# SECTION OF TAXATION
## State Bar of Texas



September 19, 2013

Mr. Daniel Werfel
Principal Deputy Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20024

RE: Comments on Proposed Treasury Regulations Section 301.6708-1 Relating to Failure to Maintain List of Advisees with Respect to Reportable Transactions

Dear Principal Deputy Commissioner Werfel:

On March 8, 2013, the Internal Revenue Service (the "IRS" or "Service") and the Department of the Treasury ("Treasury") released REG-160873-04 regarding Proposed Treasury Regulations Section 301.6708-1 relating to the failure to maintain a list of advisees with respect to reportable transactions (the "Proposed Regulations"). In the Preamble to the Proposed Regulations, the Service and Treasury requested comments on the Proposed Regulations. On behalf of the Section of Taxation of the State Bar of Texas, I am pleased to submit the following comments on the Proposed Regulations.

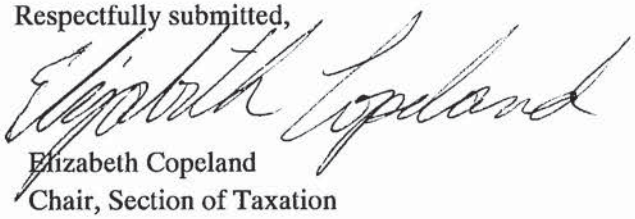
THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE SECTION OF TAXATION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE SECTION OF TAXATION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE SECTION OF TAXATION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE SECTION OF TAXATION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS

BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE SECTION OF TAXATION WHO PREPARED THEM.

We commend the Service for the time and thought that has been put into preparing the Proposed Regulations, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,



Elizabeth Copeland
Chair, Section of Taxation
The State Bar of Texas

cc: Mark J. Mazur
Assistant Secretary (Tax Policy)
Department of the Treasury

William J. Wilkins
Chief Counsel
Internal Revenue Service

Emily S. McMahon
Deputy Assistant Secretary (Tax Policy)
Department of the Treasury

COMMENTS ON PROPOSED TREASURY REGULATIONS SECTION 1.6708-1, AS PUBLISHED IN THE FEDERAL REGISTER ON MARCH 8, 2013

Principal responsibility for drafting these comments was exercised by David Colmenero, Robert D. Probasco, Shawn O'Brien and Brandon Bloom. The Committee on Government Submissions (COGS) of the Section of Taxation of the State Bar of Texas has approved these comments. Mary A. McNulty reviewed the comments and made substantive suggestions on behalf of COGS. Stephanie Schroepfer, Co-Chair of COGS, also reviewed the comments on behalf of COGS.

Although members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact Persons:

Brandon Bloom
brandon.bloom@tklaw.com
(214) 969-1106

David Colmenero
dcolmenero@meadowscollier.com
(214) 749-2462

Robert D. Probasco
robert.probasco@tklaw.com
(214) 969-1503

Shawn O'Brien
sobrien@mayerbrown.com
(713) 238-2848

Michelle Spiegel
mspiegel@mayerbrown.com
(713) 238-2717

Date: September 19, 2013

## I. EXECUTIVE SUMMARY.

We commend the issuance of the Proposed Regulations and guidance provided relating to the failure to maintain a list of advisees with respect to reportable transactions. We respectfully offer for your consideration the following suggested changes:

- Exclude the language in Prop. Treas. Reg. § 301.6708-1(b)(3),[1] which permits the IRS to leave a written request for a Section 6112 list at the last and usual place of abode or usual place of business of the person required to maintain the list;

- Revise the language in subsection (b) of the Proposed Regulations to require that, in situations where the IRS mails a request for a Section 6112 list, the notice state the date of mailing and to provide that the 20-day period begins to run from the later of three days after the stated date of mailing by the IRS or the date of actual delivery by the U.S. Post Office if the recipient can establish that delivery occurred at a later date.

- Clarify that all issues pertaining to the applicability and amount of the penalty are subject to administrative review by an IRS Appeals office;

- Clarify how the Proposed Regulations apply to law firms, accounting firms and other entities comprised of individual advisors; and

- Clarify certain aspects of reasonable compliance procedures establishing reasonable cause.

