NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON SECTION 4965

AUGUST 25, 2006

Report No. 1116

New York State Bar Association Tax Section
Report on Section 4965[1]

I. Introduction

Tax-exempt entities, knowingly or unwittingly, have gotten caught up in the world of tax shelters. Congress has responded with legislation aimed at curbing tax shelter abuses by tax exempts. The Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"), which was enacted May 17, 2006, added new Section 4965 to the Internal Revenue Code of 1986, as amended (the "Code").[2] 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 excise taxes generally apply to income or proceeds allocable to periods after August 15, 2006. The legislation also adds new reporting requirements and imposes 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 "IRS"). On July 11, 2006, the IRS issued Notice 2006-65,[3] which gives limited guidance on the new provisions and asks for public comments.

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[1] This report was drafted by Richard R. Upton with material contributions from Michelle Scott, Stuart Rosow, David Miller and Elizabeth Moller. Helpful comments were received from Kimberly Blanchard, Michael Schler, Kirk Wallace and Harvey Dale.

[2] The Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222 (2006), includes Section 516, entitled "Tax Involvement of Accommodation Parties in Tax Shelter Transactions." Section 516 of TIPRA added Subchapter F – Tax Shelter Transactions, to Chapter 42 (relating to excise taxes on private foundations and others) consisting of new Code Section 4965, "Excise Tax on Certain Tax-Exempt Entities Entering into Prohibited Tax Shelter Transactions." TIPRA Section 516 also amended Code Sections 6033 (relating to reporting), 6011 (relating to reporting) and 6652 (relating to penalties for nondisclosure).

[3] Notice 2006-65, 2006-31 I.R.B. 102.

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." Thus, the legislation may affect business relationships with bankers and investment advisors, and may reduce tax exempts' participation in various types of investments. To the extent feasible, regulations should minimize these unintended, ancillary consequences of the legislation on customary and appropriate practices and relationships.

This report is submitted in response to Notice 2006-65's request for comments on the new tax shelter provisions. Because the law is effective immediately, guidance on many of the statute's provisions is needed urgently in order to avoid disrupting routine investment activities by tax exempts that are not abusive and which should be outside the scope of the new penalty provisions.

The first section of this report gives an overview of the new law. The report then discusses the background leading up to the new law and what Congress intends to accomplish through the new provisions. Next, the report discusses anti-tax-shelter provisions of pre-TIPRA law that continue to apply to tax exempts (that reduce the need, from a tax administration point of view, for an expansive reading of the new provisions), as well as some concerns of the tax-exempt community over an expansive interpretation of the law. Finally, the report addresses specific questions and concerns and gives comments and recommendations on how the new law should be interpreted. The Appendix to this report briefly summarizes certain listed transactions

and other transactions involving exempt organizations which the IRS has determined are abusive.

II. Overview of the New Provisions

A. In General

New Section 4965 imposes excise taxes for being a party to a prohibited tax shelter transaction on a no-fault basis on many tax-exempt entities, including charities, churches, schools and all other types of Section 501(c) organizations, as well as state, local and Indian tribal governments. The taxes are increased if the entity knows or has "reason to know" that a transaction is a prohibited tax shelter transaction. Managers of all tax-exempt entities, including the foregoing, as well as qualified retirement plans, individual retirement accounts ("IRAs") and similar tax-favored savings arrangements (such as Section 403(b), 457(b) and 529 plans), are subject to excise taxes if they have actual knowledge or reason to know that a transaction they approve is a prohibited tax shelter transaction.

B. What is a Prohibited Tax Shelter Transaction?

A "prohibited tax shelter transaction" is any "listed transaction" and any "prohibited reportable transaction." A listed transaction is a transaction that is the same as, or "substantially similar" to, a transaction specifically identified by the Secretary in published guidance as a tax avoidance transaction. A list of such transactions is available on the IRS website at http://www.irs.gov/businesses/corporations/article/0,,id=120633,00.html. A "subsequently listed transaction" is a transaction that a tax-exempt organization already is a party to when the transaction becomes a listed transaction. Prohibited reportable transactions are transactions offered to taxpayers under conditions of confidentiality with respect to their design,

as well as transactions with contractual protection (where the fee is contingent on the realization of tax benefits or where the taxpayer is entitled to a refund if the desired tax consequences are not obtained).

C. When is a Tax-Exempt Entity a "Party" to a Prohibited Tax Shelter Transaction?

The new excise taxes, reporting obligations and disclosure penalties are triggered by a tax-exempt entity being a "party" to a transaction. The legislative history to Section 4965 indicates that all facts and circumstances should be taken into account in determining whether an organization is a "party" to the transaction.[4] It is not clear when indirect involvement in a prohibited tax shelter transaction – for example, through an interest in a hedge fund or other investment vehicle – will result in an organization being considered a party to a transaction. The determination will be "informed by whether the entity or entity manager knew or had reason to know that an investment of the entity would be used in a prohibited tax shelter transaction."[5]

D. Excise Taxes and Penalties

1. Excise Taxes on the Organization

If a tax-exempt organization described in Section 501(c), 501(d) or 170(c), including state and local governments (plus Indian tribal governments), is a party to a prohibited tax shelter transaction at any time during a taxable year, but does not know or have reason to know at the time it becomes a party that the transaction is a prohibited tax shelter transaction, the organization will be subject to an excise tax equal to 35% of the greater of 100% of its income from the transaction (net of any other excise taxes) or 75% of the gross proceeds it receives from the transaction that year. If the organization *does* have actual knowledge or reason to know that

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[4] H.R. Rep. No. 109-455, at 113 (2006) (Conf. Rep.) (hereinafter, the "Conference Report").

[5] *Id.*

the transaction is a prohibited tax shelter transaction at the time it becomes a party, then the excise tax will be equal to the greater of the full amount of its income from the transaction for the year (net of other excise taxes) or 75% of its proceeds.

If a transaction is not a prohibited tax shelter transaction at the time the organization becomes a party, but is subsequently "listed" by the IRS as a tax avoidance transaction, the excise tax is 35% of the greater of 100% of its income (net of other excise taxes) or 75% of its proceeds, but only for periods after the transaction first becomes a listed transaction.

2. Excise Taxes on Managers

The excise taxes imposed on managers apply to managers of all tax-exempt entities. An excise tax of $20,000 is imposed on any entity manager who approves or otherwise causes a tax-exempt entity to become a party to a prohibited tax shelter transaction *if the manger either knows or has reason to know* that the transaction is a prohibited tax shelter transaction. A separate excise tax applies to *each* approval (or other act causing the entity's participation in a prohibited tax shelter transaction).

For Section 501(c), 501(d) and 170(c) organizations, including state and local governments (plus Indian tribal governments), an entity manager is a person who has responsibilities similar to those of an officer, director or trustee of the entity and authority with respect to the act causing the entity's participation in the prohibited tax shelter transaction. In the case of qualified retirement plans and other tax-favored savings arrangements (including Section 403(b), 457(b) and 529 plans, as well as IRAs), the entity manager is the person who approves the transaction or otherwise causes the entity to become a party to the transaction.

3. Avoiding the Higher Excise Tax for Knowing Participation

The Conference Report provides that both the higher excise tax imposed on entities with actual knowledge or "reason to know," and the manager-level tax, apply if the entity or manager has "knowledge of sufficient facts that would lead a reasonable person to conclude that the transaction is a prohibited tax shelter transaction."[6] Absence of such knowledge may be demonstrated in several ways, including through reasonable reliance on a written opinion of counsel.

4. Disclosure Penalties

The legislation imposes disclosure obligations both on the tax-exempt party and the taxable party to the transaction. The taxable party is required to provide a written statement to the exempt party that the transaction is a prohibited tax shelter transaction. Failure to make this disclosure is subject to penalties.

Regardless of whether the tax-exempt party receives the required notice from the taxable party, the tax-exempt party is required to disclose to the IRS its participation in any prohibited tax shelter transaction, as well as the identities of any other known parties. A penalty of $100 per day that the disclosure remains delinquent (up to a maximum of $50,000) is imposed on the tax-exempt entity. In the case of a qualified retirement plan or similar tax-favored savings arrangement, the penalty is imposed on the entity manager, rather than the entity itself.

