Office of Chief Counsel
Internal Revenue Service
memorandum

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subject: False Statements and Penalty Computation Under Section 6700, Promoting Abusive Tax Shelters

This Chief Counsel Advice responds to your email dated December 17, 2020. In accordance with I.R.C. 6110(k)(3), Chief Counsel Advice may not be used or cited as precedent.

LEGEND

X =

Year 1 =

ISSUES

1. What constitutes a false or fraudulent statement for purposes of assessing a section 6700 penalty against a promoter?

2. Does the section 6700 penalty calculation include a promoter's gross income derived from the tax shelter promotion after the formation of the tax shelter?

3. Can the section 6700 penalty be asserted against the members, officers or employees of a promoter, in addition to asserting it against the promoter itself?

CONCLUSIONS

1. There are two types of statements that fall within the statutory bar of section 6700(a)(2)(A): statements directly addressing the availability of tax benefits and those concerning factual matters that are relevant to the availability of the tax benefits. See United States v. Campbell, 897 F2d 1317, 1320 (5th Cir. 1990).

2. Yes. The statute provides that the government is directed to assess a section 6700 penalty that is 50 percent of the gross income derived or to be derived from the organization or sale of a tax shelter, if the organization or sale involves false or fraudulent statements. Courts have found that section 6700 allows the government to assess a penalty on all gross income derived from the organization or sale of a tax shelter, including gross income derived after the formation of the tax shelter.

3. Yes. To the extent that an individual organizer or seller of the micro-captive program made, or caused to be made, false or fraudulent statements that the individual knew or had reason to know were false or fraudulent as to the availability of tax benefits, the Service may penalize each such individual under section 6700.

FACTS

X is that engaged in the promotion of micro-captive insurance transactions. X does not dispute that it organized and sold micro-captive insurance transactions. In a typical micro-captive insurance transaction, a taxpayer attempts to reduce the aggregate taxable income of the taxpayer, related persons, or both, using contracts that the parties treat as insurance contracts and a related company that the parties treat as a captive insurance company. Each entity that the parties treat as an insured entity under the contracts claims deductions for premiums for insurance coverage. The related company that the parties treat as a captive insurance company elects pursuant to section 831(b) to be taxed only on investment income and therefore excludes the payments directly or indirectly received under the contracts from its taxable income.

In Year 1, X marketed a micro-captive insurance transaction to prospective clients. X held itself out as a “turn-key” service provider of a captive insurance program with the requisite ability to provide all services needed for its clients to capitalize on their participation. X marketed and represented the captive program to its clients and prospective clients as an “insurance” program that would be respected by the IRS for federal tax purposes and thereby provide tax benefits.

Under X’s micro-captive program, the insureds paid fees to X to facilitate formation of their captives. Once established, the captives paid X monthly or annual fees to manage their activities and obligations.

LAW AND ANALYSIS

Since January 1, 1990, section 6700 of the Code has imposed a penalty on persons who promote abusive tax shelters. In pertinent part, the penalty applies to any person who

> (1)(A) organizes (or assists in the organization of) –
> (i) a partnership or other entity,
> (ii) any investment plan or arrangement, or
> (iii) any other plan or arrangement, or
>
> (B) participates (directly or indirectly) in the sale of any interest in, an entity plan or arrangement . . . ,and
>
> (2) makes or furnishes or causes another person to make or furnish (in connection with such organization or sale)-
>
> (A) a statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter. . . .

1. False Statements

A statement can be either written or oral. United States v. Music Masters, Ltd., 621 F.Supp 1046, 1058 (W.D. NC 1985). There are two types of statements that fall within the statutory bar of section 6700(a)(2)(A): statements directly addressing the availability of tax benefits and those concerning factual matters that are relevant to the availability of the tax benefits. See United States v. Campbell, 897 F2d 1317, 1320 (5th Cir. 1990). Advice and recommendations are considered statements for purposes of section 6700. United States v. Stover, 650 F.3d 1099, 1108 (8th Cir. 2011). False statements under section 6700 include representations that a plan qualifies for special tax treatment when the plan does not comply with the law. See Koresko v. United States, 123 F. Supp. 3d 654, 682-689 (E.D. Pa. 2015).

Statements are false when assertions are not qualified and customers are not notified that following the advice could subject them to IRS scrutiny. Stover, 650 F.3d at 1109-1110. Where a promoter has knowledge of the risks incident to a tax shelter, the promoter must clearly and unambiguously inform its agents, prospective clients, and current clients of that risk. See Davison v. Commissioner, T.C. Memo. 2020-58, appeal dismissed, No. 20-9002, 2020 WL 7033850 (10th Cir. Aug. 18, 2020).

