NEW YORK STATE BAR ASSOCIATION

TAX SECTION

APPLICATION OF THE IRC §§6111 AND 6112 MATERIAL ADVISOR RULES TO LAW AND ACCOUNTING FIRMS

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New York State Bar Association Tax Section Report on Application of the IRS § § 6111 and 6112 Material Advisor Rules to Law and Accounting Firms

This report[1] highlights some of the problems that law and accounting firms face when attempting to comply with the reporting and list maintenance requirements under IRC §§6111 and 6112 and recommends a definition of material advisor to address those problems.[2]

Section 815 of the American Jobs Creation Act of 2004, P.L. 108-357, Stat. 1418 (the "Act"), amended IRC §§6111 and 6112 to replace the old tax shelter registration regime with new rules that require material advisors to report and maintain lists with respect to reportable transactions. Sections 816 and 817 of the Act also amended IRC §§6707 and 6708 to replace the penalties under the old regime with more severe penalties for failure to comply with the new material advisor rules.

The NYSBA Tax Section has consistently supported the efforts of Congress and the Treasury to enhance transparency and reporting with respect to tax-motivated transactions. Development of appropriate reporting and list maintenance requirements is an on-going process and we commend Treasury's efforts in continuing to refine these rules. Recent amendments to the definition of reportable transaction, such as modification of the confidential transaction filter, elimination of the book-tax difference filter and revisions to

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[1] This report was prepared by Bryan Skarlatos, with substantial assistance from Diana Wollman and Joshua Milgrim. Helpful comments were received from Kimberly Blanchard, Peter Conners, Edward Gonzales, Janet Korins, Charles Morgan, Russell Nance, Stephen Land, Elliot Pisem, Michael Schler and Gordon Warnke.

[2] Our recommended definition of material advisor can be applied to any type of organization. However, because we are most familiar with the operation of law and accounting firms, we have limited our discussion in this report to such firms.

the "angel lists," have significantly reduced the burdens imposed on ordinary business transactions and the professionals who advise on those transactions.

Despite these improvements, there continue to be serious problems with the way in which the material advisor rules operate in the context of law and accounting firms. The material advisor rules are applied to organizations as a whole, as opposed to the individual members or employees of an organization. We agree that this is how the rules should be applied.[3] Nevertheless, because of the ambiguity surrounding the definition of what constitutes a tax statement and a reportable transaction and the determination of the minimum fee threshold, application of the material advisor rules at an organizational level creates a situation in which even the most diligent firm can unwittingly fail to report or to list a reportable transaction with respect to which it is a material advisor. In such case, the firm, through no fault of its own, could be subject to significant penalties that can be waived only in very rare circumstances, if at all.

We believe that a firm should not be subject to penalties if it has implemented adequate procedures to monitor its reporting and list maintenance requirements. Thus, we recommend that Treasury issue guidance generally providing that a firm that implements adequate material advisor procedures will not be penalized for failure to file a report or to list under IRC §§6111 or 6112, unless the firm knew or should have known that it was required to file the report or to list a transaction. Specifically, we recommend that this be accomplished by stating that a law or accounting firm that implements adequate material advisor procedures does not become a "material advisor", and therefore has no obligations under IRC §§6111 or 6112, until a designated compliance

[3] We note that, because the material advisor rules apply to organizations in most cases, there may be no penalty under the material advisor rules for an individual who willfully fails to comply with the rules. However, such an individual would be subject to sanction under Circular 230.

officer at that firm has actual knowledge that, with respect to a reportable transaction, someone within the firm has made a tax statement and the fee threshold has been met, unless the designated compliance officer, or any other person involved in management of the firm, knows or should know that one or more shareholders, partners or employees of the firm are engaged in a pattern or practice that does not comply with the material advisor reporting requirements set forth in IRC §§6111 or 6112, or have been so engaged in the past and any resulting non-compliance has not been remedied.

1. BACKGROUND

A. The American Jobs Creation Act of 2004

Section 815 of the Act amended IRC §6111 to require each material advisor with respect to any reportable transaction to file a return identifying the transaction and any potential tax benefits as well as any other information required by the Secretary. The new IRC §6111(b)(1) set forth the following definition of material advisor:

> (A) IN GENERAL – The term 'material advisor' means any person-
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> > (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
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> > (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.
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> (B) THRESHOLD AMOUNT – For purposes of subparagraph (A), the threshold amount is –
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> > (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.