Finally, the Treasury is entitled to make a written demand on any entity or manager subject to the disclosure penalty specifying a reasonable future date by which the disclosure must be filed. Failure to comply with the demand carries a penalty of $100 per day after the date provided in the demand letter (up to a maximum of $10,000) for any given disclosure.

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[6] Conference Report, *supra* note 4, at 112.

E. Effective Dates

The new provisions are effective for taxable years *ending* after May 17, 2006, regardless of when the transaction was entered into. However, the excise taxes apply only to income or proceeds that are allocable to periods beginning after August 15, 2006. Transactions to which a tax-exempt organization became a party on or before May 17, 2006 are subject to the no-fault excise tax with respect to amounts earned after August 15, 2006, but are not subject to the increased tax for knowing participation.

Notice 2006-65 provides that the disclosure requirements and related penalties apply to disclosures "the due date for which is after May 17, 2006." The statute requires that disclosure be made "in such form and manner and at such time as determined by the Secretary." The Treasury has not yet provided any detailed guidance on the disclosure provisions.

III. Background and Reasons for Enactment

One of Congress's and the IRS's primary compliance concerns in tax law today is abusive tax shelters. Section 4965 was enacted in reaction to growing concerns over the use of tax-exempt entities by third parties to conduct abusive transactions. Prior to the enactment of TIPRA, Congress and the IRS voiced growing concern over what they perceived as increasing involvement of exempt organizations as accommodation parties in such transactions.

In his 2004 testimony before the Senate Committee on Finance (the "Finance Committee"), IRS Commissioner Mark W. Everson identified the use of tax-exempt organizations as "accommodation parties" in the abusive transactions as a "major concern" for the Finance Committee to address and stated that there is often complicity between the tax-

exempt entity and the third party abuser.[7] Commissioner Everson further stated that as of the date of his testimony, five of the eight 2004 listed transactions use a tax-exempt party.[8]

In June 2004, the Finance Committee released a discussion draft (the "White Paper") that recommended legislation imposing a 100% tax on all accommodation fees and other direct benefits received by a tax-exempt organization participating in a prohibited transaction and revoking such organization's Section 170 status (or ability to receive tax deductible contributions) for one year.[9]

In January 2005, the Joint Committee on Taxation released a similar proposal (the "JCT Report"),[10] which proposed imposing penalties on organization managers as well as on the exempt organization participating in certain prohibited transactions. Additionally, upon learning that a transaction previously entered into has been deemed prohibited, the JCT Report proposed imposing reporting obligations and imposing a tax (at the unrelated business income tax ("UBIT") rate) on all income earned after learning of the prohibition.

On April 5, 2005, Commissioner Everson again appeared before the Finance Committee and testified concerning the involvement of tax exempts in tax shelters. In a written statement submitted in connection with the hearings, Commissioner Everson wrote:

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[7] IRS News Release, "Written Statement of Mark W. Everson, Commissioner of Internal Revenue, before the Committee on Finance, U.S. Senate: Hearing on Charitable Giving Problems and Best Practices," IR-2004-81 (June 22, 2004).

[8] Only one of those five listings, Notice 2004-20; 2004-1 C.B. 608, involved a foreign person or entity as an accommodation party. The rest involved various tax-exempt entities, including several qualified retirement savings vehicles. See Notice 2004-8; 2004-1 C.B. 333 (Roth IRAs); Rev. Rul. 2004-04, 2004-1 C.B. 414 (ESOPs); Rev. Rul. 2004-20; 2004-1 C.B. 546 (defined benefit retirement plans and death benefit plans funded by life insurance policies); Notice 2004-30; 2004-1 C.B. 828 (using S corporations to shift income to exempt organizations).

[9] Prohibited transactions included "listed tax shelter transaction[s] and reported transactions (with a significant purpose of tax avoidance)." It is not clear whether this was intended to cover all reportable transactions (which include listed transactions), as defined under Treas. Reg. § 1.6011-4(b). *See supra* Section IV.

[10] Summarized by the Joint Committee on Taxation on April 12, 2005. See JCT-19-05R.

> An "accommodation party" is a term generally used to describe a tax-indifferent party's involvement in a transaction that does not necessarily affect the entity's primary function, but is designed to provide tax benefits to a taxable third party. We have seen an increased use of various tax-exempt entities, including charities and other tax-exempt organizations, private and government retirement plans, Indian tribal governments, and municipal governments, to achieve abusive results. . . .
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> We have begun to name accommodation parties as participants in listed transactions (see Notice 2004-30). However, not all potential accommodation parties have a return-filing requirement. Those that do not file returns include churches, small exempt organizations, state and local governments, state and local government retirement plans, and Indian tribal governments. Thus, even where we specifically designate accommodation parties as participants, these entities are not required to disclose their participation in these transactions. [11]

On June 22, 2005, The Panel on the Nonprofit Sector released its final report on Strengthening Transparency Governance Accountability of Charitable Organizations ("Panel Report").[12] The Panel Report states the problem as follows:

> Current tax laws, which require participants in potentially abusive transactions to disclose their involvement, do not make it clear whether exempt entities, particularly those not required to file tax returns, must disclose their participation in the same manner as taxable parties. Further, since involvement by a charitable organization in an abusive tax shelter does not result in an understatement of its tax liability, penalties are generally not imposed on exempt entities for knowingly participating in such transactions. IRS officials and lawmakers have expressed concern that a growing number of charities might be caught up unknowingly in these schemes.[13]

The Panel Report cautions however that:

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[11] Written Statement of Mark W. Everson, Commissioner of Internal Revenue before the Committee on Finance, United States Senate Hearings on Exempt Organizations: Enforcement Problems, Accomplishments, and Future Director, April 5, 2005. IRS Commissioner Everson estimates that of the 31 categories of listed transactions, nearly half may involve tax-indifferent parties either as accommodation parties or as active participants.

[12] 2005 TNT 122-50 [Part 1 of 2]

[13] *Id.*

> Abusive tax shelter transactions can be quite complex, requiring sophisticated legal or financial counsel to understand whether such a transaction has been "listed" by the IRS or otherwise is subject to current reporting requirements. Many charities have neither the internal expertise nor access to professional assistance needed to properly evaluate proposed transactions. It is imperative that the IRS and the charitable sector work together to help charities identify listed and other reportable transactions, understand their reporting obligations, and avoid becoming unwitting partners in abusive tax shelters. Such an effort will require resources to ensure that organizations have the opportunity to learn about these practices and how to avoid them.[14]

On November 18, 2005, the Senate passed proposed legislation which would subject certain tax-exempt entities to penalties for being a party to a prohibited tax shelter transaction.[15] The Senate provision only penalized entities that knowingly participated in a prohibited tax shelter transaction.

In sum, prior to the enactment of TIPRA, the IRS, Congress and the not-for-profit sector expressed real concern about the involvement of tax exempts in tax shelters. The concern was three-fold: First, tax exempts should be penalized for acting as accommodation parties (in effect, selling the benefits of their tax exemption) or active participants in such transactions.[16] Second, tax exempts that are parties to tax shelters should have disclosure obligations, even if they are not otherwise obligated to file returns.[17] Finally, penalties on tax exempts that participate in abusive tax-shelter transactions need to be crafted based on a standard other than understatement of tax.[18]

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[14] *Id.*

[15] The Tax Relief Act of 2005, S.2020, 108th Cong. § 4965 (2005).

[16] *See, e.g.*, Commissioner Everson April 5, 2005 testimony, *supra* note 11. The accommodation party aspect of this legislation survives in the title to the TIPRA provision.

[17] *Id.*

[18] *See*, the Panel Report, *supra* note 12.