## II. BACKGROUND.

Section 6112 requires material advisors to maintain lists of advisees and other information with respect to reportable transactions and to make such list and information available to the IRS upon written request. Under Section 6708(a)(1), if a material advisor fails to comply with a written request for the Section 6112 list within 20 business days after the request is made, the material advisor is subject to a penalty in the amount of $10,000 for each day of the failure after the 20th business day. Pursuant to Section 6708(a)(2), the penalty will not be imposed on any day that the failure is due to reasonable cause.

## III. COMMENTS.

### A. Delivery of Written Request

We recommend that Prop. Treas. Reg. § 301.6708-1(b)(3), which authorizes the IRS to deliver the request for the Section 6112 list by leaving it at the last and usual place of abode or usual place of business, be deleted.

Prop. Treas. Reg. § 301.6708-1(b) states that the 20-business-day period begins to run from the earliest of the date that the IRS

> (1) Mails a request for the list required to be maintained under Section 6112(a) by certified or registered mail to the person required to maintain the list;

[1] Unless otherwise specified, all references to "Section" are to the Internal Revenue Code of 1986, as amended (the "Code"), all references to "Treas. Reg. §" are to the Treasury Regulations promulgated thereunder, and all references to "Prop. Treas. Reg. §" are to the Proposed Regulations.

(2) Hand delivers the written request to the person required to maintain the list; or

(3) Leaves the written request at the last and usual place of abode or usual place of business of the person required to maintain the list.

The third method of delivery (last and usual place of abode or usual place of business) did not appear in the interim guidance issued by the IRS under Section 6708 in IRS Notice 2004-80. *See* IRS Notice 2004-80, I.R.B. 2004-50 (Dec. 13, 2004). It appears for the first time in these Proposed Regulations.

By contrast, a notice of deficiency must be delivered only by certified or registered mail. Section 6212(a). The delivery methods authorized for a written request for the Section 6112 list are broader and similar to those for collection due process notices: notification of the filing of a notice of lien, Section 6320(a)(2), or notice of an intent to levy, Section 6330(a)(2). But unlike collection due process notices, a Section 6112 request requires affirmative action and imposes significant penalties if the recipient does not respond.

Further, a Section 6112 request has more in common with the notice of deficiency than with the collection due process notices and therefore should be subject to the same limited methods of delivery to assure delivery. First, the collection due process notices come into play only after the taxpayer's liability has been determined. Usually the taxpayer has already had an opportunity to challenge the liability. A notice of deficiency or Section 6112 request precedes the determination of liability or penalty; therefore, it is more important to ensure that the recipient received the notice or request. Second, realistically taxpayers in the Collections phase may be more difficult to contact through normal methods than taxpayers receiving a notice of deficiency or material advisors receiving a Section 6112 request. It may be reasonable to provide delivery options for collection due process notices, but the same logic does not apply to Section 6112 requests. Section 6112 requests have more in common with notices of deficiency, and the authorized delivery options should be similar.

We believe there are too many potential problems inherent in leaving a notice that carries such significant consequences at a person's place of abode or usual place of business. The Proposed Regulations place no restrictions or limitations on how or with whom the letter can be left. The IRS could apparently simply tape the letter to a door or window, or set it on a door step, making it susceptible to being swept away, washed away, or inadvertently destroyed in any number of different ways. Or the IRS could leave the letter with anyone at the location, including a child, staff or even an incompetent person, any one of whom may fail to deliver the letter to the intended recipient.

Moreover, the reasonable cause provisions in the Proposed Regulations do not provide adequate protection because the burden of proof is on the material advisor. *See* Preamble, Prop. Treas. Reg. 301.6708-1(b). Thus, the material advisor would be in a position of having to prove the negative (*i.e.*, that he or she did not receive the notice), which is inherently difficult. A material advisor may have nothing more than his or her word to establish that he or she did not receive the notice, which the IRS would likely consider inherently self-serving and therefore not sufficiently credible. The material advisor may not be able to offer corroboration, particularly if he or she has no idea of why he or she did not receive the notice.

