NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on Disclosure by Material Advisors

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New York State Bar Association Tax Section

Report on Disclosure by Material Advisors

This report comments on the new disclosure requirements imposed on material advisors by the American Jobs Creation Act of 2004 (the "Act"), and the interim guidance contained in Notice 2004-80 (the "Notice").[1]

I. Introduction

Section 815 of the Act requires material advisors to disclose reportable transactions to the Internal Revenue Service, and Section 817 dramatically increases the penalties for failure to make available to the IRS a list of parties and related information that they are required to maintain under the pre-existing listing requirement, which is retained, with modifications, by the Act. The effect of these changes is to substantially increase the responsibilities associated with being a material advisor.

In the Notice, the IRS released interim guidance under these provisions. The Notice retains, with minor modifications, the definitions of "material advisor" and "reportable transaction" that were used in regulations in effect under prior law. The Notice, like Section 815 of the Act, is effective for transactions "with respect to which material aid, assistance, or advice is provided after October 22, 2004."

The disclosure and listing rules for material advisors are intended to provide the IRS with more timely and complete information regarding tax shelter activity. In the absence of any precise way to define a tax shelter, these rules apply to a broad range of transactions, which unavoidably includes a large number of ordinary business transactions that have no potential for tax abuse. Our recommendations are intended to minimize any unnecessary burdens on advisors required to disclose and list these transactions, while still enabling these rules to perform their intended function.

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[1] This report was prepared by an ad hoc committee of the New York State Bar Association Tax Section, consisting of Donald Alexander, John Barrie, Andrew Berg, Kimberly Blanchard, Peter Blessing, Dickson Brown, Jonathan Cantor, Donald Carden, Angelo Ciaverella, Richard Cohen, Francisco Duque, Michael Farber, Avrohom Gelber, Edward Gonzalez, David Hariton, Justin Howell, Hillel Jacobson, Sang Ji, Stephen Land, David Moldenhauer, Deborah Paul, Elliot Pisem, Richard Reinhold, Robert Scarborough, Michael Schler, Saul Shajnfeld, Ray Simon, Eiko Stange, Lewis Steinberg, Gordon Warnke, Kirk Wallace, Hershel Wein, Brigitte White, and Victor Hollender. Stephen Land was the principal drafter. Helpful comments were also received from Arthur Feder, Jiyeon Lee-Lim, David Miller, Erika Nijenhuis, and Bob Smith.

II. Summary of Recommendations

We support the general approach taken by the Notice, which makes use of concepts already embodied in existing regulations to provide interim guidance under the Act. Of particular importance is the retention of the requirement that a person must make a "tax statement" in order to be considered a material advisor.

One of our concerns is the need to clarify that no filing is required by a material advisor until a transaction is entered into. The Notice states that the disclosure must be filed within 30 days of becoming a material advisor. Since it is generally not possible to determine whether a person is a material advisor, or even whether a transaction is reportable, until the transaction is entered into, it is not practical to require a filing before that time.

We have the following additional recommendations:

Material advisors

1. The determination of material advisor status should be based on facts that the advisor knows, should know, or reasonably expects when the transaction is entered into, which should generally mean the time of signing of a definitive agreement for each stage of the relevant transaction.

2. The requirement of a "tax statement" should be retained.

3. A potential material advisor with regard to a reportable transaction (other than a listed transaction) should be treated as a material advisor only if the advisor knows, should know, or reasonably expects that the taxpayer to whom (or for whose benefit) the statement is made has an obligation to disclose the transaction as a reportable transaction. There should be no general duty of inquiry, and no duty in any case to inquire of parties who are not clients.

4. For loss transactions, the "reasonably expected" standard should be clarified to exclude the mere statistical likelihood of a loss that depends on market movements, but rather to mean the clear expectation of a tax loss based on the design of the transaction.

5. We approve of the additional requirement that, to trigger disclosure of a transaction with a book-tax difference, there must be both a tax statement and a financial accounting statement regarding an item giving rise to a book-tax difference.

6. The current definition of "tax statement" includes oral remarks and other casual statements. We think this is too broad for advisors who are not promoters, in light of the serious penalties that are imposed under the new regime. We believe that for such advisors, the term "tax statement" should cover written statements only. Moreover, while a broad definition of tax statement that includes casual written observations or comments may likewise be appropriate for promoters, where advisors who are not promoters are concerned, tax statements should include only statements intended as tax advice.

7. The determination of minimum fee thresholds should follow the statutory rule, applying a lower fee threshold only when substantially all the tax benefits of the transaction are provided to individuals.

8. The determination whether a tax advisor is a disqualified tax advisor should be made only when the transaction is entered into, or if later, when the advisor's opinion is given.

Filing

9. Guidance should clarify that material advisors need not identify the taxpayers who are parties to the transaction, and it should likewise clarify whether any written materials received by such taxpayers must be submitted along with the description of the transaction and its tax benefits.

10. If any such additional written materials must be submitted, a procedure should be provided for redacting the names of taxpayers and for redacting any potentially privileged information.

11. A designation agreement should relieve the non-designated advisors from liability for both the listing requirement and the disclosure requirement, unless those advisors know or have reason to know that these requirements are not being satisfied by the designated advisor.

Penalties

12. The IRS should be able to waive the penalty for failure to respond to a request for information required to be maintained under the listing requirements, in appropriate cases where there was reasonable cause not to have obtained or retained this information.

13. Legislation should be sought providing for a ceiling on the penalty imposed for a failure to respond to a request for listing information.

14. For purposes of determining whether the penalty for failure to disclose can be waived, the status of a transaction as a listed transaction should be determined at the time the transaction is entered into, or alternatively at the time the filing is to be made, regardless of any subsequent decision by the IRS to treat the transaction as listed.

15. The IRS should confirm that the guidance in Notice 2005-11 regarding waivers of the Section 6707A penalty (for failure to disclose by transaction participants) is intended to apply also for purposes of the Section 6707 penalty (for failure to disclose by material advisors).

