New York State Bar Association

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December 10, 2004

Mr. Gregory F. Jenner
Acting Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3120 MT
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

The Honorable Mark W. Everson
Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: *Filing Deadline for Material Advisors under Notice 2004-80*

Dear Acting Assistant Secretary Jenner and Commissioner Everson:

I am writing, on behalf of the New York State Bar Association Tax Section, to urge that the Internal Revenue Service promptly clarify the requirement set forth in Notice 2004-80 that a material advisor file a return under § 6111 of the Internal Revenue Code "within 30 days after the date on which the person becomes a material advisor." We believe the Notice should be clarified to provide that no filing is required until 30 days after, at the earliest, the transaction is entered into or an interest is acquired (the "Closing Date"). We urge immediate guidance on this question because, in the absence of certainty, advisors may feel obligated to file a return by the February 1 deadline even for transactions that have not yet closed. For the reasons stated below, we believe this obligation would be extremely burdensome for advisors and would provide little or no benefit to the government.

Section 815 of the American Jobs Creation Act of 2004 amended § 6111 to require that each material advisor with respect to a reportable transaction make a return setting forth information identifying and describing the transaction and any potential tax benefits expected to result from the transaction no later than the date specified by the Secretary. The interim guidance provided by Notice 2004-80 generally applies existing regulations to determine what is a reportable transaction and who is a material advisor.

Section 301.6112-1(b)(2)(B) of the Income Tax Regulations provides that a transaction that has a potential for tax avoidance or evasion includes:

> "Any transaction that a potential material advisor *(at the time the transaction is entered into or an interest is acquired)* knows is or reasonably expects will become a reportable transaction..." [emphasis added]

Similarly, § 301.6112-1(c)(2)(B) of the Regulations provides that a "material advisor" includes a person who makes a tax statement to or for the benefit of:

> "A taxpayer who the potential material advisor *(at the time the transaction is entered into)* knows is or reasonably expects be required to disclose the transaction..." [emphasis added]

Under these rules, a material advisor is presumably not required until the Closing Date to determine whether a transaction is, or is expected to be, a reportable transaction.

There are good reasons for waiting until the Closing Date to determine whether a transaction is reportable. Until that time, there is no transaction; there is just an idea of a potential transaction. Such a potential transaction is inherently fluid: the size of the transaction, the parties, and the transaction elements are all subject to change, and they frequently do. A potential transaction may fall apart, even just before a planned closing. More fundamentally, until there is final agreement among the parties as to its terms, there is no "transaction" that can be pointed to and analyzed as to its reportable status.

Take, for example, the simple question of the size of a transaction. This size can be subject to change right up to closing, based on non-tax considerations such as funding needs or credit constraints, or on tax considerations such as net operating loss or foreign tax credit capacity or other tax-related constraints. Yet the size can be determinative of whether a transaction is reportable on account of an expected tax loss or book-tax difference. Suppose parties begin discussing a transaction with a size that would not generate a tax loss that exceeds the minimum threshold. At some point in the negotiations, one of the parties proposes to increase the size to a level that would generate such a tax loss. The other party might tentatively agree, and they might memorialize their plans in a nonbinding term sheet. Subsequently, the credit committee of one of the parties rejects the proposed increase, and the transaction is closed based on the original smaller size. Was there ever a reportable transaction? Should the advisors have been required to disclose the proposed transaction to the IRS during the window between the time the larger size was proposed and the time it was rejected?

Other features of the transaction are equally subject to change; for example, an aspect that affects the financial accounting treatment and therefore the size of a book-tax difference. Or a change in the terms or structure might cause the transaction to fall in or out of the "angel lists" of transactions that will not be treated as reportable by reason of a specified tax loss or book-tax difference. Or such a change might cause it to be, or to cease to be, substantially similar to a listed transaction.

Even greater uncertainty clouds the question of when a person could be said to become a material advisor before the Closing Date. To be a material advisor, a person must receive or expect to receive a minimum fee; the minimum fee varies with the nature of the transaction and its participants. In most cases, an advisor's fee will not be fixed until the Closing Date, either because all or part of the fee is not due until closing, or because the fee is based on factors, such as hours worked, that are not determinable until closing. In these common circumstances, there is no clear point before the Closing Date at which a person can be said to "become" a material advisor by virtue of reaching the fee threshold. In particular, if a person becomes a material advisor because the person "expects" to receive the minimum fee, there will typically be no identifiable date before closing on which the person can be said to have subjectively formed that expectation, or can be said objectively to have reason to have such an expectation. But unless this date is clear, there will be no clarity regarding the deadline for filing the disclosure with the IRS.