IV. Other Tax Shelter Provisions Applicable to Tax Exempts

Present law provides that a taxpayer, including a tax-exempt entity, that participates in a reportable transaction and that is required to file a tax return (including IRS Forms 990 and 990T), must attach to its return a disclosure statement in the form (IRS Form 8886) prescribed in the regulations.[19] A taxpayer has participated in a reportable transaction if the taxpayer's tax return reflects tax benefits or tax consequences of the transaction or a tax strategy described in the published guidance that lists the transaction.[20] A penalty is imposed on any person who fails to include on any return or statement any required information with respect to a reportable transaction.[21] The penalty applies without regard to whether the transaction ultimately results in an understatement of tax, and applies in addition to any other penalty that may be imposed.

Reportable transactions currently include listed transactions and four other categories of transactions: (1) confidential transactions; (2) transactions with contractual protection; (3) loss transactions; and (4) transactions involving a brief asset holding period.[22] The legislative history to Section 4965 notes that the fact that a transaction is a reportable transaction does not affect the legal determination of whether the taxpayer's treatment of the transaction is proper[23] and that existing law authorizes the IRS to define a reportable transaction

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[19] Treas. Reg. § 1.6011-4(a).

[20] Treas. Reg. § 1.6011-4(c)(3).

[21] Section 6707A.

[22] Treas. Reg. § 1.6011-4(b). In Notice 2006-6 (2006-5 I.R.B. 385), the IRS removed transactions with a significant book-tax difference from the categories of reportable transactions.

[23] Treas. Reg. § 1.6011-4(a).

on the basis of such transaction being of a type which the IRS determines as having a potential for tax avoidance or evasion.[24]

In crafting guidance on the new TIPRA provisions, Treasury should be mindful that all of the pre-TIPRA anti-tax shelter provisions remain in effect and generally apply to tax-exempt entities. It would be inappropriate for Treasury to use its regulatory authority expansively to impose onerous penalties on a tax exempt or its managers in a situation where the tax exempt is an indirect participant in the transaction and is not acting directly or indirectly as an accommodation party or active participant, but rather is similarly situated to taxable parties and where the tax exempt gets no particular benefit from participation in the tax shelter. However, it is clear that Congress was concerned that current law did not cast a broad enough net to capture abusive transactions entered into by tax exempts because of their tax-exempt status and the fact they either do not file tax returns or, because of their tax exemption, their tax returns do not reflect any tax benefits of the abusive transactions.[25]

V. Concerns Over an Overly Broad Interpretation

Many observers have criticized the new law as overbroad. As first proposed in Congress, the provision was aimed at tax-shelter transactions that a tax-exempt entity knowingly entered into. However, as enacted, the provisions apparently apply to most tax shelter-type transactions that the IRS has deemed to be *potentially* abusive, whether or not the tax exempt knew (or had reason to know) that the transaction was within the scope of the statute, and

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[24] Section 6707A(c)(1).

[25] *But see* Notice 2004-30 (concerning S corporation which requires the tax-exempt party to the transaction to be treated as a "participant" for purposes of Section 6011).

without regard to whether the transaction generates any tax or other benefits to the tax-exempt participant or involves the tax-exempt entity acting as an accommodation party.

The ABA Section on Taxation noted that the new excise taxes penalize "many common and legitimate transactions that exempt organizations engage in," placing unnecessary restrictions on the investment options available to exempt organizations.[26] It also pointed out that while taxable entities and individuals merely need to disclose their participation in such transactions, exempt entities effectively are barred from participation altogether if they wish to avoid significant excise taxes and penalties. Finally, there is no safe harbor for avoiding the no-fault excise tax, considerably raising the stakes for a correct determination that a transaction is not "substantially similar" to a listed transaction.

Many tax-exempt organizations invest through funds and pools, organized in myriad legal structures, in order to have access to the expertise of investment professionals who manage such pools, to diversify their holdings, to benefit from scale or to own part of a high quality investment that might be too large for a tax-exempt entity to acquire directly in its entirety. Large tax-exempt entities with long-term investment goals (*e.g.*, retirement plans, university endowments and private foundations) often consider it prudent to allocate some portion of their total portfolio to hedge funds and other vehicles that employ sophisticated high-risk/high-return investment strategies. Frequently, funds in which tax exempts invest hold interests in other funds, or the tax exempts participate in "fund of funds" vehicles. The top-tier fund does not control these lower-tier funds' activities and ordinarily would not know if they had an indirect relationship to a prohibited tax shelter. The tax-exempt investors typically participate

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[26] ABA Section of Taxation Comments on S.2020, February 3, 2006 (2006 TNT 24-51) (the "ABA Report").

in these funds on the same terms and conditions as taxable investors. Money from tax-exempt organizations typically constitutes only a small portion of a large pool managed according to a prescribed investment policy and strategy by a private banker or investment advisor. Often the investment advisor or manager does not know the identity of all the ultimate investors. In these cases, tax-exempt status affords neither the fund nor other investors any tax-benefit.

Where a tax-exempt organization's participation in an indirect investment provides no benefit to other investors, and is done on the same basis with the same returns as provided to taxable investors, the new penalties and disclosure requirements should not apply.

An expansive reading of the new law could inappropriately chill the routine investment activities of tax exempts to the detriment of the public, future retirees and others. An example of the concerns of tax exempts in this area is illustrated by Notice 2002-35,[27] which describes an abusive transaction involving notional principal contracts, also known as swaps. This transaction does not involve a tax exempt acting as an accommodation party. Tax exempts (and all other investors) in certain hedge funds were surprised to see, with their K-1s, a tax shelter notice, (*i.e.*, IRS Form 8886) prepared by the fund's accounting firm stating that a lower-tier fund the hedge fund invested in engaged in a series of swap transactions which could be viewed as substantially similar to the listed transaction, but which were entered into to make money. (The fund, through multiple uses of the strategy, was on both sides of the transaction, negating any potential deferral benefit.) Accordingly, the tax-exempt investors (and all other investors) in the fund were advised to file a tax-shelter notice with their tax return. In early 2006, the IRS issued Notice 2006-16[28] narrowing the scope of Notice 2002-35 in a way that

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[27] 2002-1 C.B. 992.

[28] 2006-9 I.R.B. 538.

made the swap transaction engaged in by the hedge fund not a reportable transaction (albeit several years after the tax year at issue). We believe that had Section 4965 been in effect at the time, it would have been wholly inappropriate to consider a tax-exempt investor in the hedge fund to be a "party" to the swap transaction for purposes of Section 4965, even though it could be viewed as a participant for purposes of Section 6011.

VI. Guidance is Needed

Notice 2006-65 requests comments on the interpretation of Section 4965 and related provisions. Clearly, Congress, through the statutory language, has cast a wider net than just penalizing transactions where a tax exempt knowingly acts as an accommodation party or as an active participant. Nonetheless, we 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 (including as facilitators – *e.g.*, lenders) in transactions which 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 goal for published guidance is not an easy one to achieve. The statute as written needs to be given effect in a manner that appropriately punishes those tax exempts and managers for the behavior that Congress finds inappropriate, while not impacting routine investment decisions of tax exempts. We think this goal can be achieved.

The statute should be interpreted consistently with the three problems Congress was trying to address: (1) the absence of meaningful sanctions under pre-TIRPA law for exempts acting as accommodation parties or active participants in tax shelter transactions; (2) the

need to have meaningful penalties in situations where, because of tax exemptions, penalties based on net income have little impact; and (3) a desire to have disclosure of participation by tax exempts in tax shelters for those tax exempts that otherwise do not file tax or information returns.

In crafting guidance, Treasury and the IRS should be cognizant that the vast majority of tax exempts are extremely concerned about their reputation and are institutionally conservative and cautious. Most tax exempts would rather forego a totally legitimate investment than risk exposing themselves to the opprobrium and embarrassment of being identified as a party to a prohibited tax shelter transaction.

Specific issues where we believe guidance is needed include:

A. When is a tax-exempt entity a "party" to a prohibited tax shelter transaction?

B. To avoid prohibited tax shelter transaction status, does an issuer's disclosure about a transaction need any particular reference to the fact it is not confidential?

C. Are all transactions with contractual protections prohibited tax shelter transactions?

D. Will there be any effective date relief? When does the new excise tax begin to apply to a subsequently listed transaction?