16. The IRS should consider reinstating the authority of the IRS Appeals Division to review decisions regarding penalty waivers.

Transition Issues

17. The IRS should deal flexibly with cases where an advisor determined in good faith (but incorrectly) that it was not subject to the listing requirement, particularly for transactions that closed before enactment of the Act, when the penalty risk of an incorrect determination was much lower.

18. The new disclosure requirement should apply only in cases where a tax statement is made after October 22, 2004.

19. Clarification is needed on whether the new disclosure rules apply to transactions that closed on or before the date of enactment, but where a tax statement was made afterwards.

III. Material Advisors

A. Timing of Determination

We urge that future guidance make clear that a potential advisor is required to determine its status as a material advisor only at the time the transaction is entered into. This appears to be implicit in the existing regulations: § 301.6112-1(b)(2)(i)(B) refers to "[a]ny 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"; and § 301.6112-1(c)(2)(i)(B) refers to statements made to "[a] taxpayer who

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

Indeed, there would be serious problems with requiring this determination to be made at any other time. Making this determination based on facts known before the transaction is entered into is problematic since, as pointed out in our December 10, 2004 letter, the relevant facts that will determine whether the transaction is reportable or whether the fee threshold will be met may not yet have been established. Likewise, making this determination at some time after the transaction is entered into (*e.g.*, when a loss is recognized or a book tax difference develops) may also be problematic, because the material advisor may not have any ongoing relationship with the transaction or its participants.

Accordingly, we do not believe that it would be appropriate to impose disclosure or listing requirements on persons who are not, and who do not expect to become, material advisors at the time a transaction is entered into, notwithstanding subsequent events such as the following:

(i) the minimum fee threshold is reached, contrary to expectations;

(ii) the transaction becomes reportable, contrary to expectations (*e.g.*, because of an unexpected loss or a change in the financial accounting treatment); or

(iii) the transaction is the same as or is substantially similar to a subsequently identified listed transaction.

For this purpose, we think a transaction should be deemed entered into at the time of the signing of a definitive agreement and again at the closing of the transaction.

We recognize that a different rule may properly apply to disclosures by transaction participants, since they report transaction results from year to year and can be expected to be aware of the circumstances that may cause the transaction to become listed or otherwise reportable. This is, however, a difficult burden to place on persons who are not participants, and who were not material advisors when the transaction was entered into.

Some transactions are not entered into at a single moment in time, but in a series of steps. In these cases, we suggest that the obligation to determine the material advisor's status should apply at the time of signing of a definitive agreement, and again at the closing of each of these transaction steps. The precise determination of the moment the

transaction was entered into will be less important if, as suggested in Part IV.B below, disclosures are required on a quarterly or other periodic basis.

In some circumstances, the involvement of a person who has made a tax statement will end before the transaction closes. In that event, the person should be considered to be a material advisor only if the person knows, or should know, that the transaction has closed and meets the knowledge standard described in Part III.C below. As described in Part III.C, satisfying this standard may require the advisor to make inquiries of his or her client, but not of other parties. There is little to be gained in seeking disclosure from others, since they are unlikely to have reliable information regarding the actual terms of the transaction. We considered whether a rule of this type would leave room for advisors to avoid reporting through a "talk and walk" strategy, where the advisor ceases involvement with the transaction after making a tax statement. This does not seem to us to be a realistic concern, since promoters will need to remain involved to ensure that the closing occurs and their fee is paid, and parties seeking tax advice will want to ensure that that advice is based on the terms of the transaction as it is actually closed. On the other hand, a tax advisor who discusses a transaction idea with a party who is not a client may have no involvement at all in the actual implementation of the transaction, which could occur years later. If, as we believe, the disclosure and listing rules are intended to require reporting of actual transactions rather than mere transaction ideas, we do not see how such an advisor can be required to report.

In other cases, an advisor may make a tax statement for the first time after the transaction has been entered into. § 301.6112-1(c)(2)(iv)(A) of the Regulations contains an exception from material advisor status that applies where the tax statement is not made until after the first tax return reflecting tax benefits of the transaction is filed with the IRS. We urge that consideration be given to expanding this exception to apply to any advisor who first makes a tax statement after the transaction has been entered into (but only after the last step if the transaction is entered into in steps). We think that taxpayers should be able to inquire on the proper tax treatment of a completed transaction without worrying that the inquiry itself may trigger a reporting obligation. Disclosure will have already been required from the advisors who were involved in putting the transaction together, and by the time the return is filed the taxpayer will be required to disclose. This approach would be consistent with our general view that reportable transaction status and material advisor status should be determined when the transaction is entered into.

B. Requirement of a Tax Statement

The concept of a "material advisor" was introduced by the regulations issued under Section 6112 of the Internal Revenue Code (prior to amendment by the Act), to give meaning to the terms "organizer" and "seller" of a potentially abusive tax shelter. In particular, under § 301.6112-1(c) of the Regulations, a person is a material advisor if the person receives or expects to receive a minimum fee, and makes a "tax statement" to or for the benefit of certain specified persons.

Section 6111(b)(1)(A) of the Code, as amended by Section 815 of the Act, contains for the first time a statutory definition of material advisor:

> (A) IN GENERAL.—The term 'material advisor' means any person—
>
> (i) who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and
>
> (ii) who directly or indirectly derives gross income in excess of the threshold amount (or such other amount as may be prescribed by the Secretary) for such advice or assistance.

This statutory definition does not expressly include any requirement of a "tax statement", but Section 6111(c)(2) of the Code authorizes regulations that provide exemptions from the requirements of that section. This would include, for example, an exemption for persons who do not make a tax statement.

Section A.2 of the Notice provides that the relevant provisions of § 301.6112-1 will continue to apply for purposes of determining whether a person is a material advisor, even though the underlying statutory terms have changed. Of critical importance is that the requirement of a tax statement continues to apply.