The new IRC §6111(c) goes on to give the Secretary broad authority to issue regulations providing (1) that only 1 person shall be required to meet the filing requirements of IRC §6111 in cases in which 2 or more persons would otherwise be required to meet such requirements; (2) exemptions from the requirements of IRC §6111; and (3) such rules as may be necessary or appropriate to carry out the purposes of IRC §6111.

Section 815 of the Act also amended IRC §6112 to require that each material advisor with respect to any reportable transaction maintain a list identifying each person to whom the material advisor provided advice with respect to the transaction and such other information as may be required by the Secretary. IRC §6112(b)(2) contained a provision, similar to the one in the new IRC §6111(c), giving the Secretary authority to prescribe regulations allowing 1 person to maintain a list in cases in which 2 or more persons would otherwise be required to maintain the same list.

In addition to amending the reporting and list maintenance requirements, section 816 of the Act also significantly increased the penalties applicable to a violation of these new provisions. IRC §6707 was amended to impose a penalty on any material advisor who fails to file a return under IRC §6111 on or before the date prescribed therefore or who files a false or incomplete return. The amount of the penalty is $50,000 or, in the case of a listed transaction, the penalty is the greater of $200,000 or 50% of the gross income derived by the material advisor for the aid, assistance or advice that was provided with respect to the listed transaction before the return was filed. The penalty is increased to 75% in the case of an intentional failure or act.

Pursuant to IRC §6707(c), the penalty imposed under IRC §6707 cannot be rescinded or abated with respect to listed transactions. As to other reportable transactions, the penalty can be rescinded or abated only in exceptional circumstances. The Committee Report states that

> the penalty can be rescinded only if (1) the material advisor on whom the penalty is imposed has a history of complying with the Federal tax laws; (2) it is shown that the violation is due to an unintentional mistake of fact; (3) imposing the penalty would be against equity and good conscience; and (4) rescinding the penalty would promote compliance with the tax laws and effective tax administration.

S. Rep. No. 108-192, 108th Cong., 1st Sess., at 95 (2003). Only the Commissioner of the Internal Revenue or the head of the Office of Tax Shelter Analysis has the authority to rescind a penalty that is imposed under IRC §6707 and that authority cannot be delegated. Further, there is no appeal from a decision not to rescind the penalty. Id.

Section 817 of the Act amended IRC §6708 to impose a penalty on any material advisor who fails to make a list available to the Secretary within twenty business days after receiving a written request for such list. This penalty is an indeterminate amount and accumulates at a rate of $10,000 for each day the material advisor fails to produce the list after the twentieth day following the receipt of the written request.[4] IRC §6708(a)(2) provides an exception to the penalty for any failure that is due to reasonable cause. However, failure to maintain a list, regardless of whether such failure is reasonable or inadvertent, does not constitute reasonable cause. See e.g., H.R. Conf. Rep. No. 108-126, 108th Cong., 1st Sess., at fn. 114 (2003).

[4] See NYSBA Tax Section Report on Disclosure by Material Advisors dated February 23, 2005, at 22-23 (commenting on the potentially unlimited $10,000 per day penalty for failure to provide a list).

B. Notice 2004-80

Shortly after the Act became effective, Treasury issued Notice 2004-80, 2004-50 I.R.B. 963 to alert taxpayers to the new reporting and list maintenance requirements and to provide guidance pending the issuance of regulations implementing the new requirements. Notice 2004-80 addressed the definition of reportable transaction and material advisor and set forth rules for filing returns under IRC §6111 and maintaining lists under IRC §6112.

With respect to the definition of material advisor, Notice 2004-80 specified that the definition set forth in pre-existing Treas. Reg. §301.6112-1(c)(2) will be used and that the rules in §§301.6112-1(c)(2), (c)(3), and (d) (without regard to the provisions relating to a transaction required to be registered under former IRC §6111) will apply for purposes of determining whether a person is a material advisor.