The interim guidance in Notice 2004-80 wisely excluded this method of delivery from the list of methods that trigger running of the 20-day period. We believe the Proposed Regulations should likewise exclude it.

### B. Commencement of 20-Day Response Period

We recommend that the Proposed Regulations be revised to require that, in situations where the IRS mails a request for a Section 6112 list, the notice state the date of mailing and to provide that the 20-day period begins to run from the later of three days after the stated date of mailing by the IRS or the date of actual delivery by the U.S. Post Office if the recipient can establish that delivery occurred at a later date.

Prop. Treas. Reg. § 301.6708-1(b) states that the 20-business-day period begins on the first business day after the earliest of the date that the IRS –

(1) Mails a request for the list required to be maintained under Section 6112(a) by certified or registered mail to the person required to maintain the list;

(2) Hand delivers the written request to the person required to maintain the list; or

(3) Leaves the written request at the last and usual place of abode or usual place of business of the person required to maintain the list.

If the IRS hand delivers the request or leaves it at a person's last and usual place of abode or usual place of business, the 20-day period runs – at least theoretically – from the date the request is actually received. By contrast, where the IRS delivers the request by U.S. Mail, the 20-day period would run from the date of mailing, not from the date the taxpayer actually receives it. Thus, as the Proposed Regulations are currently drafted, the taxpayer's 20-day period for responding is necessarily shortened by the amount of time it takes the U.S. Post Office to deliver the mail as compared to the other methods of delivery. This difference is significant given that the $10,000 penalty applies on a per-day basis and begins to run on the 21st day. In addition, the taxpayer may have no way of determining when the IRS mailed the request.

We believe that a material advisor should in all instances be given a full 20 days from the date he or she actually receives the request to provide the list. Under Section 6708, Congress clearly intended to give a person 20 days to provide the list. Moreover, we believe that giving a person the full benefit of the 20-day period is not only required by statute, but also appropriate given the draconian nature of the penalty. Therefore, when the IRS mails the request, we suggest that the Proposed Regulations be revised to require that the notice state the date of mailing and to provide that the 20-day period begins to run from the later of three days after the stated date of mailing by the IRS or the date of actual delivery by the U.S. Post Office if the recipient can establish that delivery occurred at a later date.

### C. Administrative Review

We recommend providing an administrative review process for all issues relating to imposition of the Section 6708 penalty, including for example whether reasonable cause exists and whether an extension request should have been granted.

The Proposed Regulations state that the failure of the IRS to grant the person's extension request in full or in part may not be reviewed in any judicial proceeding. However, we believe that issues pertaining to the applicability and amount of the Section 6708 penalty, including issues such as whether an extension should have been granted or whether reasonable cause exists, should be subject to some level of administrative review. This is particularly important because the Section 6708 penalty is an "assessable penalty" under subchapter B of chapter 68. With respect to other assessable penalties, the IRS has argued and the Tax Court has agreed that the penalty is not subject to deficiency procedures and pre-payment judicial review by the Tax Court. *See, e.g., Smith v. Commissioner*, 133 T.C. 424 (2009)

(Section 6707A penalty). The absence of administrative review therefore would allow the IRS to impose the penalty without independent review by Appeals or a court before payment is required. The material advisor would have no recourse other than to pay the penalty and file a refund claim.

We therefore recommend adding language in the Proposed Regulations clarifying that all issues pertaining to the applicability and amount of the penalty, including issues such as whether an extension should have been granted or whether reasonable cause exists, are subject to administrative review by the material advisor's local IRS Appeals office.

**D. Application to Law Firms, Accounting Firms and Other Entities** We recommend supplementing Prop. Treas. Reg. § 301.6708-1(g)(1) with language clarifying that a material advisor may still show reasonable cause even if one or more individual employees of such person would not have reasonable cause.

