

Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: October 26, 2017

to: Kristen I. Nygren
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from: Blaise G. Dusenberry
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(Procedure & Administration)

subject: Penalty for aiding and abetting understatements of income tax

This Chief Counsel Advice responds to your request for assistance dated October 26, 2017. This advice may not be used or cited as precedent.

LEGEND

P

S

ISSUE

Whether P is liable for the section 6701 penalty for aiding and abetting understatements of tax liability for returns on which his clients claimed incorrect depreciation deductions in accordance with a written "S", which had been furnished by P.

CONCLUSION

Yes. When P furnished to clients a S that mischaracterized components of 39-year depreciable property as property with a shorter useful life (e.g. 5-year property), P aided in the preparation or presentation of the returns of clients who understated tax liability through claiming excessive deductions for depreciation. P knew that the S would be used in connection with a material matter under the internal revenue laws and that when

his client relied upon such study to claim a depreciation deduction this would result in the client understating tax liability. Consequently, there is a \$1,000 penalty for each client's return that understated tax liability by virtue of claiming excessive depreciation deductions based on the S.

FACTS

P is a tax consultant-engineer who furnishes an analysis of a taxpayer's assets in order to determine the classification of articles of property for purposes of depreciation deductions. For a fee, P analyzes a taxpayer's assets and prepares a S, which is aimed at identifying assets among a taxpayer's property that could be classified as tangible personal property and other tangible property (I.R.C. section 1245 Property) and land improvements. The S re-characterizes components of 39-year depreciable property (e.g. a building) to 5-year, 7-year, or 15-year depreciable property.¹ The result of the S, which P specially prepares based on the particular types of assets owned or used by the taxpayer, details the cost of each component of a building, new or otherwise, and the number of years it can be depreciated on the taxpayer's returns. P does not prepare returns or furnish the IRS with copies of the S. Rather, P furnishes the completed S to his clients, who use them in preparing Forms 1040 or Forms 1120.

The IRS determined that the S incorrectly reclassifies property in order to accelerate or "front-load" depreciation deductions during the first 5 years the property is placed in service, thereby creating larger tax losses for P's clients. The IRS considers the portions of the S categorizing certain structural components as 5-year property to be the most egregious misrepresentations concerning the classification of property for tax purposes. You requested our views on whether P is liable for a \$1,000 penalty for each taxpayer's return upon which an excessive depreciation deduction was claimed as a consequence of following the conclusions in the S.

LAW AND ANALYSIS

Section 6701 imposes a penalty on a person who aids or abets another person in the understatement of that person's tax liability. It states:

Any person—

- (1) who aids or assists in, procures, or advises with respect to, the preparation or presentation of any portion of a return, affidavit, claim or other document,
- (2) who knows (or has reason to believe) that such portion will be used in connection with any material matter arising under the internal revenue laws, and
- (3) who knows that such portion (if so used) would result in an understatement of the liability for tax of another person,

¹ Section 168(e) includes classifications of property for purposes of determining depreciation deductions.

shall pay a penalty with respect to each such document in the amount determined under subsection (b).

The penalty amount under subsection (b) is \$1,000 and, if the return, affidavit, claim or other document pertains to the tax liability of corporation, the amount is \$10,000. The extent to which a person may be liable for the penalty is limited by section 6701(b)(3), which reads:

. . . If any person is subject to a penalty under subsection (a) with respect to any document relating to any taxpayer for any taxable period (or where there is no taxable period, any taxable event), such person shall not be subject to a penalty under subsection (a) with respect to any other document relating to such taxpayer for such taxable period (or event).

The structure of section 6701 requires the Service to identify what documents the person liable for the penalty helped prepare or present, and which also meet the criteria set out in section 6701(a)(2) and (3). Mitchell v. United States, 977 F.2d 1318, 1321-22 (9th Cir. 1992). Section 6701(a)(1) requires that the person or entity to be penalized must “aid[] or assist[] in, procure[], or advise[] with respect to the preparation or presentation of any portion of a return, affidavit, claim or other document.” Mitchell, 977 F.2d at 1322. The penalty for aiding and abetting an understatement of tax liability is imposed with respect to each document identified in section 6701(a)(1) that further meets the criteria under paragraphs (2) and (3) of subsection (a). Mitchell, 977 F.2d at 1322; Berger v. United States, 1997 U.S. Dist. LEXIS 6297, 19 (D. Conn. 1997) (“ . . . the statute plainly imposes a penalty as to each document through which the plaintiff aided or assisted in the understatement of a tax liability.”).

S

The written S satisfy the elements of a section 6701 penalty. P prepared and furnished to each of his clients a detailed S. Consequently, the S fall within the requirements of section 6701(a)(1). The S also meet the criteria of section 6701(a)(2) and (3); P knew that they would be used in connection with the preparation of individual and corporate tax returns. Thus, P knew or had reason to believe that his clients, both individual and corporate taxpayers, would use the S as guidance in claiming depreciation deductions on returns, a material matter under the internal revenue laws, and that the S would (if so used) result in understatements of tax liability of other persons. Thus, each S is a document that supports a penalty in an amount determined under section 6701(b). To the extent the S related to the tax liability of a corporation, the penalty amount is \$10,000 per S furnished. For S furnished to taxpayers other than corporations, the penalty equals \$1,000 per S furnished. I.R.C. § 6701(b)(1).²

² Note that the Service would also need to comply with section 6751(b)(1) before assessing the section 6701 penalty. The immediate supervisor of the revenue agent who initially recommended pursuing the penalty would need to approve the penalty in writing.