Treas. Reg. §301.6112-1(c)(2)(i) provides, in relevant part, that a person is a material advisor with respect to a transaction if the person receives or expects to receive at least a minimum fee with respect to the transaction and the person makes a tax statement to or for the benefit of a class of people that includes the taxpayer, other material advisors, purchasers or transferees. The regulations go on to provide a special rule that

> A material advisor generally does not include a person who makes a tax statement solely in the person's capacity as an employee, shareholder, partner or agent of another person. Any tax statement made by that person will be attributed to that person's employer, corporation, partnership or principal. However, a person shall be treated as a material advisor if that person forms or avails of an entity with the purpose of avoiding the rule of section 6111 or 6112 or the penalties under section 6707 or 6708.

Treas. Reg. §301.6112-1(c)(2)(ii).

The definition of minimum fee that is adopted in Notice 2004-80 is actually the definition that is contained in the old Treasury Regulations. See Treas. Reg. §301.6112-1(c)(3)(i). This definition from the old regulations is slightly different than the definition of minimum fee that is contained in the new version of IRC §6111(b)(1)(B). The old regulations, which are currently applicable pursuant to Notice 2004-80, state that the minimum fee is $50,000 unless every person to whom or for whose benefit a tax statement was made is a corporation, in which case the minimum fee is $250,000.[5] In cases involving listed transactions, these minimum fee thresholds are reduced from $250,000 to $25,000 and from $50,000 to $10,000. Treas. Reg. §301.6112-1(c)(3)(i).

In determining whether a minimum fee threshold is met, all fees for any advice relating to implementation of the transaction at issue are taken into account. Fees include any kind of compensation for almost any type of service rendered in connection with the transaction, including fees to analyze, document and implement the transaction, regardless of whether such services relate to the tax aspects of the transaction. Fees do not include any amount paid to a person, including an advisor, with respect to that person's role as a party to the transaction (e.g., reasonable charges for use of capital or property). The minimum fee threshold must be met independently for each transaction and it is not necessary to aggregate fees among several transactions. Treas. Reg. §301.6112-1(c)(3)(iii).

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[5] IRC §6111(b)(1)(B) provides that the minimum fee is $50,000 if substantially all the tax benefits flow to individuals and $250,000 in every other case. Thus, under the statute, if an individual receives an insubstantial or incidental tax benefit from the transaction, the minimum fee may still be $250,000. In contrast, under the regulations, if an individual receives any tax benefit regardless of how insubstantial or incidental, the minimum fee drops to $50,000. See NYSBA Tax Section Report on Disclosure by Material Advisors dated February 23, 2005, at 16-18 (commenting on the difference between the two definitions of minimum fee).

In addition to providing a definition of material advisor, Notice 2004-80 also specified the due date for filing the return required under IRC §6111. The Notice stated that a material advisor required to file a return under IRC §6111 must file the return within 30 days after the date on which the person becomes a material advisor.

C. Notice 2005-22

In response to concerns raised by commentators,[6] Treasury issued Notice 2005-22, 2005-12 I.R.B. 756, which provided guidance relating to completion of the return required by IRC §6111, modified the definition of material advisor and changed the date on which a return must be filed under IRC §6111. Notice 2005-22 stated that an advisor will be treated as becoming a material advisor when all of the following events have occurred: (1) the advisor makes a tax statement; (2) the advisor receives or expects to receive a minimum fee; and (3) the transaction is entered into by the taxpayer. Advisors, including those who stop rendering services prior to the time the transaction is entered into, must make reasonable and good faith efforts to determine whether the taxpayer entered into the transaction. The Notice also changed the due date for filing the return required under IRC §6111 from the date that is 30 days after the advisor becomes a material advisor to the last day of the month following the calendar quarter in which the advisor becomes a material advisor.