Moreover, because the minimum fee threshold changes with the nature of the transaction and its participants, the status of a person as a material advisor can be subject to change even if the fee is fixed. For example, a change in the status of a planned participant from a corporation to a partnership can change the fee threshold from $250,000 to $50,000, even if that change represents nothing more than a decision to file a check the box election. Also, if a proposed transaction that was initially thought to be reportable by reason of a book-tax difference changes in a manner that causes it to be substantially similar to a listed transaction, the fee threshold will drop dramatically. These events might cause a person to expect to become a material advisor, but there may be no identifiable date on which a proposed transaction can be said to have changed its character.

The Notice preserves the requirement that a person make a tax statement before that person can be considered a material advisor. Yet the term "tax statement" is defined broadly to include any written or oral remark about an aspect of the transaction that causes it to be reportable, and may be made by a person who is not a tax expert and outside the context of "pitching" the transaction to a potential participant. Given the possible informality of the context in which such a statement might be made, and the evidentiary issues of identifying the date on which an oral statement was made, it would be troubling to have a filing deadline depend on the date of a "tax statement."

Serious penalties arise if a potential material advisor guesses wrong as to the filing deadline. The minimum penalty is $50,000, but it can be much greater for a listed transaction. Moreover, under Sections 6707(c) and 6707A(d), the penalty can be rescinded only in limited circumstances (and not at all for a listed transaction), and there is no right to a judicial appeal. With penalties of this type at stake, it is essential that persons potentially subject to these penalties clearly understand when the filing deadline is.

Notice 2004-80 contemplates the interim use of Form 8264, Application for Registration of a Tax Shelter, for filings by material advisors until a new form is issued. Even with the modifications provided in the Notice, the Form requires more precise information regarding the terms of the transaction, including the cost of an investment and the date the investment is acquired, than will typically be available while the transaction is still being negotiated. (This is not a new problem: under the old registration rules, parties would frequently file a vague form at the outset of a transaction and an amended form after closing. Those filings, however, were made for a much more limited class of transactions, and where the status of the tax shelter organizers was not in doubt.) If the purpose of the filing is to disclose a specific transaction, it make sense to wait until there is a specific transaction to disclose.

The scope of the term "material advisor" is intentionally broad, and includes, in addition to promoters hawking deals that are obviously reportable, law firms and other professional advisors working on a wide range of transactions in the course of their practices, only a small portion of which may be reportable. Determining whether a transaction is reportable requires focused attention on the economic and legal terms of the deal as well as the growing number of listed transactions and factors that appear on the angel lists. If this exercise is done after closing when the terms of the deal are set, the work may be burdensome, but it need be done only once. Any filing requirement that was pegged to some earlier date would effectively impose a continuous monitoring requirement for advisors on a variety of transactions, many of which may turn out not to be reportable. Indeed, in that situation it is difficult to imagine how even conscientious advisors could stay consistently in compliance, and an early deadline will likely put the IRS in a position of having to overlook "non-waivable" penalties in order to avoid manifest injustice.

The disclosure and listing requirements for material advisors serve two important functions: to alert the IRS to potentially abusive transactions that should be audited, and to provide more timely intelligence to the IRS on newly minted tax avoidance arrangements. The Tax Section supports the efforts of the IRS to achieve these objectives while avoiding unreasonable burdens on taxpayers.

Making clear that the filing deadline is 30 days after the Closing Date, rather than some earlier date on which a person might be said to become a material advisor, will substantially ease the burden on taxpayers and their advisors, while still providing timely notice to the IRS of potentially abusive transactions that should be audited. There is no audit reason for the IRS to hear about these transactions before they close, since for those that do close the audit will not begin until after the end of the taxable year in which the closing occurs.

We acknowledge that, in principle, an earlier filing deadline could speed the flow of intelligence to the IRS regarding newly minted tax avoidance arrangements. Further, we recognize that the IRS has a legitimate interest in learning about these arrangements in a timely manner so that it can formulate a view as to their legitimacy, and take countermeasures where appropriate, including identifying new listed transactions, issuing regulations or other administrative guidance, or proposing legislation.

The IRS does not, however, need earlier notice of listed transactions, as it already knows about them. As to the other categories of reportable transactions, there could be some benefit to earlier notice, but as long as the current scheme for identifying reportable transactions and material advisors is in place, it is simply not practicable to impose a filing deadline before the Closing Date. It might be possible, although difficult, to fashion different guidelines that were sufficiently clear to identify a filing deadline before the Closing Date. But those guidelines do not exist in the current regulations or Notice 2004-80; and until they do, the things that potential material advisors must do to avoid penalties will remain hopelessly vague. In the meantime, waiting to receive filings until after the Closing Date will address the problems outlined above, with only a modest delay in the flow of information to the IRS.

We plan to provide more detailed comments on the disclosure and listing requirements for material advisors, as requested in Notice 2004-80. There is an urgent need, however, to clarify the filing deadline for material advisors, as the first returns will become due under the terms of the Notice on February 1, 2005.

Respectfully submitted,

Lewis R. Steinberg
Chair

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