E. What is the meaning of "proceeds"?

F. Is there any ability to waive penalties?

VII. Discussion

A. "Party" to a Prohibited Tax Shelter Transaction.

1. Overview of the Issue and Legislative History

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, in which the tax-exempt entity enters into the transaction on its own behalf,[29] and indirect involvement in a prohibited tax shelter transaction through an investment in another entity. The distinction sought here is between those transactions in which the tax-exempt entity has a real role (either directly or through one or more entities formed for the purpose of engaging in the transaction) as opposed to mere investments in other entities that are intended to engage in transactions other than tax shelters.

The Conference Report provides:

> In general, the conferees intend that in determining whether a tax-exempt entity is a "party" to a prohibited tax shelter transaction all the facts and circumstances should be taken into account. Absence of a written agreement is not determinative. Certain indirect involvement in a prohibited tax shelter transaction would not result in an entity being considered a party to the transaction. For example, investment by a tax-exempt entity in a mutual fund that in turn invests in or participates in a prohibited tax shelter transaction does not, in general, make the tax-exempt entity a party to such transaction, absent facts or circumstances that indicate that the purpose of the tax-exempt entity's investment in the mutual fund was specifically to participate in such a transaction. However, whether a tax-exempt entity is a party to such a transaction will be informed by whether the entity or entity manager knew or had reason to know that an investment of the entity would be used in a prohibited tax shelter transaction. Presence of such knowledge or reason to know may indicate that the purpose of the investment was to participate in the prohibited tax shelter transaction and that the tax-exempt entity is a party to such transaction.[30]

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[29] Such direct participation should include either entities controlled by the tax exempt or majority-owned entities formed for the purpose of engaging in the transaction.

[30] Conference Report, *supra* note 4, at 113.

We believe that Section 4965 can and should be interpreted using two steps. The first threshold determination to be made is whether an exempt organization is directly a party to a prohibited tax shelter transaction (including through an entity controlled by the exempt or a majority-owned entity). In such case, the statute clearly applies and relief should be limited. Second, in cases involving investments by tax exempts in entities (other than, e.g., controlled entities) where the tax-exempt entity is not directly a party to the tax-shelter transaction, as described below, Treasury should use its regulatory authority to provide that a tax-exempt entity will not be a party to the transaction if certain safe harbor conditions are satisfied.[31]

2. Direct Party to the Transaction

Section 4965(a)(1)(A) provides that "[i]f a transaction is a prohibited tax shelter transaction at the time any tax-exempt entity . . . becomes a party to the transaction, such entity shall pay a tax . . . ." Party implies that there is a counterparty. The statute supports the conclusion that the transactions Congress is most concerned about are those where a tax exempt

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[31] Support for treating the investment vehicle, rather than the tax-exempt investor, as the party to the transaction can be found in *Elkins v. Commissioner*, 81 T.C. 669 (1983). In *Elkins*, on October 27 or 28th, 1976, a partnership entered into a sublease agreement for coal properties under which it had to pay a production royalty. Under the regulations in effect at the time, the royalties were deductible as they accrued. On October 29, 1976, the IRS announced proposed regulations that would defer the deduction until the coal is sold. The proposed regulations grandfathered any lease "binding prior to [October 29] upon THE PARTY who in fact pays or accrues such royalties" *Elkins*, 81 T.C. at 675 (citing Prop. Treas. Reg. § 1.612-3(b)(3) (emphasis added). At the at the end of November 1976, Elkins purchased an interest in the partnership.

The final regulations (issued in December 1977) provided: "In the case of advanced royalties paid or accrued by a partnership the 'party' who, under the preceding paragraph, must be obligated prior to October 29, 1976, with respect to the payment of the advanced royalties is the partner, not the partnership." T.D. 7523, 1978-1 C.B. 193-94. In other words, the final regulations took the position that the "party" to the lease was the partner. Because Elkins bought his interest in the partnership after October 29, 1976, the IRS sought to deny him a current deduction for his share of the royalty payments. Elkins argued that "the partnership rather than the partner must be considered 'the party who in fact pays or accrues such royalties.'" *Elkins*, 81 T.C. at 676-77. The court agreed. It held that the partnership was indeed the "party" that was entitled to be grandfathered. The same reasoning could be used to argue that a tax-exempt investor in a partnership or other investment vehicle should not be treated as a "party" to a prohibited tax shelter transaction, absent facts or circumstances that indicate that the purpose of the tax-exempt entity's involvement was specifically to participate in the transaction.

affirmatively and directly enters into a tax-shelter transaction; that is, two-party transactions between a tax exempt and a taxable person.[32]

All of the examples cited in the hearings and commentary leading up to the enactment of Section 4965 entail direct involvement of an exempt organization in a transaction being deemed abusive.[33] For example, Notice 2004-30 involved an exempt purportedly becoming an S corporation shareholder to absorb taxable income for the benefit of the taxable owners of the S corporation. Notice 2003-81 involved a charity that was the recipient of a purported charitable donation of offsetting foreign currency puts and calls.[34] Notice 2004-41 involved a conservation organization that purchased property, placed a conservation easement on such property and sold the property to a taxable person for a fraction of its cost and received a purported charitable contribution equal to the difference between the charity's purchase price and sales price for the property.[35] A tax-exempt (or foreign) party is critical to SILO and LICO transactions. Step-down preferred requires a tax-exempt holder to absorb income characterized as a dividend but economically a return of capital.

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[32] *See* amended Section 6011(g), which requires the "taxable party to a prohibited tax shelter transaction" to "disclose to any tax exempt entity . . . which is a party to such transaction that such transaction is such a prohibited tax shelter transaction."

[33] Commissioner Everson's testimony indicates that he was concerned not only with the situations where a tax exempt was serving as an accommodation party, but also with situations where the tax exempt was an "active participant." As noted above, he specifically observed that, "[o]f the 31 categories of listed transactions, nearly half may involve tax indifferent parties either as accommodation parties or as active participants." April 5, 2005 Testimony, *supra* note 11. It is not clear what Everson means by "active participant." An example of a situation where the tax exempt is an active participant but not necessarily an accommodation party is the conservation easement transaction described in Notice 2004-41. 2004-9 I.R.B. 526. *See* the Appendix.

[34] 2003-2 C.B. 1223.

[35] 2004-2 C.B. 31.

Situations where the tax exempt is directly a party to the prohibited tax shelter transaction are the easiest and most natural fits for the statutory prohibition.[36] We believe that direct participation should be expanded to include participation through a controlled or majority-owned entity that is itself not taxable (typically by reason of being a disregarded entity, partnership or other flow-through entity). Participation through a domestic corporation (which is taxable) should not cause the tax-exempt owner to be treated as a party to the transaction, even if the corporation is controlled or majority-owned by the tax exempt. Investments through taxable corporations do not implicate any of the policies Congress is attempting to discourage involving the abuse of tax-exempt status.

The Tax Section does believe that, assuming Section 4965 applies by its terms to tax exempts that are direct parties to any prohibited tax shelter transaction, in appropriate situations, relief from penalties should be considered, as discussed in Section VIIE.

3. Indirect Investments

a. Overview

Indirect participation by a tax exempt in a prohibited tax shelter transaction raises entirely different policy concerns and issues than direct investment. Clearly, certain indirect investments can and should result in a tax-exempt investor being treated as a party to a

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[36] Despite the breadth of the statute, Treasury and the IRS may want to consider limiting the imposition of penalties under Section 4965, even for direct participation in a tax shelter, if the tax exempt is not acting as an accommodation party or an active participant in the tax shelter and the transaction gives the tax exempt no benefit that a taxable person would not have received. The guidance could accomplish this result by narrowly interpreting "party" to mean an active participant or accommodation party. This guidance could be premised on interpreting the statute consistently with those purposes evidenced by the title of the TIPRA provision, "Tax Involvement of Accommodation Parties in Tax Shelter Transactions." In such case, the Section 6011 disclosure provisions and related penalties should apply, treating the tax exempt the same as a regular taxpayer.