2. THE DIFFICULTIES ARISING FROM APPLICATION OF THE MATERIAL ADVISOR RULES TO LAW AND ACCOUNTING FIRMS

The definition of material advisor provided by Notices 2004-80 and 2005-22 (which incorporated parts of Treas. Reg. §301.6112-1(c)(2)), creates significant uncertainty for law and accounting firms attempting to comply with the reporting and list

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6 See e.g, letter from the NYSBA Tax Section to Gregory F. Jenner and The Honorable Mark W. Everson dated December 10, 2004.

maintenance requirements of IRC §§6111 and 6112. In fact, it is very possible, or even inevitable, that firms will run afoul of their reporting and list maintenance obligations despite their best efforts to keep themselves informed of what their various partners, shareholders, employees and clients are doing. In such cases, through no fault of their own and despite their best efforts to comply, the firms will be subject to recently enhanced penalties that will be extremely difficult, if not impossible, to waive. Further, firms that are subject to these penalties will suffer embarrassment and reputational damage in their relationship with the Internal Revenue Service (the "IRS") and their clients even though they were not at fault.

This inequitable situation arises from the combination of the way in which the material advisor rules are applied to collective entities, such as law and accounting firms, and the ambiguity of the triggers for becoming a material advisor. Treas. Reg. §301.6112-1(c)(2)(ii) provides a special rule for material advisors which states that when a person makes a tax statement in that person's capacity as an employee, shareholder, partner or agent of another person, that tax statement is attributed to the person's employer, corporation, partnership or principal. This rule is the linchpin that makes the law or accounting firm the potential material advisor with respect to any reportable transaction.

While we understand why Treasury chose to confer material advisor status on firms as opposed to individual shareholders, partners and employees, the fact is that this rule imposes an unwieldy administrative burden on firms to monitor the statements made by each of its shareholders, partners and employees, the fees earned with respect to each separate transaction and the characteristics of each separate transaction. From a

practical perspective, this burden is very difficult to manage, especially for law and accounting firms that have large and active tax practices, many of which involve practitioners scattered in several different offices throughout the world. The difficulties are further compounded by the reality that non-tax practitioners, such as corporate and real estate attorneys and audit partners, often discuss taxes with their clients (i.e., make a "tax statement") even though no one, neither the professional nor the client, understands the discussion to constitute tax advice.

A. The Definition of a Tax Statement

The definition of what constitutes a tax statement is very broad and therefore difficult for firms to monitor. The regulations define a tax statement to include "any statement, written or oral, that relates to a tax aspect of a transaction that causes the transaction to be a reportable transaction." Treas. Reg. §301.6112-1(c)(2)(iii)(A). Unfortunately, it is often impossible to know at the time a statement is made whether a transaction is going to be a reportable transaction. For example, a person may make a statement about a tax loss without knowing at the time whether the loss will actually occur, whether the $10 million threshold will be met, or whether the loss transaction will be on the "angel list." Or, a person may make a statement about a credit without knowing at the time whether the credit will arise or whether the asset holding period will be satisfied. Similarly, it is difficult to apply the rules in the case of a transaction that becomes listed or substantially similar to a listed transaction long after the last tax statement about it has been made.

Perhaps most importantly, the inclusion of any oral statement within the definition of a tax statement expands the universe of possible tax statements exponentially beyond formal opinions, memoranda and e-mails to telephone conversations and casual comments. It is almost impossible to monitor every oral utterance by every person within a firm, including everyone from first year associates, to corporate lawyers, to the head of the tax department.

Given the breadth of the definition of what constitutes a tax statement, we submit that it is not possible to implement a system that fully evaluates every transaction as to which a tax statement has been made. Even if a firm requires each shareholder, partner and employee to confirm on a quarterly basis whether they have or have not made a tax statement with respect to a reportable transaction, it is not realistic to expect every person within the firm who makes an oral tax statement either accurately to analyze whether the transaction is reportable under these complicated rules or, alternatively, to report to management that he or she has made the statement. Further, it is virtually impossible to determine whether oral tax statements are being made that are not being reported to management. Even attempting to monitor this aspect of the material advisor rules on a quarterly basis is an overwhelming task, especially for firms that include hundreds or thousands of professionals.

B. The Minimum Fee Threshold

Another difficulty that firms encounter in monitoring their material advisor compliance obligations relates to tracking the minimum fee threshold. The minimum fee threshold is $250,000 if every person to whom or for whose benefit the tax statement was made is a corporation. The minimum fee drops to $25,000 when listed

transactions are involved. However, if any person to or for whose benefit a tax statement is made is an individual, including individuals who derive a tax benefit indirectly through a pass-through entity such as a partnership, S corporation, or trust, then the fee threshold drops to $50,000, or $10,000 for listed transactions.