Although the Notice constitutes only interim guidance, we strongly urge that any future regulations defining "material advisor" continue to exclude persons who have no involvement with the tax aspects of the transaction, or whose involvement is so minimal that they are not considered to have made a "tax statement". There are good reasons for this exclusion. First, these persons will often lack sufficient understanding of the facts or relevant law to determine whether the transaction is reportable. Second, in virtually every case there will be another advisor, who does make such a tax statement, and who will be better situated to make this determination and to assemble the necessary information.

C. Awareness of Reportable Transaction Status

The current definition of a tax statement in § 301.6112-1(c)(2)(iii)(A) of the Regulations states:

> A tax statement means any statement, oral or written, that relates to a tax aspect of a transaction that causes the transaction to be a reportable transaction…

The regulations clarify how this standard applies to the five categories of reportable transactions apart from listed transactions. For some of these categories, the standard is limited in ways that minimize the risk that a person might inadvertently become a material advisor by making a tax remark without even being aware of facts that might cause the transaction to be reportable. For example, if the transaction is reportable because of confidentiality, a statement is covered by this standard only if it concerns a tax benefit of the transaction and the confidentiality restriction is imposed by or for the benefit of the person making the statement, or that person knows of the confidentiality restriction. Thus, a person cannot become a material advisor on a confidential transaction without being actually aware of the facts that cause it to be reportable.

Similarly, in the case of a transaction with contractual protection, a statement is covered only if it concerns a tax benefit of the transaction and the person making the statement provides the contractual protection or knows of the contractual protection being provided by someone else. Here again, the standard is appropriately limited to limit the risk of inadvertent material advisor status.

The standards for the remaining categories, involving loss transactions, transactions with book-tax differences, and transactions with brief holding periods, do not explicitly ensure that the person making the statement will be aware of facts that might cause the transactions to be reportable. For example, a person could make a tax statement about the tax treatment of a loss without knowing the size of the loss, or whether the asset sold has a qualifying basis that would cause the loss to qualify for the angel list. It appears to us that much of the anxiety among potential material advisors about the risk of inadvertent material advisor status arises from a concern that a transaction in these categories might be reportable without the material advisor knowing it.

This concern would to a large extent be mitigated by confirming and clarifying the actual knowledge standard of § 301.6112-1(c)(2)(i)(B) of the Regulations. This section treats a person as a material advisor with respect to a reportable transaction (other than a listed transaction) only if the person 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* to be required to disclose the transaction under § 1.6011-4 because the transaction is or is reasonably expected to become a transaction described in § 1.6011-4(b)(3) through (7); [emphasis added]

Under this rule, it appears that a person cannot be a material advisor in this context unless the advisor has actual knowledge, or a reasonable expectation, that the taxpayer is required to disclose. A pure actual knowledge standard might allow the possibility that a potential advisor would attempt to maintain ignorance of a transaction's reportable status in the face of circumstances where that status could be readily inferred or ascertained. For this reason, we suggest that a person can be a material advisor if the person knows, should know, or reasonably expects that the transaction is reportable. For purposes of this "should know or reasonably expect" standard, an advisor would be expected to draw reasonable inferences from the apparent facts, and to make inquiries of its client that are suitable in light of those apparent facts.

We do believe, however, that under the relevant standard there is, or should be, any further duty to investigate whether the transaction is reportable. A person making a tax statement who does not know, and cannot readily infer, that the taxpayer may be required to disclose the transaction based on the facts before him or her should not be subject to the material advisor penalties on the grounds that the advisor would have known about the disclosure requirement if a proper investigation had been made. In other words, we do not think the regulations impose a general duty of investigation on advisors in the absence of alerting facts. Otherwise, there would be no definable limit to the nature of the investigations that advisors would have to undertake to assure themselves that they had not unwittingly advised on a reportable transaction. Also, we do not believe that an advisor "should know" facts that are not known to it or its own client, and therefore there should be no duty to make inquiries of third parties.

This approach reflects a view that the term "material advisor" should catch only those who know, should know, or reasonably expect they are working on reportable transactions. Under this view, there is no attempt to enlist the private sector in an effort to seek out which transactions are reportable so that they can be reported to the IRS. We think this is a sensible approach, and recommend that future guidance make this clear. The implications can be seen in the following examples:

> *Example 1—Loss Transaction.* A tax lawyer makes a tax statement on the sale of an asset at a sizable loss. The lawyer was not involved when the asset was acquired. There is no reason to believe that the asset does not have a qualified

basis and no reason to suspect that the loss arose from tax-motivated structuring. Unbeknownst to the tax lawyer, the asset was acquired in part with unsecured purchase money indebtedness, so it lacks a qualified basis, and the transaction is reportable.

Example 2—Transaction with a Book/Tax Difference. A tax lawyer makes a statement regarding the tax treatment of an item. On a separate occasion, a corporate lawyer at the same firm makes a statement regarding the book treatment of that same item. Neither is aware that there is a book-tax difference that would cause the transaction to be reportable.

Example 3—Transaction with a Brief Holding Period. The advisor makes a statement regarding the creditability of a foreign tax. There is no reason for the advisor to believe that the asset is being hedged elsewhere in the group. Unbeknownst to the advisor, an affiliate of the taxpayer has entered into hedging arrangements that shorten its holding period, with the result that the transaction is reportable.

In each of these cases, the person making the tax statement should not be treated as a material advisor and should not have any further duty to inquire.

To dispel any uncertainty in this regard, it would be helpful if future guidance were to make clear that:

(i) A potential material advisor with regard to these categories of reportable transactions will be treated as such only if the advisor knows, should know, or reasonably expects that the taxpayer to whom or for whom the statement is made has an obligation to disclose the transaction as a reportable transaction; and

(ii) In determining whether the advisor "should know" that a transaction is reportable, the advisor should draw reasonable inferences from the apparent facts and make suitable inquiries of the advisor's own client in response to any such apparent facts, but should have no obligation to make further inquiries regarding other facts that may affect the determination of whether the transaction on which it is advising is reportable.

