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August 25, 2006

Mr. Eric Solomon
Acting Deputy Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3112 MT
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

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

Re: Prohibited Tax Shelter Transactions Under §4965

Dear Acting Deputy Assistant Secretary Solomon and Commissioner Everson:

I am pleased to enclose New York State Bar Association Tax Section Report No. 1116, commenting on Section 4965, which was added to the Internal Revenue Code by The Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"). The report responds to the request for comments contained in Notice 2006-65, 2006-31 I.R.B. 102.

Section 4965 imposes new excise taxes on a broad range of tax-exempt entities–and their managers–for participation in "prohibited tax shelter transactions." The new law is effective for taxable years ending after May 17, 2006; the excise taxes generally apply to income or proceeds allocable to periods after August 15, 2006. TIPRA also amended Sections 6033, 6011 and 6652, adding new reporting requirements and imposing penalties on both the taxable party and the tax-exempt party for failure to disclose participation in such transactions to the Internal Revenue Service.

The new tax shelter rules present substantial issues for the tax-exempt community, their partners or co-investors, and their investment advisors. Because the excise taxes and disclosure requirements apply whether or not a tax-exempt "party" knows or has reason to know that an investment constitutes a prohibited tax shelter transaction, the new law may cause tax-exempt organizations to change their otherwise proper investment policies and practices to avoid inadvertently becoming a "party." To the extent feasible, regulations should minimize these unintended, ancillary consequences of the legislation on customary and appropriate investment practices and relationships. We accordingly recommend restraint in interpreting the new law, so that the sanctions of Section 4965 appropriately fall on those exempt entities and their managers that are inappropriately using their exempt status in accommodating others in transactions that have a significant purpose of evading or avoiding federal income tax, or are active participants in a tax shelter or engage in tax shelter transactions in order to shelter their own taxable income.

The enclosed Report addresses, among others, the following issues:

- Because the excise taxes imposed under Section 4965 and the disclosure requirements under Section 6033(a) apply only where a tax-exempt entity is a "party" to a prohibited tax shelter transaction or a subsequently listed transaction, immediate guidance is needed on when a tax-exempt entity should be treated as a "party to the transaction." A definition needs to be formulated both for direct participation, where the tax-exempt entity enters into the transaction on its own behalf (including through controlled or majority-owned entities), and indirect involvement in a prohibited tax shelter transaction through an investment in another entity. In cases involving investments by tax exempts in entities (other than, e.g., controlled entities), where the tax exempt is not directly a party to the tax shelter transaction, the Report recommends that the Treasury Department and the Service provide a safe harbor under which a tax exempt will not be a "party to the transaction," even if an entity in which the tax exempt invests is itself a party to a tax shelter transaction, if all of the following conditions are satisfied:

1. The tax exempt is a passive investor in the investment vehicle and did not otherwise participate in the decision to enter into the tax shelter (including, for these purposes, failing to exercise a veto right);

2. The return to the tax exempt from the tax shelter is no different than the return from such transaction received by taxable investors. For these purposes, the return includes not only the amount of any income or proceeds received but also their character for tax purposes;

3. The anticipated return to the tax exempt does not depend upon or involve a role for its tax-exempt status; and

4. The tax exempt did not invest in the entity knowing (or with reason to know) that the entity intended to invest in one or more prohibited tax shelter transactions.

- Although Congress gave the new excise taxes and disclosure rules immediate effect (as is customary with anti-abuse laws), we recommend that where the application of the new law to a situation is not clear from the statute, the effective date for the excise taxes and disclosure rules should not precede the issuance of final regulations. Further, for subsequently listed transactions, we recommend that guidance should expressly permit avoidance of the Section 4965 penalties if the offending subsequently listed transaction is unwound, rescinded or otherwise corrected within 90 days after the transaction becomes listed.

- Guidance is needed on the meaning of "proceeds" attributable to a prohibited tax shelter transaction. Neither the statute nor the legislative history gives any further clarification or examples of what is intended in this context. The Report recommends that "proceeds" should mean total or gross receipts, reduced by any return of investment/basis, but without any deduction of related expenses or taxes.

- A strong case can be made for not enforcing the full breadth of the statute against innocent or unsophisticated tax exempts. We believe that the Service has the authority to compromise the penalties that would otherwise be imposed by Section 4965 on tax-exempt entities, and it would best achieve Congress' objectives if the regulations expressly stated that the Service will take into account voluntary disclosure as a relevant factor. Given the potentially confiscatory nature of Section 4965 (especially if a broad definition of proceeds were adopted), a regulation of this type would encourage tax exempts that discover that they have inadvertently entered into a possible prohibited tax shelter transaction to disclose the transaction, rather than take the position that the transaction is not substantially similar to a listed transaction and fail to disclose.

We appreciate your consideration of our recommendations and comments. We would be pleased to discuss these matters with you further or provide any other assistance that you would find helpful.

Respectfully submitted,

Kimberly S. Blanchard
Chair

Enclosure

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