It can be very time consuming for a firm to determine whether any individual may have received a tax benefit, either directly or indirectly, with respect to a particular transaction. As a result, a firm must either expend the time and effort to review each transaction to determine whether an individual will receive a direct or indirect tax benefit or, alternatively, the firm can simply assume that the lower threshold will apply and monitor all transactions that generate more than $10,000 of fees just in case it involves a listed transactions. However, there are very few transactions that generate less than $10,000 in fees. As a result, firms are essentially forced to assume that the fee threshold has been met and they must conduct at least a preliminary analysis of nearly every transaction that involves tax advice to determine whether it meets the other requirements under the material advisor rules.

C. The Definition of Reportable Transaction

Finally, the complexity and ambiguity surrounding the definition of a reportable transaction add to the burden of compliance in this area. The analysis of whether a transaction constitutes a reportable transaction requires a significant amount of time and effort from a person who is familiar with the relevant definitions, the IRS list of listed transactions, the "angel lists" and every detail of the subject transaction. Nevertheless, even an experienced tax practitioner who is familiar with the rules can sometimes encounter problems identifying a reportable transaction. Further, it sometimes

can be difficult to determine whether a given transaction is "substantially similar" to a listed transaction.

The determination of whether a transaction is reportable is even more difficult with respect to a transaction that has not closed or a transaction that becomes listed (or substantially similar to a listed transaction) at some date in the future. In both cases, the potential material advisor must monitor the transaction long after the tax statement is made and the advice is given to determine whether the transaction will become a reportable transaction in the future, either when it ultimately closes or when it becomes listed. The problem created by these rules is illustrated by the theoretical possibility that a transaction can become listed so long after the advice is given that the statute of limitations has closed with respect to the taxpayer, but the material advisor is still obligated to file a report and maintain a list with respect to the transaction.

The difficulty in identifying when a tax statement has been made, when the fee threshold has been meet and when a reportable transaction exists creates an environment in which a firm can fail to identify a reportable transaction even though it took reasonable precautions and believed that it had adequate procedures in place to catch any reportable transaction with respect to which one of its shareholders, partners or employees made a tax statement and for which it received the minimum fee. In such cases, it seems unfair and inequitable to impose a penalty on the firm for failing to report the transaction under IRC §6111 or for failing to maintain or produce a list under IRC §6112, especially when those penalties are difficult if not impossible to waive.

3. RECOMMENDED MODIFICATION TO THE DEFINTION OF MATERIAL ADVISOR

It is our recommendation that a firm that has implemented adequate procedures to monitor its material advisor obligations does not qualify as a material advisor until it becomes aware that the three specified elements of the current material advisor definition are met. This recommendation addresses the ambiguity inherent in applying the current material advisor definition to a firm and will reduce the possibility that a firm will be penalized under IRC §§6707 or 6708 even though it took reasonable steps to monitor its reporting obligations. Adequate procedures should be a set of procedures that are sufficient to ensure, in all but the most unusual cases, that a firm will discover whether the three elements are present. Once a firm implements these adequate procedures, it should be protected from penalties unless it becomes aware (as discussed below) that the three elements are present with respect to a reportable transaction and nevertheless fails to file or keep a list, or unless it knew or should have known that someone in the firm is engaged in a pattern or practice of non-compliance with the material advisor rules, or was so engaged and any resulting non-compliance has not been remedied.

Specifically, we recommend that Treasury adopt a definition of material advisor which provides that a material advisor is not treated as becoming a material advisor until all of the following events have occurred: (1) the material advisor makes a tax statement; (2) the material advisor receives (or expects to receive) the minimum fees; (3) the transaction is entered into by the taxpayer; and (4) with respect to a firm that has implemented adequate material advisor procedures, the designated compliance officer has actual knowledge that the first three requirements of this definition have been satisfied,

unless the designated compliance officer, or any other person involved in management of the firm, knows or should know that that one or more shareholders, partners or employees of the firm are engaged in a pattern or practice that does not comply with the material advisor reporting requirements set forth in IRC §§6111 or 6112, or that that one or more shareholders, partners or employees of the firm were so engaged and any resulting non-compliance has not been remedied.[7]

This definition of material advisor would modify the provisional definition set forth in Notices 2004-80 and 2005-22. The modified definition would enable a firm that has implemented adequate material advisor procedures to avoid being penalized. At the same time, it removes this protection if the firm is reckless in its monitoring of the material advisor rules or if it turns a blind eye to a renegade individual who is flouting the rules.