Section 6708 applies to "any person who is required to maintain a list under Section 6112(a)." Section 6112 requires such a list to be maintained by a "material advisor" (as defined in Section 6111 and Treas. Reg. § 301.6111-3(b)). Generally, Section 6111 defines a material advisor as any "person" who provides material aid, assistance or advice with respect to a reportable transaction and who derives gross income for such aid, assistance or advice in excess of certain threshold amounts ($50,000 in the case of a transaction benefitting natural persons and $250,000 in any other case). The term "person" is defined in Section 7701(a)(1) to include an individual, partnership or corporation, among others. Based on the above definitions, law firms, accounting firms, and other similar entities will often qualify as material advisors with respect to reportable transactions.

These entities often employ a number of individuals who could provide material aid, assistance or advice with respect to a reportable transaction. Treasury anticipated the particular effect Section 6112 and the related Sections of the Code would have on such entities when it finalized Treas. Reg. § 301.6111-3(b)(2)(iii)(A), which provides (in relevant part):

> 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.

Prop. Treas. Reg. § 301.6708-1(f)(1) defines a "material advisor" as "a person described in section 6111 and § 301.6111-3(b)." Therefore, any application of the Proposed Regulations would treat the entity (i.e., the law firm or accounting firm) as the material advisor, and not the individual lawyer or accountant. The actual application of Treas. Reg. § 301.6111-3(b)(2)(iii)(A) to the Proposed Regulations, particularly Prop. Treas. Reg. § 301.6708-1(g), may lead to unintended consequences to the firms. It is unclear under the Proposed Regulations if and to what extent the actions, inaction, efforts, etc. of an individual advisor employed by a firm will affect the firm's ability to show reasonable cause. Therefore, we respectfully suggest further clarification as set forth below.

*Ordinary Business Care*

We recommend supplementing Prop. Treas. Reg. § 301.6708-1(g)(3) with language clarifying that a person may still show ordinary business care and, therefore, reasonable cause even if individual employees of such person did not exercise ordinary business care, as long as the person had appropriate procedures in place, and generally adhered to such procedures.

Prop. Treas. Reg. § 301.6708-1(g)(3) provides (in relevant part):

> The exercise of ordinary business care may constitute reasonable cause. To show ordinary business care, the person may, for example, show that it established, and adhered to, procedures reasonably designed and implemented to ensure compliance with the requirements of Section 6112.

It is possible that a firm has such procedures in place and generally adheres to them, but that an individual employee disregards certain of the procedures that results in a failure to comply with Section 6112. The example in Prop. Treas. Reg. § 301.6708-1(c)(4) suggests that such situations would qualify for an extension of the time within which to supply the list. This portion of the Proposed Regulations, however, does not directly address reasonable cause. We respectfully suggest adding a similar example or adding language at the end of Prop. Treas. Reg. § 301.6708-1(g)(3) similar to the following:

In circumstances in which an employee of a material advisor fails to follow the list maintenance procedures of his employer, the employer may still demonstrate reasonable cause if the failure represents an isolated incident and the employer acted promptly to correct the error upon learning of the employee's non-compliance.

*Reliance on Opinion or Advice*

We recommend supplementing Prop. Treas. Reg. § 301.6708-1(g)(5)(i) with language clarifying that reasonable reliance on the advice of an independent tax professional is evaluated based on the knowledge and good faith of the individual employee(s) primarily responsible for compliance procedures for the particular transaction at issue, rather than other employees at the firm.

Prop. Treas. Reg. § 301.6708-1(g)(5)(i) provides (in relevant part), "[a] person may rely on the advice of an independent tax professional to establish reasonable cause. The reliance, however, must be reasonable and in good faith, in light of all the other facts and circumstances." As a practical matter, the assessment of the independence of another tax professional cannot be a "committee decision"; the assessment must be made by the employee primarily responsible for the transaction, who requests the independent tax professional's advice. If the employee who is primarily responsible follows reasonable procedures in seeking such advice, the reasonableness of reliance should be based on that employee's knowledge and good faith. It would be inappropriate to impute the knowledge of all individuals at the firm in assessing the reasonableness of reliance. Therefore, we respectfully suggest supplementing Prop. Treas. Reg. § 301.6708-1(g)(5)(i) with language clarifying that reasonable reliance on the advice of an independent tax professional is evaluated based on the knowledge and good faith of the individual employee(s) primarily responsible for compliance procedures for the particular transaction at issue, rather than other employees at the firm.

