Office of Chief Counsel
Internal Revenue Service
memorandum

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subject: Calculation of Penalties Under Section 6700, Promoting Abusive Tax Shelters

This Chief Counsel Advice responds to your email dated November 23, 2020. In accordance with I.R.C. 6110(k)(3), Chief Counsel Advice may not be used or cited as precedent.

LEGEND

X =

ISSUE

Does the section 6700 penalty calculation include a promoter's gross income derived from the organization or sale of a tax shelter after the formation of the tax shelter?

CONCLUSION

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.

FACTS

X is a corporation that engaged in the promotion of 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.

Here, X set up and provided ongoing services related to the continuing maintenance and management of a micro-captive insurance company. In response to the Service's questions posed during the section 6700 audit of the promoter, promoter asserted that section 6700 penalties are calculated only on the income derived from initial promotional and/or organizational activity that occurred before the formation of the micro-captive insurance company. X received ongoing maintenance and management fees relating to the micro-captive insurance companies. X made false statements regarding available tax benefits while engaged in both organizational and sales activities.

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. . . .

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, gross income derived 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.

X cited two cases as standing for the proposition that 6700 penalties are calculated only on income derived from initial promotional and/or organizational activity that occurred before the formation of the micro-captive insurance company. The cases cited are inapposite. In Schulz v. United States, 2018 WL 3405240 (N.D.N.Y. July 12, 2018), the court found that the promoter's tax shelter activity was the distribution of blue folders that promoted frivolous tax arguments and that the penalty should be calculated on the gross income derived from the tax shelter activity. The case supports the legal conclusion that section 6700 allows the government to assess a penalty on gross income derived or to be derived from the facilitation or organization of the tax shelter. In Hargrove, an unreported case that analyzed a prior version of section 6700(a)(1), the

court considered whether each sale was to be treated as a separate activity for purposes of assessing multiple $1000 minimum penalty amounts under that prior version of section 6700(a)(1). Hargrove & Costanzo v. United States, No. CVF06046LJODLB, 2008 WL 4133928 (E.D. Cal. Sept. 4, 2008). But the rule for activities occurring on or after October 23, 2004 provides that the penalty amount is equal to 50 percent of the gross income derived (or to be derived) from the organization or sale of a tax shelter by the person penalized. The legislative history of section 6700 shows that Congress believed that pre-2004 penalty rate discussed in Hargrove was insufficient to deter the type of conduct that gave rise to the penalty. S. Rep. No. 180-192 (2003). Accordingly, Congress amended section 6700 to modify the penalty amount to equal 50 percent of the gross income derived by the person from the activity for which the penalty is imposed. See IRC§ 6700(a).

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