We note that taking a narrow view to the definition of "party" to the transaction is difficult given the words of the statute chosen by Congress. We also note that such a narrow interpretation in effect could be viewed as incorporating an intent test into the statute, which Congress chose not to do.

prohibited tax shelter transaction. Thus, for example, a fund that is created to exploit a strategy where tax exemption is critical and involves a transaction with taxable counterparties should cause a tax-exempt participant to be a party within the meaning of Section 4965. For example, a fund established to invest in step-down preferred should cause its tax-exempt owners each to be treated as a party.

However, routine investments in another entity "in general" (in the words of the Conference Report) should not cause the tax-exempt investor to be treated as a "party" to prohibited tax shelter transactions to which the investment entity directly or indirectly is a party.

An exclusion for most indirect investments would protect a tax-exempt organization and its managers from penalties for inadvertent, unintentional investments in funds or entities that hold, or subsequently invest in, prohibited tax shelter transactions. The Conference Report states that in evaluating indirect transactions, "whether a tax-exempt entity is a party to such a transaction will be informed by whether the entity or the entity manager knew or had reason to know that an investment . . . would be used in a prohibited tax shelter transaction."[37] This language provides a basis for using "knowledge" as a factor in determining whether indirect investments are to be penalized. In addition, the regulations should adopt the position in the Conference Report that an organization is responsible for investigating any transaction that would be unusual or extraordinary for the organization. Seeking advice from tax advisors and reasonable reliance on their opinions would be one way, but not necessarily the only way, to establish that the tax-exempt organization and its managers fulfilled their responsibilities.

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[37] *Supra* note 4, at 113.

b. Indirect Investment in Prohibited Reportable Transactions

The policies underlying treating listed transactions as prohibited tax shelter transactions differ from those originally calling for disclosure of reportable transactions. The ABA Report on the prohibited tax shelter transaction provisions as proposed correctly notes:

> With respect to "reportable transactions" that are confidential transactions or transactions with contractual protection, in contrast to listed transactions, the IRS has made no determination that any such transaction is an abusive tax shelter. Indeed, the proposed legislation misconstrues the role of the reporting requirements related to potential tax shelters. These requirements are intended to provide the IRS with information on a timely basis so that the IRS may subsequently determine which transactions to examine, and from those examined, which transactions to challenge. Moreover, due to the penalties imposed on those who fail to comply with these reporting requirements, taxpayers tend to err on the side of over-reporting. As a result, a large portion of the transactions reported to the IRS may be in compliance with applicable tax laws. We understand, for example, that certain low-income housing transactions (which often involve exempt organization participants) are reported because they could be construed as having contractual protection, notwithstanding that the underlying tax benefits are clearly sanctioned by Congress. Customary agreements by investment managers not to expose exempt organizations to unrelated business income tax could also be construed to involve "contractual protection," and therefore be reportable transactions subject to penalty. There is an insufficient correlation between the enumerated transactions that are reportable or reported, on the one hand, and the presence of an actual abusive tax shelter, on the other hand, to justify the imposition of penalties on tax-exempt entity participants.[38]

We also note that in many situations involving investment funds, tax-exempt entities likely will not even be aware of (or have access to information concerning) confidentiality agreements and other contractual arrangements entered into at the fund level. Accordingly, a tax-exempt entity should be treated as a party to a prohibited reportable transaction only if the tax-exempt entity (or its agent) is an actual signatory to the confidentiality

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[38] ABA Report, *supra* at note 26.

agreement or the agreement giving contractual protection. We recommend that a tax-exempt entity presumptively should not be treated as a party to a prohibited reportable transaction by reason of an investment in an entity (that is not controlled or majority-owned by the tax exempt) that is a party to a prohibited reportable transaction. A tax-exempt entity's investment in an entity would only cause the tax-exempt entity to be a party to a prohibited reportable transaction if the tax-exempt entity invested knowing (or with reason to know) that the entity engages or intends to engage in prohibited reportable transactions.

c. Indirect Investment in Listed Transactions

The more difficult issues arise in the case of indirect participation in a listed transaction through another entity. The issue arises most often in circumstances in which the tax exempt is one among many investors in a partnership or other entity that itself is not a tax shelter vehicle, but engages in one or more transactions that may be viewed as substantially similar to a listed transaction. In most cases, the tax exempt has no control or decision making authority with respect to entering into the prohibited tax shelter and receives no different return than the other investors. Although the same rules, requiring an analysis of all of the facts and circumstances, should apply in the case of indirect as well as direct participation in tax-shelter transactions, we believe it would be appropriate for the regulations to establish a safe harbor. Under this safe harbor, as described below, routine investments by tax-exempt entities would not result in the imposition of penalties under Section 4965 as a result of the investment entity engaging in a prohibited tax shelter. The regulatory exclusion should encompass all types of indirect investments, whether through corporations, partnerships, LLCs, RICs, REITs or trusts.

We believe that such a position is consistent with the intent of the statute. Tax-exempt investors, especially retirement accounts, universities and private foundations,

reflect a major source of capital, some substantial amount of which is earmarked for alternative investments, including private equity, management buyout and hedge funds. To impose a no-fault penalty on investors in funds in which they have no input (and may not know about the tax-shelter transaction until after it is concluded) would only cause these investors to exclude all funds in which there is any risk of a tax-shelter transaction.[39] A likely result could be the withdrawal of substantial capital now available for these types of investments, and we think it is inappropriate to interpret the statue in this manner. Moreover, this result follows guidance in the legislative history that indirect involvement generally would not result in an entity being considered a party to the tax-shelter transaction, absent some evidence that the tax exempt was more than a mere passive investor.[40]

Nevertheless, the safe harbor should be narrowly constructed. The legislative history clearly indicates that if a tax-exempt organization makes an investment, for example, in a mutual fund that, in turn, "invests in" or participates in a prohibited tax shelter transaction and the tax-exempt organization knew or had reason to know that an investment of the mutual fund would be used in a prohibited tax shelter transaction, then the excise tax would apply.[41] The drafters clearly intended that the excise tax could apply to investments.

We believe that the regulations should adopt a safe harbor rule that a tax exempt that makes an investment in an entity will not be considered a party to a prohibited tax shelter transaction engaged in by that entity if all of the following conditions are satisfied:

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[39] We acknowledge that well advised tax exempts already routinely are asking for side letter agreements with funds in which the fund represents that the tax-exempt investor will not be a party to a prohibited tax shelter transaction by reason of an investment in the fund.

[40] Conference Report, *supra* note 4, at 113.

[41] *Id.*

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;[42]

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.

Absent such a safe harbor, the new provision could have a detrimental chilling effect on a tax-exempt entity's ability to invest in many types of investment programs. In the case of the fourth factor, a tax exempt that holds a 20% or less interest (on a look through basis) in the entity that is a direct party to a prohibited tax shelter transaction,[43] and that otherwise satisfies the safe harbor, would be presumed not to know (or have reason to know) that the entity would be participating in prohibited tax shelter transactions. The IRS would have the burden of proof to demonstrate that such a tax exempt knew or had reason to know that the entity would participate in prohibited tax shelter transactions.

In this regard, offering circulars and private placement memoranda often contain securities laws disclosures indicating that it is possible that the fund or entity might hold interests in reportable transactions. A recent example of such a disclosure is:

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[42] Often, an issuer gives tax exempts an opportunity to invest in the same underlying fund either through a partnership (or an entity treated as a partnership) or an offshore corporation, depending on the tax-exempt entity's tolerance for UBIT. For purposes of the proposed safe harbor, in the case of an investment in a corporation that in turn holds an interest in the investment vehicle, the character of the return would be determined at the corporate level.

[43] This 20% figure is one possible bright line percentage and is intended to distinguish between a portfolio investor and an investor with sufficient interest in the entity to have the burden of proof on the knowledge issue.

> *Tax Shelter Reporting*. Persons who participate in or act as material advisors with respect to certain "reportable transactions" must disclose required information concerning the transaction to the IRS. In addition, material advisors must maintain lists that identify such reportable transactions and their participants. Significant penalties apply to taxpayers who fail to disclose a reportable transaction. Although each Fund is not intended to be a vehicle to shelter U.S. federal income tax, and the new regulations provide a number of relevant exceptions, there can be no assurance that a Fund and certain of its Shareholders and material advisors will not, under any circumstance, be subject to these disclosure and list maintenance requirements.