To reduce uncertainty and provide some standard by which firms will be evaluated, we recommend that Treasury provide guidance regarding what constitutes adequate material advisor procedures. Any set of adequate material advisor procedures should:

- be reasonably expected to cause someone responsible for material advisor compliance within the firm to discover on a timely basis whether any of its shareholders, partners or employees has made a tax statement with respect to a reportable transaction;
- generate accurate results and encourage people who are unsure about any aspect of the rules or the firm's procedures to seek guidance;

[7] This standard is similar to the standard that has been adopted in section 10.36(a)(2) of Circular 230 with respect to firms' compliance with the written opinion standards.

- permit the IRS to verify that the procedures are being followed;
- be sufficiently reasonable and practical so that firms will enforce and individuals will comply with the procedures; and
- be sufficiently flexible so that they can be adapted and implemented by any firm, regardless of its size or budget.

As part of this report, a working group of the NYSBA Tax Section conducted an informal confidential survey of various law and accounting firms with offices in New York City to determine how firms are addressing the material advisor requirements. The survey revealed that several firms have spent a considerable amount of time, effort and money to develop systems to monitor their material advisor obligations and, predictably, that some of those systems work more smoothly than others. Some of the larger firms have created sophisticated tracking systems with specialized software or automatic e-mail notifications and follow-up inquiries by individual employees or committees specifically assigned to this task. Other firms rely on written or even oral notifications to, and confirmations from, professionals.

In summary, we discovered that most firms' systems fall within two general categories: (1) matters-based systems; and (2) professionals-based systems. The matters-based systems track billable matters created by the firm and require some responsible person to determine whether a matter may involve a reportable transaction, whether a tax statement may be made respect to the matter and whether the fee threshold is met. This determination can be made at various dates, such as when the matter is opened, when a certain fee amount is billed or at other intervals. In many cases, it may be necessary to reevaluate a matter that initially did not appear to involve a reportable

transaction. This process of following up and reevaluating can become complex and cumbersome.

The professionals-based system requires professionals to confirm on a periodic basis whether a tax statement has been made by them with respect to a reportable transaction. In some cases, a separate system is created to monitor the minimum fee threshold. Of course, one issue with a professionals-based system is the need to follow up with each professional to make sure that the proper confirmation is provided on a timely basis. A few firms used a combination of the matters-based and professionals-based systems.

Some firms track all matters or professionals within the firm to determine whether any person may have made a tax statement, regardless of how insignificant. Other firms determined that the material advisor rules were intended to apply only to those tax statements that were intended by the professional, and could reasonably be construed by the client, to constitute tax advice and, therefore, limited their procedures to tax professionals within the firm. This later approach is most consistent with a common sense interpretation of these complex rules and significantly reduces the burden of compliance.

The most important conclusion we have drawn from our informal survey is that any adequate material advisor procedures must balance the firm's need to discover relevant information on a timely basis against the need to develop a system that is cost effective and workable for a broad spectrum of firms. Based on a balancing of these factors, we recommend that adequate material advisor procedures be defined as a written policy that is implemented by the firm and that includes the following elements: (1)

written notification and training for all of the firm's newly hired tax professionals, plus periodic, but no less than annual, notification and training for all professionals, outlining the requirements under IRC §§6111 and 6112 as well as the procedures implemented by the firm as part of these rules and cautioning non-tax professionals to refrain from discussing tax matters with their clients; (2) the designation of at least one material advisor compliance officer within the firm who is responsible for overseeing these procedures and ensuring compliance with the reporting and list maintenance obligations of IRC §§6111 and 6112; (3) implementation of procedures that require each tax practitioner within the firm to confirm to a material advisor compliance officer on a quarterly basis whether or not they have made a tax statement with respect to a reportable transaction.