In providing this guidance, it would also be useful to indicate whether, in the absence of specific information, a potential material advisor should presume that a loss or a book-tax difference is or is not on the angel list. We think it is more consistent with the

"know or should know" standard for such a person to be generally entitled to presume that a transaction is not reportable absent knowledge that it is. This would mean, for example, that if the advisor does not know whether a loss asset was acquired for cash, the advisor would be entitled to presume that it was. Similarly, if an advisor does not know the basis of the loss asset and it would not be unreasonable for the advisor to believe that the loss is below the reporting threshold, the advisor would be entitled to presume that the loss is below the reporting threshold. In either case, however, the advisor would be expected to draw appropriate inferences from the apparent facts, and make suitable inquiries of its client if those facts alerted the advisor to a significant possibility that the transaction might be reportable. If, however, guidance were to be issued taking a different view, it would be very important to set standards regarding these presumptions, and for the advisor's obligation to make inquiries regarding these points.

Finally, it is important to be clear about *who* must have this knowledge. Many potential material advisors are large institutions with thousands of employees, and often there are many individuals in diverse departments that will be involved in a particular transaction. To make these rules work in practice, there would have to be at least one individual at that institution who knew that the tax statement was made and who also knew, should have known, or reasonably expected that the taxpayer was required to disclose the transaction. Only in such a case would the institution be aware that it had to put in motion the disclosure and list maintenance arrangements.

D. Loss Transactions

A tax statement relates to a loss transaction if it concerns the item giving rise to the loss that causes the transaction to be reportable. A potential difficulty with applying this standard to material advisors is that whether the transaction is reportable depends on whether it actually produces a loss, not on whether it is expected to produce a loss. For taxpayers that participate in the transaction, this approach is workable, since it is reasonable to expect taxpayers actually claiming a loss in a particular year to make the necessary disclosures in that year.

Material advisors, however, typically help execute the transaction and then go away. § 301.6112-1(c)(2) of the Regulations provides that a person is a material advisor only if a tax statement is made to, among others:

> A taxpayer who the potential advisor (at the time the transaction is entered into) knows is or reasonably expects to be required to disclose the transaction…because the transaction *is or is reasonably expected to become* a [reportable] transaction… [emphasis added]

It therefore appears that, from a material advisor's point of view, whether a transaction is a loss transaction is to be determined based on knowledge or expectations at the time the transaction is entered into, and there is no requirement that the advisor continue to monitor the transaction to determine whether a loss in fact occurs. This appears to be also implicitly true under the Notice, which imports by reference the definition of material advisor contained in these regulations.

As discussed in Part III.A above, we support an approach that generally requires potential material advisors to determine the status of a transaction as reportable (whether as a loss transaction or otherwise) only at the time that it is entered into, regardless of whether subsequent events require disclosure by a transaction participant. We have a concern, however, that in practice there may be difficulties in applying the "reasonably expected" standard to loss transactions. In particular, it appears to us to be unrealistic to expect advisors, particularly legal and other non-financial advisors, to predict market movements, and with hindsight an actual loss might appear after the fact to be one that should have been reasonably expected. Moreover, the category of loss transactions seems to be principally targeted at transactions that are intended to produce tax losses, rather than investments that, by their speculative nature, run a high risk of resulting in an economic loss.

Consider, for example, a speculative investment that, statistically, is likely to lose money; but if it succeeds, the payoff is expected to be great enough to justify the substantial risk of loss. Such an investment could be worth making in the absence of tax considerations. We do not believe that the mere statistical likelihood of a loss should mean that the transaction is, for these purposes, "reasonably expected" to produce a loss. Similarly, a person with a naked short position in a growth stock might be likely to incur a loss, since growth stocks more often that not go up in value. But a person taking such a position is speculating that the stock will go down in value, and such a transaction also should not be considered to be "reasonably expected" to produce a loss.

Even in cases where a transaction is designed to maximize basis, there may be no clear expectation of realizing a loss. For example, an acquisition may be structured as a "B" reorganization rather than a merger under Section 368(a)(2)(E) to take advantage of carryover basis rules that enhance the acquiror's basis in the target's shares, and the shares' carryover basis may be higher than the shares' value. Such a transaction, however, should not be reportable unless the advisor knows, should know, or reasonably expects that the acquirer has a present intention to sell the shares and recognize the loss.

We therefore recommend that the "reasonably expected" standard be clarified to mean more than the mere likelihood of a loss based on market movements, but rather the clear expectation of a tax loss based on the design of the transaction. This standard should be sufficient to capture transactions that are intended to produce tax losses, without bringing in a wide variety of speculative investments.

E. Transactions with Book-Tax Differences

The existing regulations treat a tax statement as relating to an aspect of a transaction that causes it to be a transaction with a significant book-tax difference if the statement concerns an item that gives rise to the book-tax difference. Section A.2 of the Notice further provides that a person will be a material advisor under this test only if the person "also makes a statement, oral or written, that relates to the financial accounting treatment of the item(s) that give rise to a significant book-tax difference."

We welcome this change, and encourage that it be retained in future guidance. It is unclear, however, whether the requirement that the same "person" make both the tax statement and the accounting statement means that they have to be the same individual. § 301.6112-2(d)(3) of the Regulations defines "person" by reference to the general definition in Section 7701(a)(1) of the Code, which broadly includes any individual or entity. This would suggest that where the potential material advisor is an organization, it could become a material advisor if one employee makes a tax statement regarding an item, and another employee makes an accounting statement regarding that same item.

We believe that a requirement that the same individual make both the tax and the accounting statements would be too restrictive, and could be easily avoided by orchestrating who says what. At the same time, however, it is also possible that these statements could be made by separate individuals in completely disparate contexts. For example, it is possible for a transaction to generate a significant book-tax difference even if that difference is not a motivation for the transaction (since there may be offsetting differences going the other way). A tax lawyer giving tax advice on the transaction may have no reason to know that a corporate colleague is discussing the financial accounting treatment in connection with the negotiation of financial covenants.