Treasury guidance should expressly state that the presence of such disclosure does not prevent the tax-exempt investor from relying on the proposed safe harbor, so long as the offering documents do not affirmatively indicate that a strategy of the fund is to invest in or finance prohibited tax shelter transactions.

B. Prohibited Reportable Transactions

1. Narrow Interpretation Appropriate

Section 4965(e)(1)(C) defines "prohibited reportable transaction" to mean "any confidential transaction or any transaction with contractual protection (as defined under regulations prescribed by the Secretary) which is a reportable transaction (as defined in Section 6707A(c)(1))." Section 6707A(c)(1) refers to Section 6011. The first parenthetical in Section 4965(e)(1)(C) suggests that Congress intends prohibited reportable transactions to be interpreted more narrowly than would be the case under Section 6707A(c)(1). A narrow, limited interpretation is sensible in light of the onerous nature of the Section 4965 penalties and the required reporting under Section 6011 to which most tax exempts are otherwise subject.[44]

One possible approach would be to require reporting of all prohibited reportable transactions to which a tax exempt is a party (which, per our recommendations above, generally would include only situations in which the tax exempt either is directly a party or is a party through a controlled or majority-owned entity other than a taxable corporation), but to consider waiving penalties in such situations. Waiver of penalties is discussed in Section VIIE below.

2. Confidential Transactions

Regulations issued December 29, 2003, superseded regulations issued earlier in 2003 and significantly narrowed the definition of confidential transaction.[45] The new regulations treat a transaction as reportable by reason of confidentiality provisions only if (a) the taxpayer has paid an advisor a minimum fee *and* (b) such advisor directly or through a related party imposes a limitation on the disclosure of the tax treatment and tax structure of the transaction

[44] As discussed *supra* in Section IV, we note that in some cases, tax exempts may avoid the reach of Treas. Reg. § 1.6011-4(c)(3) because, as tax-exempt entities, their returns often do not reflect any tax benefits or tax consequences of a transaction that otherwise would give rise to a reporting obligation.
[45] T.D. 9108, 2004-1 C.B. 429.

that protects the confidentiality of the advisor's tax strategies.[46] Thus, under the Section 6011 regulations, standard confidentiality provisions among parties to a transaction are no longer covered. Accordingly, confidentiality agreements for the benefit of the parties no longer have to include a waiver of confidentiality with respect to tax treatment and tax structure in order to avoid being subject to the tax reporting requirements applicable to reportable transactions by reason of being treated as a transaction offered under conditions of confidentiality.

It has come to our attention that since enactment of Section 4965, some practitioners are again putting language in disclosure documents expressly stating that the tax aspects of the transaction are not confidential. We consider the reappearance of such "magic language" to be unnecessary. A recent example of such language, in a post-TIPRA limited partnership agreement, is as follows:

> Tax Shelter Disclosure. Notwithstanding anything herein to the contrary, each Limited Partner (and each employee, representative, and other agent of such Limited Partner) may, except to the extent necessary to comply with any applicable United States federal or state securities laws, disclose to any and all Persons, without limitation of any kind, the tax treatment and tax structure of its investment in the Partnership and any transactions entered into by the Partnership and all materials of any kind (including opinions or other tax analyses) that are provided to such Limited Partner or other Person relating to such tax treatment and tax structure. This authorization is not intended to permit disclosure of any other information. . . .

We would welcome an express statement from the IRS and Treasury that the term "confidential transaction," as used in Section 4965, has the identical meaning and interpretation as it does under Reg. § 1.6011-4(b)(3) and that no special language is needed or appropriate to show that a transaction is not confidential.

3. Contractual Protection

[46] Treas. Reg. § 301.6011-4(b)(3).

The ABA Report, as quoted above, notes that certain low-income housing deals and investment management agreements where the investment manager agrees not to expose the tax-exempt client to UBIT are being disclosed under Section 6011 as potentially reportable transactions because of the "contractual protection" being offered.[47] This may or may not be appropriate under the Section 6011 regulations. However, it would not be appropriate to treat such arrangements as offering contractual protection for purposes of Section 4965 and thus as prohibited reportable transactions under the provision. Accordingly, we recommend that guidance be issued to the effect that these types of statements of assurances do not constitute contractual protection under Section 4965.

C. Effective Date Relief; Application to Subsequently Listed Transactions

1. Effective Date Relief

Congress gave the new excise taxes and disclosure rules immediate effect, as is customary with anti-abuse laws. To the extent the statute clearly applies to a situation, the effective date must be respected. However, insofar as 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. The Conference Report clearly contemplates that Treasury will develop interpretative regulations on such topics as indirect participation in a tax-shelter transaction, not all of whose content can be derived from the statutory language. Such interpretive regulations should apply prospectively only after the issuance of final regulations.

2. Subsequently Listed Transactions.

[47] See ABA Report, *supra* note 26.

Section 4965(b)(1)(A) provides that the penalties, in the case of a subsequently listed transaction, are based on the net income or proceeds which are "attributable to such transactions" and which are "properly allocable to the period beginning on the later of the date such transaction is identified by guidance as a listed transaction by the Secretary or the first day of the taxable year." Although the statutory language is awkwardly drafted, the tax presumably begins to apply when the transaction is listed. [48]

For example, assume that a calendar year, tax-exempt entity becomes a party to a transaction in 2006 and the IRS lists the transaction July 1, 2007. For the 2006 tax year, the "later of" date is the later of January 1, 2006 and July 1, 2007, so there is no tax for 2006. For 2007, the "later of" date is the later of January 1, 2007 and July 1, 2007, so the tax applies beginning on July 1, 2007. For 2008, the "later of" date is the later of January 1, 2008 and July 1, 2007, so the tax begins on January 1, 2008. In effect, this means the tax begins to apply on the date the transaction becomes listed.

Assuming the statute is interpreted to impose penalties starting when a transaction is listed, and in light of the harshness of the statute, 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.[49] Such relief might be implemented by a special effective date provision in the notice listing the transaction, stating that, for Section 4965 purposes, the listing is effective 90

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[48] The "later of" phraseology – and, in fact, the whole conjunctive form of the provision –is mere surplusage.

[49] The 90-day period is intended to allow sufficient time for the tax exempt to learn that a transaction it is a party to has become listed and to take appropriate steps to exit the transaction. Note that Section 612 of the Pension Protection Act of 2006 provides an exemption from certain prohibited transaction excise taxes imposed under Section 4975 if the transaction is corrected within 14 days after the fiduciary discovers, or should have discovered, that the transaction is a prohibited transaction.

days after publication of the notice. Relief might be conditioned on the tax-exempt entity appropriately disclosing its participation in such transaction, possibly on Form 8886.

D. Meaning of Proceeds

If a tax-exempt organization is a party to a prohibited tax shelter transaction, Section 4965(b)(1) imposes a penalty excise tax on the organization measured, in the alternative, by the tax-exempt entity's "net income . . . for such taxable year which . . . is attributable to such transaction" or "the proceeds received by the entity for the taxable year which . . . are attributable to such transaction . . . ." Guidance is needed on the meaning of "proceeds" attributable to a prohibited tax shelter transaction. Neither the statute nor the legislative history give any further clarification or examples of what is intended in this context.

We believe the IRS and Treasury have significant latitude in defining "proceeds." There is no indication in the statute or legislative history that Congress intends Section 4965 to be confiscatory. Rather, the history to the statute indicates a desire to have a meaningful penalty in situations where the tax exempt has little or no net income from the transaction. Based on the structure of the statute, a reasonable definition of proceeds would be total or gross receipts, reduced by any return of investment/basis, but without any deduction of related expenses or taxes.[50] We acknowledge that regulations and authorities in other areas of the law would not allow an offset for investment, but find the policies underlying Section 4965 best served by a narrower definition of proceeds.[51]

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[50] A pocket Webster's defines "proceeds" as "the profits from a business or fund-rising venture." The regulations under 6045 (information reporting) generally refer to *gross* proceeds as "the total amount paid to the customer or credited to the customer's account . . ." or "the total cash received or to be received . . . in connection with the . . . transaction." *See, e.g.*, Treas. Reg. §§ 1.6045-1(d)(5), 1.6045-4(i). Section 4965 refers to "proceeds," not gross proceeds.