Statements in the context of micro-captive insurance transactions include opinions, promotional materials, reports, tax savings projections, or other statements (or materials relied upon in making such statements) that are false or fraudulent as to any matter

material to exclusion of income under section 831(b) or tax deductions under section 162 for premiums paid by the insured.

2. Penalty Computation

Section 6700(a) provides that the "penalty shall be equal to 50 percent of the gross income derived (or to be derived) from such activity by the person on which the penalty is imposed" if the activity involves false or fraudulent statements. 26 U.S.C. § 6700(a). The "activity" giving rise to a section 6700 penalty encompasses the entire promotion facilitated and organized by the promoter. Tarpey v. United States, No. CV-17-94-BMM, 2019 WL 5820727, at *2–3 (D. Mont. Nov. 7, 2019). Courts have found that "[s]ection 6700 allows the government to assess a penalty on 'gross income derived or to be derived' from the tax shelter activity." In re MDL-731 Tax Refund Litig. of Organizers & Promoters of Inv. Plans Involving Book Properties Leasing, 989 F.2d 1290, 1302 (2d Cir. 1993); Davison v. Commissioner, T.C. Memo. 2020-58, appeal dismissed, No. 20-9002, 2020 WL 7033850 (10th Cir. Aug. 18, 2020). This language contemplates assessments on current earnings, but also assessments on earnings to be derived in the future from the facilitation and organization of an abusive tax shelter. Id.

Recently, in Davison v, Commissioner, T.C. Memo. 2020-58, the Tax Court found that section 6700 penalties were appropriately assessed and accurately calculated based on the promoter's gross income derived from the entire promotion. The promoter's gross income included amounts paid as a retainer for the promoter's ongoing services in 2009 and 2010 for facilitating and organizing the tax shelter, including serving on a board of directors, years after the formation of the abusive tax shelter. Id. In Tarpey v. United States, No. CV-17-94-BMM, 2019 WL 5820727, at *2–3 (D. Mont. Nov. 7, 2019), the district court found that the "activity" giving rise to the penalty against Tarpey, the promoter, encompassed the entire promotion facilitated and organized by the promoter, and included the promoter's solicitation of timeshare donations, timeshare appraisals, and direct profits to his other organizations.

These cases illustrate that section 6700 allows the government to assess a penalty on gross income derived from the facilitation and organization of the entire promotion, and the penalty is not limited temporally to activity occurring prior to the formation of the tax shelter. In the context of micro-captive insurance transactions, section 6700 allows the government to assess a penalty on a promoter's gross income derived from the facilitation and organization of the entire tax shelter by the promoter, not just gross income pre-dating the formation of the micro-captive insurance company. For example, this would include ongoing maintenance and management fees received related to the continued facilitation and organization of the promotion as well as any other fees relating to the continued facilitation and organization of the promotion.

3. Assertion of Penalty Against Persons Other Than X

Whether X's members', officers', or employees' false or fraudulent statements as to the availability of tax benefits or concerning factual matters that are relevant to the availability of the tax benefits violated section 6700 requires consideration of the facts and circumstances. The IRS must show that the person knew or had reason to know that the statements they made were false or fraudulent as to a material matter. Section 6700(2)(A). Courts often look to three factors to determine whether a person had the requisite scienter to violate section 6700: (1) the extent of the person's reliance on knowledgeable professionals; (2) the person's level of sophistication and education; and (3) the person's familiarity with tax matters. See, e.g., United States v. Estate Preservation Services, 202 F.3d 1093, 1103 (9th Cir. 2000). While these factors are not always dispositive of the issue, they help the Service and the courts focus on the relevant facts and circumstances. In addition, although section 6700 does not impose a duty of inquiry, it "allows imputation of knowledge" as long as it is "commensurate with the level of comprehension required by the [person's] role in the transaction. United States v. Campbell, 891 F.2d 1317, 1321-22 (5th Cir. 1990). Thus, the greater the person's involvement in the transaction, the more likely it is that the person knew or had reason to know that the statements he made, or caused others to make, were false or fraudulent. H.R. Rep. 101-247 at 1397 (1989).

To the extent that the organizers or sellers of the micro-captive program made, or caused to be made, false or fraudulent statements that they knew or had reason to know were false or fraudulent as to the availability of tax benefits, the Service may penalize each of them under section 6700. Application of the penalty to each of these persons will require a facts and circumstances analysis of their involvement in the promotion and whether they knew or had reason to know that their statements as to the availability of the tax benefits were false or fraudulent.

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