We think that the actual knowledge standard discussed above is the appropriate way to avoid inadvertent material advisor status here. Reporting should be required by an organization if there is an individual at that organization with actual knowledge that the tax and financial accounting statements were made, and that the taxpayer is required to disclose the transaction on account of the book-tax difference.

F. Problems with Oral and Other Casual Tax Statements

Even with the various limitations that have been incorporated in the rules, we have some concern with the scope of the term "tax statement", which can cover any oral or written statement about the relevant aspect of the transaction, regardless of whether that statement is being given as advice, is asserted in the course of a negotiation, or is merely an offhand remark. In the context in which the term was originally developed, the only consequence of being overly broad was that an advisor who was inadvertently caught might have to scramble to produce some records, or suffer a mild penalty.

The stakes are now significantly higher. Instead of merely being required to keep records, and to respond to an IRS request if made, material advisors also now have an affirmative disclosure obligation, and both this obligation and the listing requirement are backed by serious penalties. This is too much freight to load on the back of a casual tax statement.

There are also serious evidentiary issues associated with the inclusion of oral statements. Not only are there difficult questions of proof and refutation if the IRS were to assert that a person is a material advisor based on an oral statement, but there are also problems for conscientious institutions seeking to verify their own compliance with these rules. Written statements can be reviewed, and there are records to substantiate their existence. Oral statements, however, can generally be substantiated only through the possibly conflicting recollections of those who made or heard them.

By contrast, the final Circular 230 regulations, sweeping as they are, cover only written advice. We believe that benefits of including oral advice within the scope of a material advisor's tax statement are not sufficient to justify the resulting difficult questions of proof and compliance. We therefore recommend that the term "tax statement" be limited to those in written form. Similarly, in the case of transactions with book-tax differences, only written statements regarding the financial accounting treatment should be taken into account.

We recognize that disregarding oral statements may make it possible for some promoters to avoid material advisor status by being careful not to put any tax statements in writing. This possibility, however, should not significantly affect the ability of the IRS to detect and fight tax shelters. Even if the promoter makes no written statement, in virtually every case there will be another advisor who does, and that person will likely be a material advisor subject to the disclosure and listing requirements. Moreover, it is difficult to market a tax-oriented transaction without mentioning its tax treatment in writing, and making the promoter's marketing job more difficult is unlikely to cause

harm to the fisc. We therefore believe that the disclosure and listing rules can perform their role effectively even if material advisors include only those who make written statements.

We note, however, that some members of the Committee believe that, notwithstanding any evidentiary difficulties, oral statements should serve to confer material advisor status on the person making the statement if they are made for the purpose of persuading or otherwise inducing a taxpayer to enter into a transaction. This might include, for example, the case where a promoter tells a client to enter into a transaction *because* it will generate a tax benefit, such as a loss to offset an unrelated gain. It might also include the case where an advisor attends a meeting, or participates in a conference call, for the express purpose of helping a promoter persuade a client that tax benefits will be available. We think, however, that any such exceptions for oral statements should be clearly defined and limited.

We suggest that a different standard should apply, however, to advisors who are not promoting the transaction. These include principally attorneys, but also accountants and other persons involved in the implementation of the transaction. The minimum fee thresholds include all fees for services, so these advisors may satisfy those thresholds even if they are not retained to give tax advice. These advisors may, in the course of working on the transaction, make a statement regarding the tax treatment. We do not believe it makes sense to treat these advisors as material advisors unless the statement is itself tax advice, rather than a mere comment on, or acknowledgement of, the tax treatment.

Of course, a tax advisor who is also promoting the transaction should be held to the same standards as other promoters. For this purpose, a promoter can be defined as anyone who is involved in the marketing of the transaction or tax strategy, as was done in Notice 2005-12. That Notice defined marketing activities to include:

> (1) soliciting, directly or through an agent, taxpayers to enter into a transaction or tax strategy using direct contact, mail, telephone or other means; (2) placing an advertisement for the transaction in a newspaper, magazine, or other publication or medium; or (3) instructing or advising others with respect to marketing of the transaction or tax strategy.

We think it is appropriate to treat persons engaged in these activities as material advisors if they make a tax statement, however casual. But attorneys and other advisors who are not promoters should not be treated as material advisors unless they actually give tax

advice.[2] Statements by a tax lawyer or accountant would be presumed to constitute advice, and these advisors should not be permitted to avoid material advisor status simply by disclaiming that their tax statements constitute advice.

The effect of this suggestion would be to eliminate material advisor status for those who are not promoting the transaction and are not giving tax advice, without having to inquire whether a tax statement was made. This change should not impede the flow of information to the IRS, since the people promoting the transaction and giving tax advice will still be material advisors subject to the disclosure and listing requirements. But it will protect other advisors from inadvertently becoming subject to significant penalties on the basis of a casual tax statement that finds its way into a document or e-mail that they produce. This suggestion has even greater urgency if tax statements continue to include oral statements.

G. Minimum Fee

The Notice uses the definition of minimum fee that is contained in § 301.6112-1(c)(3)(i) of the Regulations, which provides:

> The minimum fee is $250,000 for a transaction if every person to whom or for whose benefit the potential material advisor makes or provides a tax statement with respect to the transaction is a corporation. The minimum fee is $50,000 for a transaction if any person to whom or for whose benefit a potential material advisor makes or provides a tax statement with respect to the transaction is a partnership or trust, unless all owners or beneficiaries are corporations (looking through any partners or beneficiaries that are themselves partnerships or trusts), in which case the minimum fee is $250,000. For all other transactions, the minimum fee is $50,000.

Here, the amount of the fee threshold is determined by the characteristics of the persons to whom or for whose benefit the potential material advisor makes or provides a tax statement.

When these regulations were first drafted, there was no statutory definition of material advisor. We now have one; and while the statutory definition uses the same fee thresholds, they are applied differently. Section 6111(b)(1)(B) of the Code provides:

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[2] We do not recommend a similar limitation on statements regarding the financial accounting treatment. As a result, a person giving tax advice with regard to an item could be a material advisor even if that person is not qualified to give advice on the financial accounting treatment, but does make a statement about it.

