banker. Furthermore, the investment banker conducted due diligence on the matter by consulting with his own counsel. In turn, underwriters' counsel exercised due diligence by querying tax counsel as to the basis of his opinion and, in view of the lack of inconsistent guidance, had no reason to know that the Service would tax the bonds.

XIII. Conclusion

We recognize that there are circumstances under which a lawyer's failure to exercise ordinary care may lead to the making of statements or the rendering of opinions that are materially false and that such inadequate conduct is appropriately the subject of Section 6700 penalties. It is essential, however, that the Government not use the threat of Section 6700 penalties as a routine audit tool. Furthermore, we strongly recommend that the Government issue a clear set of guidelines as to the conduct that will result in the imposition of Section 6700 penalties in accordance with the recommendations set forth in this report.