[51] A narrow definition of proceeds would avoid treating a tax exempt that makes an investment in a prohibited tax shelter transaction (and receives back its investment plus something in addition)

It can be argued that the phrase "attributable to such transaction" means that proceeds should reflect amounts generated by the transaction, and that any return of the organization's investment (basis, that was used in or allocated to the transaction), should be excluded from "proceeds" because a return of the investment is not attributable to (*i.e.*, generated by) the transaction. This definition of proceeds would encompass fees, if any, plus other payments or distributions attributable to the tax-shelter transaction.[52]

An analysis of how "proceeds" as defined above, might apply to the listed transactions described in the Appendix is instructive. We recommend that implementing guidance contain specific examples of what constitutes proceeds in particular types of prohibited tax shelter transactions and that regulations allow the IRS to issue revenue rulings or other guidance on the meaning of proceeds in newly listed transactions.

1. Conservation Easement Shelter

Presumably Congress used the word "proceeds" to address the conservation easement transaction described in Notice 2004-41,[53] which Commissioner Everson specifically mentioned in his testimony. Even if the drafters had this transaction in mind, it is not clear what is intended by the term "proceeds."

Assume Charity buys Blackacre for $1,000 (knowing that if it does not buy the property, a developer will). Charity puts an easement on Blackacre worth $400 and sells the property to donor for $600. Donor then makes a "gift" to Charity of $400. Clearly the proceeds are not zero (the difference between the $1,000 total received and the land cost of $1,000).

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disproportionately more harshly than a tax exempt that makes no investment but receives a fee for acting as an accommodation party.

[52] We do acknowledge that "proceeds" is not necessarily the term that would be used if Congress intended to limit the excise tax to "fees" and similar amounts paid to an accommodation party.

[53] See Appendix (discussing Notice 2004-41 further).

Congress was concerned that if the tax was limited to the tax-exempt organization's "spread" from these types of transactions, then there would not be sufficient disincentive for tax exempts to engage in them. The amount involved, if it were an act of self-dealing, would be either the $600 stated amount of the sales price or the $1,000 sales price as recharacterized in Notice 2004-41.[54] We believe in this situation, the proceeds are the $400 easement; *i.e.*, the property Charity ends up with after the dust has settled (it spent $1,000 purchasing the property and received $1,000 - - $600 for selling the property plus a $400 contribution; it ends up with the easement).

2. The Foreign Currency Transaction

In this transaction, the charity receives offsetting put and call agreements on foreign currencies, purportedly allowing the taxpayer to claim an artificial loss. Here, the proceeds should be the full amount the tax exempt receives on closing out the contracts (which may be very small, given the offsetting nature of the put and call).

3. The Reinsurance Arrangement

In the Reinsurance Arrangement, the taxpayer shifts income, that otherwise would be taxable income for the taxpayer, to a subsidiary that is exempt as an insurance company under Section 501(c)(15). In this transaction, the taxpayer remits insurance payments it receives (as an insurance agent) from its customers to an unrelated insurance company, which in turn forwards a portion of the premiums back to the taxpayer's exempt subsidiary as reinsurance payments. The reinsurance payments would have been taxable if paid directly to the taxpayer. The proceeds should be the reinsurance premiums that the Section 501(c)(15) subsidiary receives. This is the

[54] We gave consideration to whether the concept of "proceeds" is similar to the concept of the "amount involved" for purposes of section 4958 and 4941. This would seem to address concerns of the government that charities be vigilant about not participating in these transactions. We think the use of a self-dealing or excess-benefit transaction analogy is of limited benefit.

amount that the exempt entity actually receives as a result of the transaction, as well as the amount of income that is improperly shielded from taxation.

4. The S Corporation Transaction

It is not clear what the "proceeds" should be in the S corporation transaction. Is it the purported value of the S corporation stock at the time contributed? No, as this stock actually has very little value. Is it the amount of S corporation income shifted to the tax exempt (even though the tax exempt did not receive any related distributions)? Once again, no, as the tax exempt did not end up with any economic value by reason of such allocations.[55] Looking again at what the tax exempt was left with when the dust settled, "proceeds" should be the amount received when the tax exempt sells the S stock back to the S corporation or its shareholders.

[55] Query whether the excise tax based on net income should apply based on the amount of taxable income allocated to the exempt entity by the S corporation?

5. Step-down Preferred

Here, the proceeds should be the amount of dividends received by the exempt on its step-down preferred.

6. LILO/SILO Transaction

As with the foreign currency transaction, in the lease-in lease-out ("LILO") and the sale-in lease-out ("SILO") transactions there are a number of different obligations that offset one another. Rev. Rul. 2002-69[56] indicates that in a typical LILO transaction, the tax indifferent party keeps the "remaining portion" of the headlease as its "return on the transaction." (The "remaining portion" is the portion left after the tax indifferent party makes its rental payments under the sublease and invests a required portion in highly-rated debt securities that should mature in an amount sufficient to fund the fixed amount due under the fixed-payment option.

Notice 2005-13 gives two examples of SILOs. In one of the examples, the Notice states that the tax indifferent party intends to utilize only a small portion of the "proceeds" (*i.e.*, the amount received by the tax indifferent party in the sale portion of the sale-in lease-out transaction) of the purported sale-leaseback for operational expenses or to finance or refinance the acquisition of new assets. On the one hand, this could mean that "proceeds" means the entire purchase price amount not offset by the purported rental payments constituting the lease-out portion of the sale-in lease-out transaction. However, the more appropriate interpretation in the Section 4965 context is that proceeds means the amount the tax exempt receives after the offsetting payments are made, namely that "small portion" it is left with that it does use for operational and similar expenses, and that is not paid back pursuant to its rent obligations.

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[56] 2002-2 C.B. 760.

E. Ability to Waive Penalties

A strong case can be made for not enforcing the full breadth of the statute against innocent or unsophisticated tax exempts. First, there are constitutional issues at its margins (excise taxes imposed on state and local governments,[57] confiscatory excise taxes for transactions that later are determined to be legal, etc.). Second, as the past history of inurement indicates, extreme penalties (*e.g.*, loss of exempt status) are bad tax policy and courts strain to avoid penalties that are disproportionate to the crime. Third, full enforcement encourages basically good tax exempts that inadvertently find themselves in tax shelters to avoid detection rather than disclose. The possibility of amnesty would encourage full disclosure and blunt these deficiencies in the statute.

We believe that the IRS 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 IRS will take into account voluntary disclosure as a relevant factor. Given the potentially confiscatory nature of the section (especially if a broad definition of proceeds is adopted), a regulation of this type will 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.

The regulations should provide availability for relief from the penalties in several situations. As discussed above (Section VIIB of this Report), an appropriate candidate for

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[57] *See* the Government Finance Officers Association comments on Section 4965 in which it contends that Section 4965 is written so broadly that "it opens the door for direct taxation of state and local governments with no specific congressional approval and no judicial review." Doc. 2006-14460, 2006 TNT 148-23.

potential penalty relief would be prohibited reportable transactions that the tax exempt appropriately discloses.

Further, relief potentially should be available in situations where the tax exempt exercised reasonable care in analyzing whether the transaction was a prohibited tax shelter. We believe such a rule should apply only in circumstances in which the tax exempt received a return which is no different than the return received by taxable investors and the tax exempt sought advice with respect to the transaction. Such advice would need to be in writing and would need to address all of the facts and issues presented by the transaction.[58] It may be appropriate to condition penalty relief on the timely filing of disclosure statements.[59]

In addition, penalty relief should be available in situations where the IRS either delists a transaction or subsequently narrows the scope of a listed transaction in a manner that makes a transaction that was "substantially similar" to a listed transaction no longer a prohibited tax shelter transaction.[60] Such relief also should apply where the courts reject the IRS's position regarding a listed transaction.