(B) THRESHOLD AMOUNT.—For purposes of subparagraph (A) [defining material advisor], the threshold amount is—

"(i) $50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons, and

"(ii) $250,000 in any other case.

In contrast to the regulations, the statute chooses the fee threshold based on the characteristics of the persons claiming the tax benefits. Notwithstanding this inconsistency, there seems to be little doubt that the regulations can validly vary the amounts set forth in the statute, since the Conference Report to the Act provides, at page 385, that the fee thresholds shall be those set forth in the statute "or such other amount as may be prescribed by the Secretary."

The approach taken by the regulations raises questions about the identity of the person "to whom or for whose benefit" the tax statement is made. Literally, the person to whom the statement is made will always be an individual, but presumably it is intended that a statement made to an individual acting as an employee for a corporation will be treated as having been made to the corporation. [3] If the regulations deliberately intend to broaden the category of persons to whom or for whose benefit tax statement is made beyond those persons who are claiming tax benefits from the transaction, it is not clear who these additional persons are or why it makes sense to include them.

More significantly, the regulatory fee threshold drops to $50,000 if *any* relevant person is an individual, whereas the statutory fee threshold drops to $50,000 only if *substantially all* of the tax benefits are claimed by individuals. Thus, under the regulatory scheme it is much more likely that a misunderstanding by a potential material advisor could lead the advisor to mistakenly conclude that the higher fee threshold applies, with possibly serious consequences to the advisor under the new penalties.

The Regulations reduce the fee threshold for listed transactions (including transactions that are substantially similar to a listed transaction) from $250,000 to $25,000 and from $50,000 to $10,000. Thus, the same issues arise in the context of a listed transaction, and there is the further possibility that whether a person is a material advisor may depend on whether the transaction is reportable as a listed transaction or for

[3] § 301.6112-(c)(2)(ii) makes clear that a material advisor does not include an individual acting as an employee; in such a case, it would be the employer that is the material advisor. There is no express rule, however, that would treat a tax statement made *to* an individual acting as an employee as having been made to that individual's employer.

some other reason. The statute does not contain separate fee thresholds for listed transactions; but, as noted, authority does exist to vary the statutory amounts.

We question whether it is wise to exercise this authority to multiply the number of fee thresholds. The statute does not provide separate fee thresholds for listed transactions. While we support measures that give the IRS current information on these transactions, the reduced fee thresholds for listed transactions in the Regulations are so low as to bring within their scope advisors whose role in the transaction may not have been in fact material.

We recommend making any distinction between individuals and corporations on a basis that is closer to the statutory scheme, which looks to the persons claiming the tax benefits. If the goal is to apply the lower fee threshold to transactions that are aimed at individuals, the statute does a better job than the regulations at capturing that universe of transactions. Since a potential material advisor may not have reliable information regarding the tax status of transaction participants (and should not be strictly liable for getting it wrong), the determination of the fee threshold should be based on the advisor's reasonable belief in this regard.

H. Disqualified Tax Advisors

A further consequence of being a material advisor is that, under Section 6662A(d)(3)(B)(ii) of the Code, any opinion provided by such an advisor may not be relied on to avoid penalties under Section 6662A if the advisor participated in the organization, management, promotion, or sale of the transaction. If an opinion is given at the time of closing, the determination of whether the person giving the opinion is a disqualified tax advisor should be made on the basis of the facts and reasonable expectations at that time. For example, it would be unfair to take away a taxpayer's right to rely on an opinion of counsel from an adviser who was not a disqualified tax advisor when the opinion was given, merely because subsequent events (such as an unexpected loss) cause the transaction to be reportable.

If an opinion is given subsequent to closing, we believe it would be reasonable to require that the person giving the opinion not be a disqualified tax advisor at that time. This may require revisiting the question of whether the person is a material advisor, but only for purposes of determining whether the person is a disqualified tax advisor, and this subsequent determination should not trigger disclosure or listing obligations.

If an opinion is given before closing, it may not be possible to say at that time whether the person is a material advisor, but it seems reasonable to treat the person as a

disqualified tax advisor based on the circumstances at the time of closing, since the participants can, if they wish, make it a condition to closing that the opinion be of a type that can be relied on.

IV. Filing

A. Contents

The temporary use of Form 8264 for filings by material advisors is understandable under the circumstances, but trying to adapt a form that was developed for a different purpose has led to some confusion about the substance of what needs to be reported.

The confusion starts with the first line of the form. We understand that a material advisor need not include the names of taxpayers on materials sent to the IRS (as opposed to on lists maintained for the benefit of the IRS). Moreover, there are good reasons for not requiring that the names of taxpayers be included in such materials:

(i) The existence of the listing requirement is based on the premise that the IRS will not have names of parties before it makes a request.

(ii) The Notice permits a single Form 8264 to be filed for substantially similar transactions, which only makes sense if the disclosure is generic for the transaction.

(iii) Not requiring disclosure of names will likely reduce asserted claims of privilege.

(iv) The request for a "name" on the form relates to the purposes of the prior registration rules, where a tax shelter could be identified by the name of the entity in which the parties would invest.

Nevertheless, the first line of Form 8264 asks for the "tax shelter name," the instructions to the form state, "the tax shelter name will be that of the tax shelter entity if the entity has an employer identification number separate from that of a principal organizer registering the transaction," and the instructions appear to suggest that otherwise it should be the name of the principal organizer of the transaction. This has led some advisors to question whether the name of the taxpayer is required in the absence of any other principal organizer.

We therefore think the first line should ask for the "reportable transaction name". It should be clarified, moreover, that the taxpayer itself should never be viewed as a

principal organizer for this purpose. In any case, the forms should clearly state that the names of taxpayers are not required.

Guidance is also needed regarding line 8 of the form, which states, "For confidential corporate tax shelters, attach any written material presented to potential participants…" The Notice does not indicate how to translate this statement in a manner that meets the new reporting procedures for a broad range of potentially privileged reportable transactions. It is therefore not clear what written materials are required, if any, in addition to a description of the structure, steps and benefits of the relevant transaction. If no additional written materials are required, this should be clarified. If any such materials are required, this should be clearly stated and the privilege issues set out in C. below should be considered.

