Penalties

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Tax Practitioners Beware: New Guidance Provides Limited Relief from Penalties for Failure to Comply with List Maintenance Requests

Imagine you are a partner at an accounting firm and you discover that, several years ago, one of your partners provided advice to a few clients regarding a type of retirement plan that was a reportable transaction. After auditing the taxpayers, the IRS is now focusing on your firm as a possible material advisor and has requested the firm to provide a list with respect to all reportable transactions for which it was a material advisor. Failure to provide the requested information within 20 days of the request can result in crushing penalties of as much as $10,000 per day!

Treasury recently issued proposed regulations under Code Sec. 6708 to provide guidance on how list maintenance penalties will be imposed.[1] The proposed regulations cover three main areas: (1) extensions of time for complying with list maintenance requests; (2) reasonable cause for failure to furnish lists within the 20-business-day time period; and (3) how penalties are applied where advisors have entered into designation agreements. Before discussing the proposed regulations, it is helpful to review the list maintenance rules of Code Sec. 6112 and the penalties under Code Sec. 6708.

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List Maintenance Rules and Penalties

Code Sec. 6112 requires that each material advisor with respect to a reportable transaction prepare and maintain a list and furnish such list upon written request of the IRS. The list must identify each person to whom or for whose benefit the material advisor has made or provided a tax statement, the taxpayers and advisors involved, and detailed descriptions of the tax structure and the purported tax treatment of the reportable transaction. The material advisor must also maintain, and produce to the IRS upon request, documents related to

the transaction and any designation agreements. The material advisor must retain the list and related documents for seven years following the earlier of the date on which the material advisor last made a tax statement relating to the transaction or the date the transaction was entered into, if known. The material advisor must furnish the list to the IRS within 20 business days from the date of the IRS's request.

A material advisor who fails to furnish the list upon request is subject to a penalty of $10,000 for *each calendar day* after the twentieth *business day* that the material advisor fails to provide the list. The proposed regulations state that the penalty accrues daily and continues for each calendar day until, and including, the day the person's failure to furnish a list in the required form ends. There is no maximum penalty amount, and the penalty is cumulative. The penalty generally applies to the firm or other organization, and not the individual partners or professionals.

There is a reasonable cause exception to the imposition of the penalty.[2] However, prior to these proposed regulations, Treasury had not issued any guidance regarding Code Sec. 6708 penalties. Also, there have been virtually no judicial decisions regarding Code Sec. 6708,[3] making Treasury's proposed guidance on reasonable cause very welcome to practitioners representing material advisors.

Extensions of the 20-Business-Day Period for Furnishing the List

In the preamble to the Proposed Regulations, Treasury explains that Congress intended the Code Sec. 6708 penalty to be "time-sensitive," and accordingly, the IRS will not grant extensions where a significant reason for the request is to delay production of the list. Any extensions will be for a short time period and not routinely granted.

The proposed regulations do permit the IRS to grant extensions, at its discretion, if prior to the expiration of the 20-business-day period, the advisor cannot meet the deadline despite diligent efforts to maintain the materials and furnish the list. The advisor must submit a written extension request that contains the following items: (1) briefly describe the information and documents that comprise the list; (2) explain why additional time is necessary; (3) propose a schedule for completion of the production of the list; (4) state that to the best of the person's knowledge, all information and records relating to the list have been maintained in accordance with Code Secs. 6001 and 6112; and (5) state that the request is not made for the purpose of avoiding the list maintenance obligations.[4]

These requirements for making a valid extension request are very strict, and short of a natural disaster, there are limited circumstances in which a material advisor could obtain an extension. The proposed regulations contain an example where a brief extension may be granted. In the example, a large law firm is a material advisor and has educated its attorneys about reportable transactions and the reporting and list maintenance rules, and has policies in place to ensure compliance, but unbeknownst to the firm, one of its attorneys, who is no longer with the firm, did not comply with respect to one transaction. Because the firm will have to search for responsive documents in its storage facility and contact clients for information, it will not be able to respond within 20 business days. In this example, the IRS granted a 10-day extension, but only with respect to the one transaction at issue.[5]

This example is instructive in two respects. First, it illustrates how difficult it will be to obtain an extension, and that practitioners representing material advisors should continue to advise their clients that for all practical purposes, the 20-business-day deadline will not be extended. Second, the description of the law firm and its practices provides a template for the kinds of policies and procedures that firms advising on reportable transactions should have in place: annual sessions to educate professionals about how to identify reportable transactions and the reporting and list maintenance requirements, and firm policies requiring all attorneys to provide information and documents related to reportable transactions to the firm's compliance officer for list maintenance purposes. Any firm that is advising with respect to reportable transactions should implement these or similar policies and procedures immediately. Doing so will both ensure the ability to timely respond to list maintenance requests, and also may give the firm some leeway with the IRS if an unexpected situation arises, as in the example. Moreover, as described below, having these policies in place will support the firm's reasonable cause defense if it is not able to timely and fully respond to a list maintenance request.