Returns of Individuals and Corporations

You also asked whether P is liable for a \$1,000 penalty for each of the five years a client used the S to prepare his tax return and claim an excessive depreciation deduction. This raises the question of whether P aided or assisted in the preparation or presentation of his client's tax returns. Each of P's clients had to file a Form 1040 or 1120 with the IRS in order to claim a deduction for depreciation.³ P aided or assisted in the preparation of each individual or corporate tax return upon which a client claimed a depreciation deduction in an incorrect amount by virtue of misclassifying personal or real property in accordance with the S. The purpose behind P's review, analysis and classification of a client's articles of property was to assist his client in preparing and filing a tax return that included a depreciation deduction exceeding the allowable amount under the Code and thereby understating taxable income. By furnishing a S to a client that classified certain real property as personal property, with purported useful life of only 5 years, P aided or assisted his clients in the preparation of incorrect returns for 5 different tax periods. As a result, he is liable for one penalty for each of the years for which a return was filed with the IRS claiming an excessive deduction for depreciation. In regard to P's individual clients, the penalty on P would be \$5,000 (\$1,000 for each of the 5 understatements reflected in 5 separate tax returns) and for corporate clients the penalty is \$10,000 per return.

These facts are analogous to those in Mitchell, in which a tax shelter organizer reviewed and signed tax returns for an S corporation and K-1 forms for each of the shareholders which showed their purported shares of deductions and credits. Although Mitchell clearly aided in the preparation or presentation of the S corporation returns, the court found that section 6701(a)(1) was satisfied with respect to other documents as well.

Mitchell's aiding also pertains to portions of all 34 investors' individual tax returns, because each investor incorporates the tax information contained on the Form K-1 supplied by Mitchell into his or her U.S. individual tax returns. Thus, Mitchell aided in the preparation or presentation of documents that relate to the returns of 35 persons.

Mitchell, 977 F.2d at 1322. Just like the investors in Mitchell, every client of P incorporated onto his or its tax return a claim for a depreciation deduction that was directly tied to the misclassified property included in the S. P aided in the preparation or presentation of the tax returns of his clients.

³ An individual taxpayer receiving net profits (loss) from a trade or business can claim a deduction for depreciation on Schedule C, and a taxpayer who receives net rental income may claim a depreciation deduction on Schedule E. 2016 Form 1040, Schedule C, part II, line13; Schedule E, line 18. The returns of corporate taxpayers include spaces upon which the taxpayer can claim depreciation deduction. 2016 U.S. Corporation Income Tax Return (Form 1120), line 20; 2016 U.S. Income Tax Return for an S Corporation (Form 1120S), line14.

The opinion in Berger v. United States, *supra*, is distinguishable from the present case. In Berger, the government sought to impose a penalty under section 6701 based solely upon the plaintiff's filing of false Forms 5300, "Application for Determination for Employee Benefit Plan" with the IRS. Each form related to a separate corporation that claimed tax benefits for more than one year in reliance on a false Form 5300. The court held that the section 6701 penalty was limited by the number of false Forms 5300 prepared and was not calculated by the number of tax years affected. Berger, 1997 U.S. Dist. LEXIS 6297, at 20. That case is distinguishable from P's conduct because the government did not argue in Berger that the plaintiff had aided or assisted with respect to the preparation or presentation of the corporate returns that claimed tax benefits in reliance on the Forms 5300. "[T]he conduct allegedly warranting imposition of a section 6701 penalty was the plaintiff's alleged falsification of the forms 5300." *Id.*

You also raised the question of whether section 6701(b)(3), quoted above, applies to the facts presented here. That provision precludes the IRS from imposing separate section 6701 penalties for multiple documents in the same year involving the same taxpayer. Mattingly v. United States, 924 F.2d 785, 792-93 (8th Cir. 1991). The Court of Appeals for the Eighth Circuit ruled that an individual who prepared 46 returns for taxable year 1983 with understatements of tax attributable to non-allowable investment tax credits was subject to the section 6701 penalty on each of the returns, but not for the 8 carry-over returns prepared for subsequent tax years. *Id.* at 793. In Emanuel v. United States, 705 F.Supp. 434 (N.D. Ill. 1989) the IRS assessed a section 6701 penalty against an individual for each return he prepared for taxable year 1982 containing an incorrect investment tax credit, and also one or more penalties for every application for tentative refund (Form 1045) filed on behalf a client for an earlier or subsequent tax year.⁴ The district court held that the IRS violated section 6701(b)(3) by imposing additional penalties based on the Forms 1045 because they "related to" the year 1982. 705 F.Supp. at 438.

Here, because the tax returns and relevant schedules of P's clients do not claim credits or deductions that are carried over from a previous taxable year, neither Emanuel nor Mattingly controls. The above interpretation is also consistent with section 6701(b)(3) because P will not be subjected to multiple penalties for a given client for a single taxable period.

The legislative history to section 6701 states that the penalty was intended to apply as a civil counterpart to the criminal penalty on aiding or assisting in the preparation or presentation of false or fraudulent returns or other documents. S. Rep. No. 97-494, at 1022 (1982). Section 7206(2) is the criminal penalty applicable to a person who willfully "aids or assists in, or procures, counsels, or advises the preparation or presentation . . . of a return, affidavit, claim, or other document . . ." This language is virtually the same as in section 6701(a)(1). Courts have applied the criminal penalty to all participants in a

⁴ The preparer filed the Forms 1045 for those of his clients who did not use up entirely the purported investment tax credit in year 1982.

scheme which results in the filing of a false return, whether or not those parties actually prepare it. United States v. Hooks, 848 F.2d 785, 791 (7th Cir. 1988). Likewise, section 6701 is the civil counterpart applicable to P in connection with furnishing the S to his clients and for assisting in the preparation of tax returns reflecting understatements of tax.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[REDACTED]

[REDACTED]

[REDACTED]

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