B. Timing

Firms that are potential material advisors are gearing up for compliance with the new disclosure requirements. This requires educating people about the new rules, identifying which transactions require disclosure, and establishing procedures to ensure that the filings are made on time. The procedures for timely filings require setting calendars that alert those responsible to the relevant deadlines and provide time for any internal reviews that may be considered appropriate.

Under the Notice, a filing could be due any day of the year. Each transaction would have its own deadline. A firm's compliance responsibilities, however, would be far easier to manage under a system of fixed filing dates. For example, if the filings for transactions closing in a particular calendar quarter were due thirty days after the end of that quarter, there would be time to identify those transactions, prepare the forms, and arrange for internal review on a scheduled basis.

The success of the new disclosure rules depends on effective compliance by material advisors. A move to periodic filing would streamline that compliance, with only a minor effect on the timing of the flow of information to the IRS. It seems to us that quarterly filing strikes the right balance between timeliness and ease of compliance,[4] but any periodic arrangement would be a step forward in this regard.

[4] Members of the Tax Section of the American Bar Association have recently expressed a similar view. Letter of Kenneth Gideon to Commissioner Mark Everson (January 26, 2005).

C. Privilege

Both the disclosure and listing requirements for material advisors potentially involve disclosure of information covered by the common-law attorney-client privilege or the Section 7525 federally authorized tax practitioner confidentiality provision. The Section 7525 rule, however, is less likely to be relevant since Section 813 of the Act eliminates this confidentiality provision in the context of tax shelters, within the meaning of Section 6662(d)(2)(C) of the Code. That tax shelter definition is very broad, and will likely cover most reportable transactions.

The Notice does not address claims of privilege. § 301.6112-1(g)(2) of the Regulations contains a procedure under which a material adviser can assert a claim of privilege in response to a request from the IRS under the list maintenance rules. A similar procedure is needed for the new disclosure requirements, to deal with cases where some of the information required to be disclosed may be privileged. The procedure can be essentially the same as that provided in the listing context, so that the material advisor is obliged to identify any documents that are withheld as privileged, and to represent that to its knowledge the privilege has not been waived. We think that a material advisor who follows those procedures to make a good faith assertion of privilege should not be subject to penalties for failure to make a timely disclosure, even if that claim is ultimately overruled.

D. Designation Agreements

Section 6111(c)(1) of the Code authorizes regulations providing that only one person shall be required to meet the new disclosure requirements for material advisors in cases where two or more persons would otherwise be required to meet these requirements. Section A.3 of the Notice provides that the rules in the tax shelter registration regulations regarding designation agreements, § 301.6111-1T Q&A-38 and 39, will apply for purposes of these disclosure requirements. Consequently, if a group of material advisors designates one of them to file the disclosure, the others will not be responsible even if the designated advisor fails to do so, unless the other advisors know or have reason to know of the failure.

We approve of this use of designation agreements, and recommend that they continue to be allowed in any future guidance. We are concerned, however, by the failure to provide a similar rule for the listing requirement. Section 6112(b)(2) of the Code contains similar authority to provide for designation agreements in the context of the listing requirement, and § 301.6112-1(h) does provide for designation agreements. Section B of the Notice generally provides that the existing regulations shall continue to

apply for purposes of the listing requirement, and this presumably includes the provisions regarding designation agreements.

Our concern is that § 301.6112-1(h) does not relieve the other material advisors of liability if the designated material advisor fails to make the list available. This rule undercuts the usefulness of designation agreements, since all advisors will be forced to maintain the list to protect against the possibility that the designated advisor fails to comply. While this problem existed under prior law, the penalty risk was so small that other advisors could bear that risk. Under the new penalty regime, a designation agreement will be of little use unless it affords protection from liability. Of course, the protection should be available only where the advisors reasonably believe that the designated advisor will fulfill its obligations. We therefore recommend that a designation agreement have the effect of relieving the non-designated advisors from liability for the listing requirement as well as the disclosure requirement, unless those other advisors know or have reason to know that those requirements are not being satisfied by the designated advisor.[5]

V. Penalties

A. Potentially Unlimited Listing Penalty

Under Section 6708 of the Code, before amendment by the Act, the penalty was $50 for each person with respect to whom there was a failure to satisfy the listing requirements, with a maximum penalty of $100,000 for each calendar year. Since many transactions involve only a handful of participants, the amount of the penalty was often nominal. By contrast, the penalty provided by Section 6708, as amended by Section 817 of the Act, is $10,000 *per day* in which there is a failure to respond to a request for listing information. The penalty is to be waived if the failure is due to reasonable cause, but the Conference Report states, at 388 n. 505, "In no event will failure to maintain a list be considered reasonable cause for failing to make a list available to the Secretary."

This change represents the maximum possible swing of the pendulum, from a penalty that was typically trivial to one that is potentially unlimited. Consider a case in which a material advisor fails to maintain a list, whether for good reason, bad reason, or no reason at all. It may be impossible for that advisor to respond fully to a request for information if the advisor does not have the information and cannot get it. It could be

[5] A similar recommendation was made in our 2003 Report, at pages 48-49. The matter is more urgent now, however, because of the expanded penalties.

argued in such a case that, absent a waiver, the penalty would mount at $10,000 per day *forever*. The only relief would be that provided under the bankruptcy laws.

We see no reason why material advisors should be exposed to a risk of this sort. Even for outright tax fraud there are limits to the penalties that may be imposed. There are many interpretive issues involved in determining whether a transaction is reportable and whether a person is a material advisor. An advisor could legitimately conclude in a particular case that it is not a material advisor and is not required to keep a list. If a court disagrees, and the advisor cannot provide the requested information, then absent a waiver a penalty perpetual motion machine could start running.[6]

Troublesome possibilities of this sort could be avoided by acknowledging in regulations that there can be reasonable cause for failure to maintain the information required under the listing rules. The statement in the Conference Report quoted above, that failure to maintain a list should not be considered reasonable cause for non-compliance with a request for listing information, should be read as referring to cases of willful intransigence; that is, where an advisor knows of its obligations but refuses to obtain, or subsequently destroys, the necessary information.