The requirement of a written policy will ensure that firms have considered their obligations under the material advisor reporting and list maintenance rules and will provide evidence of what the firm has or has not done to fulfill those obligations. Once a firm produces its written policy in response to a material advisor audit, the only questions will be whether the policy properly includes all the necessary elements of an adequate material advisor procedure, whether the firm properly implemented that policy and whether the material advisor compliance officer, or any other person involved in management of the firm, knew or should have known that some individual was engaged in a pattern or practice of non-compliance.

Notification and training of the firm's professionals is necessary to ensure that they are aware of and understand the material advisor rules and the measures the firm is taking to comply with those rules. Requiring periodic notification and training helps to

remind the professionals of the firm's obligations and reinforces the need to comply with the firm's measures to ensure compliance. Requiring the notification to be in writing creates a verifiable record of the firm's compliance with the adequate material advisor procedures.

The designation of at least one material advisor compliance officer is necessary because each shareholder, partner or employee's knowledge of whether a tax statement has been made and whether the fee threshold has been met with respect to any reportable transaction has to be collected in one centralized source. Further, it is helpful to have at least one individual within the firm who is responsible for reporting or maintaining a list of the appropriate transactions. The material advisor compliance officer must be a person who is willing to undertake this responsibility and, by virtue of their training and position within the firm, is able to understand and apply the reporting and list maintenance requirements set forth in IRC §§6111 and 6112 and, finally, is able to oversee and monitor the firm's material advisor procedures, including collecting information, responding to inquiries and resolving issues.

Essentially, we are recommending a type of safe harbor. Treasury should specify that, to receive the protection incorporated within the proposed definition of what constitutes a material advisor, firms must implement a version of a professionals-based system pursuant to which all tax practitioners within the firm must confirm to the compliance officer on a quarterly basis whether or not they have made a tax statement with respect to a reportable transaction. We believe that this system achieves the best balance between the need to ensure the firm's compliance with the material advisor rules and the need to be sufficiently flexible and practical so that it can be implemented by

firms of all types and sizes. Quarterly confirmation from tax practitioners will ensure that the firm's compliance officer knows, in all but the most unusual cases, whether the firm has to report or keep a list with respect to a reportable transaction. At the same time, this system does not require firms to make any changes to the way in which they open and account for matters within the firm and it does not require any investment in specialized software or tracking systems. While some firms may choose to automate the confirmation process, other firms can adopt less structured forms of confirmation, including e-mails, memoranda or oral communications.

The recommended system requires confirmations only from tax practitioners. A tax practitioner should be defined for these purposes to include any professional who holds himself or herself out as being a tax advisor with respect to U.S. federal tax matters.[8] Only U.S. federal tax practitioners should be required to make the confirmation for several reasons. First, tax practitioners are the only people within the firm who are likely to make statements that are intended, and are construed by the client, to constitute tax advice. Second, as a practical matter, it is very difficult to educate professionals who do not regularly provide tax advice about the reporting requirements so that they understand them well enough to accurately identify reportable transactions. Finally, requiring confirmations only from tax practitioners is much more practical than requiring all shareholders, partners and employees of a firm to make quarterly confirmations. A procedure that requires hundreds or even thousands of confirmations each quarter is far too burdensome for most firms to administer.

[8] We are aware that some non-tax professionals, such as real estate, mergers and acquisition and investment fund lawyers, will sometimes discuss taxes with their clients. However, we do not believe these professionals should be required to make a certification because these discussions are not the type of tax advice that should fall within the scope of the material advisor rules.

4. CONCLUSION

The breadth of the definition of what constitutes a tax statement, combined with the difficulty in determining whether a transaction is reportable and the relatively low fee threshold for situations involving individuals, make it almost impossible for a law or accounting firm to know with certainty whether it has satisfied the elements to become a material advisor with respect to a reportable transaction. This creates a situation in which firms, through no fault of their own, may run afoul of the material advisor reporting requirements and become subject to penalties that can be difficult or impossible to waive. Accordingly, we recommend that Treasury adopt a definition of material advisor as set forth above which will protect firms from being penalized unless they were aware of their obligations yet nevertheless failed to file reports or keep lists or unless they knew or should have known that someone in the firm is engaged in a pattern or practice of non-compliance, or was so engaged and the non-compliance has not been remedied.