### E. Reasonable Cause

Section 6708(a)(2) provides a reasonable cause defense against the penalty for failure to make the required list available on demand by the Secretary. Prop. Treas. Reg. §§301.6708-1(g) and (h) elaborate on what constitutes reasonable cause. We commend the IRS for its efforts to provide guidance on the application of this defense, but we respectfully suggest the following clarifications concerning reasonable compliance procedures that would establish reasonable cause.

*Accept Ordinary Business Care As Reasonable Cause*

Prop. Treas. Reg. §301.6708-1(g)(3) provides a general standard for determining reasonable cause for failure to comply:

> The exercise of ordinary business care *may* constitute reasonable cause. To show ordinary business care, the person *may*, for example, show that it established, and adhered to, procedures reasonably designed and implemented to ensure compliance with the requirements of section 6112....Notwithstanding the occurrence of an isolated and inadvertent failure, a person still *may* be able to demonstrate that the person exercised ordinary business care, considering all the relevant facts and circumstances, but only if the person had established and adhered to procedures reasonably designed and implemented to ensure compliance with the requirements of section 6112. [Emphasis added.]

We believe that, absent extraordinary circumstances, reasonable compliance procedures should always result in a finding of reasonable cause. We therefore respectfully suggest that Prop. Treas. Reg. § 301.6708-1(g)(3) be revised to provide:

> The exercise of ordinary business care *shall* constitute reasonable cause. For example, if the person shows that it established, and adhered to, procedures reasonably designed and implemented to ensure compliance with the requirements of section 6112, the person has shown ordinary business care....Notwithstanding the occurrence of an isolated and inadvertent failure, a person still *would* be able to demonstrate that the person exercised ordinary business care, considering all the relevant facts and circumstances, if the person had established and adhered to procedures reasonably designed and implemented to ensure compliance with the requirements of section 6112. [Emphasis added.]

*Reasonable Cause For Omissions of Transactions or Advisees*

We recommend that certain of the examples in the Proposed Regulations be replaced by or supplemented with one or more examples in which the advisor had reasonable cause for omitting a transaction or advisee from the list.

The rules concerning whether a transaction is a "reportable transaction," and whether an advisor is a "material advisor" with respect to a specific person, are complex and difficult to apply. We believe that most failures to comply with Section 6112 will result from failures to identify, whether inadvertently or through a mistaken application of the rules, a particular transaction or advisee as subject to these requirements.

The Proposed Regulations include twelve examples, but only three involve the omission of specific advisees from the required list. In two of the three examples,[2] the advisor demonstrates that it is not a material advisor with respect to those clients. Such examples are superfluous to guidance as to reasonable cause. Reasonable cause is not relevant because the original list was complete and the reasonable cause defense is not needed to avoid a penalty. The third example[3] concludes that there was no reasonable cause because the supervisor did not review the list prior to sending it to the IRS. (Pre-submission review is discussed further below.)

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[2] Section 301.6708-1(g)(6), Example 2, and Section 301.6708-1(h)(3), Example 2.
[3] Section 301.6708-1(h)(3), Example 3.

In our experience, IRS personnel considering potential penalties may be less likely to find reasonable cause if the facts and circumstances do not fit neatly within any of the examples in the applicable regulations. We are concerned that the absence of an example in which the advisor failed to list a transaction or advisee but had reasonable cause for the omission might be interpreted as a presumption that the material advisor can never show reasonable cause for such omissions. We therefore respectfully suggest that the first two examples be replaced by or supplemented with one or more examples in which the advisor had reasonable cause for omitting a transaction or advisee from the list.

*Pre-Submission Review*

We recommend that the examples be modified or supplemented to eliminate the implication that a pre-submission review would reasonably be expected to detect the omission of a transaction or advisee from the list.