Even in cases of willful intransigence, as a matter of proportionality in punishment it seems that there should be some maximum penalty, which could be related to the gross income derived by the material advisor from the transaction. This may be difficult to achieve, however, without a legislative amendment. We recommend that consideration be given to such an amendment.

There may also be cases where there was no reasonable cause to fail to maintain a list, but neither was there willful intransigence; the failure may have been due to simple negligence or inadvertence. For example, this could occur where persons implementing a non-tax-motivated reportable transaction (such as the sale of property at a loss) are simply unaware of the requirements of Section 6112. Such an advisor might not qualify for a penalty waiver, but the need for a limit to the size of the penalty is even stronger here than in the case of willful intransigence.

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[6] Although the maximum potential penalty is infinite, because it accrues over time the *present value* is a large but finite sum, being essentially an amount sufficient to earn $10,000 per day (after tax) at prevailing interest rates. In a low interest-rate environment, this present value could exceed $150 million.

B. Waiver of Disclosure Penalties

Section 6707 of the Code, as amended by Section 816 of the Act, provides that the penalty for failure to satisfy the new disclosure requirements for material advisors shall be subject to the same restrictions on waiver as those provided by new Section 6707A(d) of the Code for the penalty for failure to disclose by transaction participants. In particular, no waiver of the penalty is allowed for a listed transaction, and for other transactions, a waiver is allowed only if it "would promote compliance with the requirements of this title and effective tax administration." No judicial review of a decision not to waive a penalty is allowed.

We have general concerns with statutory restrictions on penalty waivers, which we expressed last year when the legislation was being considered by Congress.[7] We also have the following specific concerns under the legislation as enacted.

First, since the penalty for failure to disclose a listed transaction is not waivable at all, it is especially important to know when the status of a transaction as listed is to be determined. Consistent with our recommendation above regarding the timing of when material advisor status is to be determined, we believe that, for penalty waiver purposes, whether a transaction is a listed transaction should be determined at the time it is entered into. Alternatively, the determination could be made at the time of the required filing by the material advisor or transaction participant, although we note that these will be at different times. We do not believe it is appropriate, however, to subject an advisor or a participant to a more rigid penalty regime by subsequently reclassifying a transaction as listed.

Second, we believe that the IRS should take a flexible view as to when a waiver would promote compliance and effective tax administration. We support the approach taken by Notice 2005-11, which takes into account all of the relevant facts and circumstances for this purpose, including (1) whether the taxpayer has a history of complying with the tax laws; (2) whether the violation results from an unintentional mistake of fact; and (3) whether imposing the penalty would be against equity and good conscience. Notice 2005-11 explicitly addresses only the penalty under Section 6707A of the Code for failure to disclose by transaction participants. Since Section 6707 of the Code, which contains the penalty for failure to disclose by material advisors, cross-references the penalty waiver provisions of Section 6707A(d), we assume that the

[7] Letters dated March 18, 2004 to the House Ways and Means Committee regarding H.R. 2896 - Tax Shelter Penalty Provisions, and to the Senate Finance Committee regarding S. 1637 - JOBS Act - Tax Shelter Penalty Provisions.

guidance in Notice 2005-11 is intended to apply also for purposes of the Section 6707 penalty, and it would be useful to have confirmation to that effect.

Section 6707A(d) states that a decision not to waive a penalty is not reviewable by a court. Notice 2005-11, however, goes further to state that such a decision shall also not be reviewable by the IRS Appeals Division. We are puzzled by this restriction on IRS review of penalty waivers, since it appears to us that such review within the IRS could promote a more consistent and fair application of the penalty. We suggest that the IRS consider reinstating the potential for review by the IRS Appeals Division.

VI. Transition Issues

A. Increased Listing Penalty

The increased penalty for failure to provide requested information under the listing requirements is effective for requests made after October 22, 2004, even if the transaction occurred earlier. Some advisors on these earlier transactions may have taken the view in good faith that, although the matter was not entirely clear, the listing requirements did not apply. This may have been a reasonable decision at the time, given the modest penalties that would have resulted from being wrong on this issue. While the IRS can demand the required information in cases where the listing requirement applies, we recommend that the IRS be prepared to give consideration to cases where the information was not maintained because of a good faith determination that it was not required.

B. Disclosure Requirement

Section 815(c) of the Act applies the new disclosure requirement for material advisors "to transactions with respect to which material aid, assistance, or advice referred to in section 6111(b)(1)(A)(i) of the Internal Revenue Code of 1986 (as added by this section) is provided after the date of enactment of the Act." Section 6111(b)(1)(A)(i) is the first prong of the material adviser test (the second being the minimum fee), and it includes any person "who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction."

In the Notice, this first prong has been replaced by the requirement of a tax statement, as provided under the existing regulations. Although the Notice recites the statutory transition rule, it does not provide any guidance on what is "material aid, assistance or advice" for this purpose.

We recommend that the same standard be applied for the transition rule as is applied for the definition of material advisor. Under this standard, the new disclosure requirement will apply in cases where a tax statement is made after October 22, 2004. This approach avoids the need to develop a separate body of interpretation of the phrase "material aid, assistance or advice" that will be of no relevance after the transitional period.

We note that under this standard, it does not matter when the fee was earned. Even if the bulk of the fee was earned pre-enactment, if a tax statement is made after that time, the new disclosure requirements will apply.

We are concerned, however, with situations where the transaction closed on or before October 22, 2004 but a tax statement was made afterwards, perhaps in connection with preparation of a tax return. It is not clear to us that the new legislation was intended to cover transactions that had already been closed by the time of enactment, and it would be useful to have clarification on that point.