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[58] We believe such a high standard is required given the no fault nature of the penalty. In addition, it may also be appropriate to condition relief on the tax-exempt ceasing to participate in the transaction after it has been determined to be a prohibited tax shelter.

[59] It also may be appropriate to condition penalty relief on the tax exempt having unwound, rescinded or otherwise having corrected the transaction upon learning that it was a prohibited tax shelter transaction. *See* note 49, *supra*.

[60] *See* Notice 2006-16 narrowing the scope of Notice 2002-35 (concerning certain notional principal contracts).

Appendix A

Description of Certain Tax Shelters Involving Exempts

The listed transactions involving tax-exempt accommodation parties are not run-of-the-mill transactions but rather unusual structures that seek to exploit the entities' tax-exempt status. Examples of such transactions are described below.

The Foreign Currency Transaction[61]

The foreign currency transaction involves the assignment of offsetting foreign currency options to a charity in order to claim substantial artificial losses. In the transaction, a taxpayer (the "Taxpayer") pays a premium to purchase a call option and a put option on a foreign currency (the "Purchased Option" or "Purchased Options"). The Purchased Options are traded on a regulated futures exchange and thus subject to the mark-to-market rules contained in Section 1256, which requires the Taxpayer to recognize the inherent gain or loss at the time of any assignment of a currency contract traded on a regulated futures exchange. The Taxpayer also receives premiums for writing a call option and a put option (the "Written Option" or "Written Options") on a different foreign currency. The Written Options are not subject to Section 1256. Based on historical data, the Taxpayer reasonably expects to have (i) a loss in a Purchased Option and a gain in a Written Option and (ii) a gain in a Purchased Option and a loss in a Written Option. Before the close of the calendar year, the Taxpayer assigns the Purchased Option that had a loss and the offsetting Written Option that had a gain to a charity. This structure allows the Taxpayer to recognize the loss on the assigned Purchased Option, a Section

[61] Notice 2003-81.

1256 contract, without recognizing the corresponding gain on the assigned Written Option, which is a non-Section 1256 Contract.

The S Corporation Transaction[62]

The S corporation transaction is structured to shift taxation away from taxable S corporation shareholders to a tax-exempt entity, for the purpose of deferring or avoiding taxes. The transaction is initiated by a *pro rata* distribution by the S corporation to each of its shareholders of nonvoting stock and warrants that are exercisable into nonvoting stock. Then, the S corporation shareholders purport to donate the nonvoting stock to the tax-exempt organization (presumably, an entity fully exempt from tax such as a municipality or an entity with UBIT net operating losses). Although the S corporation shareholders effectively retain the economic benefits associated with ownership, either through stock options or repurchase rights, they transfer approximately 90% of the outstanding shares of S corporation stock to the tax-exempt entity. By doing so, they shift the pass-through of 90% of the S corporation's taxable income from the original shareholders to the tax-exempt organization, for purposes of deferring or avoiding taxes. The S corporation shareholders retain voting control and thus control over the timing of the corporate distributions. During the period that the tax-exempt organization holds the S corporation shares, the S corporation distributes little or none of its profits. Eventually, the original shareholders exercise the warrants and dilute the shares of nonvoting stock held by the tax-exempt entity, or the S corporation or the original shareholders repurchase the nonvoting stock at a value that is substantially reduced as a result of the warrants' existence. Thus the S corporation shareholders manage to defer tax on profits, while retaining control and substantially all the economic value of the S corporation.

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[62] Notice 2004-30.

The Reinsurance Arrangement[63]

The reinsurance arrangement is used by a taxpayer such as an automobile dealer (the "Taxpayer") who offers customers the opportunity to purchase an insurance contract through the Taxpayer in connection with the products or services being sold. The Taxpayer offers insurance to its customers by acting as an insurance agent for an unrelated insurance company ("Company X"). The Taxpayer also forms a wholly owned corporation ("Company Y") to reinsure the policies sold by the Taxpayer and takes the position that Company Y is tax exempt under 501(c)(15). The Taxpayer remits the payments it receives from its customers to Company X. Company X pays any claims and state premium taxes due and then keeps a portion of the premium amount for itself. Under Company Y's reinsurance agreement with Company X, Company X subsequently transfers the remainder of the premiums to Company Y as reinsurance premiums. The end result is that income that is properly attributable to the Taxpayer is shifted to Company Y, Taxpayer's wholly-owned reinsurance company, which is subject to little or no federal income tax.

In 2004 Congress amended the definition of "insurance company" under Section 501(c)(15) so as to address the misuse of 501(c)(15) exempt organizations.[64] In part because the IRS perceived that the amendments would curtail the abusive use of reinsurance arrangements, the IRS released Notice 2004-65 stating that reinsurance arrangements would no longer be identified as listed transactions.[65]

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[63] Notice 2004-65, 2004-41 I.R.B. 599; Notice 2002-70, 2002-2 C.B. 765.

[64] Committee Report for JCX-12-04, HR 3108.

[65] *See also* Notice 2004-41; Committee Report for JCX-12-04, HR 3108; Notice 2003-35, 2003-1 I.R.B. 992; Notice 2006-42, 2006-19 I.R.B 878.

The Conservation Easement[66]

In the transaction described in Notice 2004-41, a tax-exempt organization purchases property and places a conservation easement on it. Then the charitable organization sells the property, subject to the easement, to a buyer for a price substantially less than the price paid for the property. In addition, the buyer makes a second payment, designated as a "charitable contribution." The sales price plus the contribution reimburses the charitable organization for the cost of the property. (Apparently, the tax-exempt organization receives no fees, but ends up holding a conservation easement on land that otherwise would not have one.) In Notice 2004-41 the IRS announced that in appropriate cases, it would treat the total of the Taxpayer's payments to the charitable organization as purchase price paid by the buyer for the property, with no part being treated as a charitable contribution.

The LILO/SILO Transactions[67]

In the LILO Transaction and SILO Transaction, a taxpayer (the "Taxpayer") enters into a lease-in lease-out transaction or an alleged sale-leaseback transaction, respectively, for the purpose of benefiting from rental expense deductions and certain other deductions. For example, in the LILO Transaction, a tax-indifferent party purports to lease property to Taxpayer (the "Headlease"), who immediately leases the property back to the tax-indifferent party through a sublease (the "Sublease"). Under the Headlease, a portion of the rental payments by the Taxpayer to the tax-exempt entity must be prepaid (the "Prepayment"). The Taxpayer claims the rental expense deductions at the time of the Prepayment. Typically a foreign bank or foreign branch of a domestic bank makes a nonrecourse loan to the Taxpayer, which is used to fund the

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[66] Notice 2004-41.

Prepayment. In addition to the rental deductions, the Taxpayer claims interest expense deductions relating to the nonrecourse loan.

Step-Down Preferred/Fast Pay Stock[68]

The Step-Down Preferred Transactions are multiple-party financing transactions that use conduit entities to allocate income to tax-exempt participants. A corporate sponsor (the "Taxpayer") forms a conduit entity (the "Company"), often a REIT or a RIC, that issues two classes of stock, common stock and so called "fast-pay preferred stock." The Taxpayer holds substantially all of the common stock while the tax-exempt participant holds the fast-pay preferred stock. The fast-pay self-amortizing preferred stock has limited voting rights and provides for preferred dividends to be paid for a fixed period, such as ten years. At the end of the fixed period, substantially all of the residual value of the Company shifts to its common stock, with the result that the Company realizes an economic benefit without incurring tax liability for it. If the principal asset of the Company is a debt instrument, by treating the payments on the fast-pay preferred stock as dividends, the Company is able to take deductions without recognizing the corresponding income.

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[67] Notice 2005-13, Notice 97-21, 1997-1 C.B. 407.

[68] *See* T.D. 8853, 2000-4 I.R.B. 377; Treas. Reg. § 301.7701(1)-3.