The Proposed Regulations include two examples that discuss a supervisor's review of the list before it is submitted to the IRS ("pre-submission review"). One example involves the omission of a particular document from the list.[4] Because the supervisor "carefully reviewed the list to verify that it was comprehensive and accurate," and promptly provided the necessary document after being notified of the omission, the advisor had reasonable cause. The other example involves the omission of 15 advisees.[5] The advisor did not maintain a list contemporaneously with the issuance of advice and a supervisor did not review the final list before sending it to the IRS. Because the advisor could not establish a good faith effort to comply, it did not have reasonable cause for the failure to furnish the complete list.

We concur that pre-submission review is appropriate but the inefficacy of pre-submission review in identifying certain types of omissions makes it an inappropriate factor in determining whether a material advisor had reasonable cause for failing to comply with the Section 6112. For example, if the relevant transactions and advisees were identified contemporaneously with the issuance of the material advisor's advice,[6] a pre-submission review would be expected to detect most omissions of specific documents associated with those transactions and advisees. However, if the relevant transactions or advisees were not contemporaneously identified, and are therefore omitted from the list, it is unlikely that an additional pre-submission review would detect such omissions.

Many advisors handle a large volume of transactions, and relatively few are reportable transactions. Within the 20-day period, neither a supervisor nor individuals with primary responsibility for specific client matters could conduct a thorough review of *all* client matters to identify any omissions of transactions or advisees from the list. If the material advisor is a company handling a large number of transactions, it is highly unlikely that even a "careful review" of the list conducted during this limited period could have identified the missing advisors.

For the above reasons, we respectfully suggest that these examples be modified or supplemented to specify that an advisor can demonstrate reasonable cause for the omission of a transaction or advisee from the list, even if a pre-submission review did not identify such omissions. Such a revision clarifies that a person can show reasonable cause when there was an omission of a transaction or advisee. It also appropriately emphasizes that the procedures designed to ensure contemporaneous identification are much more important, because they are more likely to be effective, than a pre-submission review.

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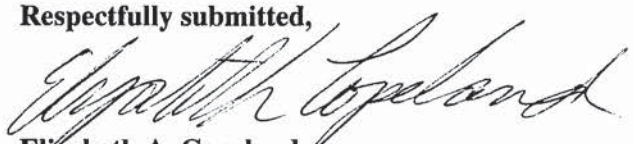
[4] Prop. Treas. Reg. § 301.6708-1(h)(3), Example 1.
[5] Prop. Treas. Reg. § 301.6708-1(h)(3), Example 3.
[6] Prop. Treas. Reg. § 301.6708-1(h)(3), Example 1.

*Advice Of Independent Tax Professional*

We recommend that the Proposed Regulations explicitly reject any presumption of a lack of ordinary business care from the failure to consult with an independent tax professional.

Prop. Treas. Reg. § 301.6708-1(g)(5) provides (in relevant part), that "[a] person may rely on the advice of an independent tax professional to establish reasonable cause." We agree that such reliance should qualify as reasonable cause. However, we are concerned about the possible implications of this provision. For other penalties with similar safe harbor defenses, as a practical matter the IRS and courts have often presumed that the taxpayer did not exercise reasonable care if it did not consult with an independent tax professional. Such a presumption may be appropriate for inexperienced taxpayers facing complex tax issues, but it would not be appropriate for most material advisors, who do have the necessary background and experience to evaluate their list maintenance obligations without seeking outside advice. Although the Proposed Regulations do not require consultation with an independent tax professional to establish reasonable cause, we respectfully recommend that the Proposed Regulations explicitly reject any presumption of a lack of ordinary business care from the failure to consult with an independent tax professional. This lack of a requirement is implied,[7] but due to past presumptions by the IRS and courts in other contexts, we believe an explicit rejection is warranted.

**Respectfully submitted,**



**Elizabeth A. Copeland**
**Chair, Section of Taxation**
**The State Bar of Texas**

[7] Prop. Treas. Reg. § 301.6708-1(g)(6), Example 7.