Reasonable Cause

Reasonable cause determinations are made on a case-by-case and day-to-day basis, taking into account all relevant facts and circumstances. The grounds for reasonable cause include good faith, the exercise of

ordinary business care, supervening events and reliance on an independent opinion or advice.[6]

The most important factor in determining reasonable cause is the material advisor's good-faith effort to comply with Code Sec. 6112. The good-faith factors include the material advisor's effort to (1) determine or assess status as a material advisor; (2) determine the information and documentation required to be maintained; (3) meet its obligations to maintain a readily-producible list; (4) make the list available to the IRS within the 20-business-day period (or extended period); and (5) ensure that the list furnished to the IRS is accurate and complete.[7]

The exercise of ordinary business care also may constitute reasonable cause. Ordinary business care would include the material advisor establishing and adhering to procedures reasonably designed and implemented to ensure compliance with Code Sec. 6112. Also, the material advisor must take immediate steps to correct any failure relating to the list upon discovery. Such failure to take immediate remedial measures weighs against a finding that the material advisor exercised ordinary business care. Treasury indicates that isolated and inadvertent failures to immediately make corrections will not prevent a finding of ordinary business care, but only if the material advisor had established and adhered to its compliance procedures.[8]

> For the unintentional material advisor who was not aware that a transaction was even reportable or that its advice constituted a tax statement, rigid application of these proposed regulations may produce unnecessarily harsh results.

Supervening events also can be reasonable cause for failure to comply with a list maintenance request where the failure to timely furnish the list "was due solely to a supervening event beyond the person's control," such as fire, flood, storm or other casualty, illness, theft or another similarly unexpected event that damages or impairs the material advisor's business records or system for processing and providing these records or that affects the ability to maintain the list or make it available to the IRS. Reasonable cause will only exist during "the period that a person who exercised ordinary business care would need to provide the list from alternative records in existence, or make the list available, under the specific facts and circumstances."[9]

Reliance on an opinion or advice of an independent tax professional also may establish reasonable cause. The reliance must be reasonable and in good faith in light of the facts and circumstances. The advisor is not considered to be an independent tax professional unless she or he is knowledgeable in the relevant aspects of federal tax law and is not a material advisor with respect to the specific transaction that is the subject of the list request. The advice must have been received prior to the time for providing the list and will be considered reasonable only if the independent tax professional expressed a reasonable belief that it was more likely than not that there was no obligation under Code Sec. 6112. Examples of such advice are that the firm is not a material advisor, the transaction is not a reportable transaction or the information withheld was not required to be produced. The advice must take into account all relevant facts and circumstances, not rely on unreasonable legal or factual assumptions or unreasonable representations or statements of the person seeking advice, and not rely on or take into account the possibility that a list request may not be made. Where the advice is from a nonindependent tax professional, the IRS will consider whether there was reasonable cause in light of all of the other facts and circumstances, but the advice will not be sufficient on its own to establish reasonable cause.[10]

In one Example, a law firm requested an opinion from another law firm on whether a transaction is the same or substantially similar to a reportable transaction such that it would be a reportable transaction. The advisor law firm, however, provided tax advice to clients who invested in the same kind of transactions. Because the advising firm is a material advisor with respect to a transaction that is the same or similar, it is not an independent material advisor. The IRS will consider the advice in determining reasonable cause in light of all the facts and circumstances, but the advice is not sufficient to establish reasonable cause independently.[11]

Designation Agreements and Concurrent Application of the Penalty

A designation agreement is a written agreement in which multiple material advisors with respect to a transaction designate a single advisor to maintain the list and furnish it to the IRS if requested. The proposed regulations provide that if there is a designation agreement, and the

designated material advisor fails to comply with a list request, a penalty shall accrue against the other nondesignated material advisor(s) until the designated advisor complies.[12] The example in the proposed regulations illustrates this point and states that a penalty will be imposed on all material advisors unless there is reasonable cause. Having entered into a designation agreement is not identified as a good-faith factor or part of exercising reasonable business care. Reasonable cause is a facts-and-circumstances analysis, however, and Treasury has stated that the enumerated factors are not exclusive. Accordingly, a party to a designation agreement may be able to argue reasonable cause if it believed in good faith that the designated material advisor was responding to the list maintenance request. Because it is unclear how these provisions will interact, to be on the safe side, material advisors should consider their list maintenance requirements to be nondelegable duties and make sure that they themselves are prepared to comply.

Conclusion

The main take-away from the proposed regulations is that material advisors may have difficulty obtaining extensions or arguing for reasonable cause if they have not taken steps to be compliant with Code Sec. 6112 *before* ever receiving a list maintenance request. Tax practitioners should take heed and establish procedures to ensure compliance. For the unintentional material advisor who was not aware that a transaction was even reportable or that its advice constituted a tax statement, rigid application of these proposed regulations may produce unnecessarily harsh results. Hopefully the IRS will recognize that some material advisors had no idea that they were involved in reportable transactions and will consider whether such material advisors acted in good faith upon receiving a list maintenance request even though they were not compliant prior to the request.

Endnotes

1 8 FR 14939 (Mar. 8, 2013).
2 Code Sec. 6708(a)(2).
3 The only decision so far is *Iantosca v. Benistar Admin IRSs, Inc.*, DC-MA, 2012 U.S. Dist. LEXIS 20693 at *13, n.3 (Feb. 17, 2012), where the court held that in no event is a failure to maintain a required list considered reasonable cause for failing to make the list available to the IRS.
4 Proposed Reg. §301.6708-1(c)(3)(ii).
5 Proposed Reg. §301.6708-1(c)(4).
6 Proposed Reg. §301.6708-1(g).
7 Proposed Reg. §301.6708-1(g)(2).
8 Proposed Reg. §301.6708-1(g)(3).
9 Proposed Reg. §301.6708-1(g)(4).
10 Proposed Reg. §301.6708-1(g)(5).
11 Proposed Reg. §301.6708-1(g)(6) (Example 7).
12 Proposed Reg. §301.6708-1(c)(3).