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February 5, 2007

Hon. Mark. W. Everson  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, DC 20224

Re: Comments Concerning Section 4965 of the Internal Revenue Code of 1986

Dear Commissioner Everson:

Enclosed are comments concerning section 4965 of the Internal Revenue Code of 1986. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Susan P. Serota  
Chair, Section of Taxation

Enclosure

- cc: Donald L. Korb, Chief Counsel, Internal Revenue Service
- Eric Solomon, Assistant Secretary (Tax Policy), Treasury Department
- Michael J. Desmond, Tax Legislative Counsel, Treasury Department
- W. Thomas Reeder, Benefits Tax Counsel, Treasury Department
- Eric San Juan, Deputy Tax Legislative Counsel- Legislative Affairs, Treasury Department
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- Lois G. Lerner, Director (Exempt Organizations), Internal Revenue Service

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**COMMENTS CONCERNING  
SECTION 4965 OF THE INTERNAL REVENUE CODE OF 1986**

The following comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, the Comments should not be construed as representing the position of the American Bar Association.

The Comments were prepared by members of the Exempt Organizations and Employee Benefits Committees of the Section of Taxation. Principal responsibility for preparing these Comments was exercised by Michael A. Clark. Substantive contributions were made by Roger Baneman, David A. Shevlin, Andrew Oringer, and Michael I. Sanders. The Comments were reviewed by LaVerne Woods, Chair of the Committee on Exempt Organizations; Greta E. Cowart, Chair of the Committee on Employee Benefits; T. David Cowart, for the Committee on Government Submissions; Richard S. Gallagher, the Council Director for the Committee on Exempt Organizations; and Priscilla E. Ryan, the Council Director for the Committee on Employee Benefits.

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

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Date: February 5, 2007

## Executive Summary

Section 4965,<sup>1</sup> added to the Code as part of the Tax Increase Prevention and Reconciliation Act of 2005 (“TIPRA”),<sup>2</sup> imposes a punitive excise tax on tax-exempt entities (including certain benefit plans) that are parties to “prohibited tax shelter transactions.” The excise tax applies irrespective of whether the tax-exempt entity knew or had reason to know that a transaction was a prohibited tax shelter transaction. A separate excise tax applies to any entity manager who approved the exempt organization’s becoming a party to the transaction, while knowing or having reason to know that the transaction was a prohibited tax shelter transaction. It is not clear under section 4965 whether, in many common situations, a transaction is a “prohibited tax shelter transaction,” or when a tax-exempt entity is a “party” to such transaction. As a result, section 4965 has the potential to disrupt many existing and appropriate market practices, unless guidance is provided to address these issues.

Because TIPRA does not provide a clear definition of when a tax-exempt entity may be a party to a prohibited tax shelter transaction, many routine investment transactions by tax-exempt entities could be covered even though the tax-exempt entity had no knowledge of, or control over, the specific investment that constituted a prohibited tax shelter transaction. For example, tax-exempt organizations investing in alternative investment funds or “hedge funds” have no control over the investments chosen by the fund manager.

The definitions incorporated by reference into new section 4965 are part of a preexisting statutory regime<sup>3</sup> designed to assure that a broad range of “reportable” transactions are disclosed to the Internal Revenue Service (the “Service”) so that the tax benefits of such transactions can, if appropriate, be carefully examined. Outside of the context of new section 4965, taxpayers may avoid penalties by disclosing the relevant transaction. As a result, any ambiguities in the definitions of “listed” or “reportable” transactions may cause no serious harm (other than additional paperwork for taxpayers and the Service); taxpayers may, when in doubt, simply disclose the transaction. We understand that such “protective disclosures” account for a large volume of taxpayer disclosures under section 6111, and “protective” disclosures are also being provided with respect to new section 6011(g).

The regime under section 4965 is quite different. An exempt entity cannot avoid penalties under section 4965 by making a protective disclosure, as other taxpayers can. The new regime as a result makes clarity in these definitions critical for tax-exempt entities.

These Comments focus on the issues presenting the most urgent need for guidance: (1) clarifying the definition of a “party” to exclude a tax-exempt entity that participates in certain common collective investment vehicles; and (2) clarifying the definition of

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<sup>1</sup> All references to sections herein are references to sections of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise expressly stated herein and “Regulations” refer to Treasury Regulations issued thereunder.

<sup>2</sup> Pub. L. No. 109-222, § 516 (2006).

<sup>3</sup> Sections 6111, 6112, and 6707A.

“prohibited tax shelter transaction” to exclude certain non-abusive transactions commonly entered into by exempt organizations. For the reasons described below, we believe that proposed regulations or other guidance to be issued under section 4965 (“4965 Guidance”) should focus on areas that show a potential for abuse. Our recommendations are as follows:

1. We recommend that 4965 Guidance provide (based on the language of the Conference Report<sup>4</sup>), that a tax-exempt entity’s investments in collective investment vehicles be treated as making the tax exempt entity a “party” to a “prohibited tax shelter transaction” only if either: (1) the tax-exempt entity has the ability to direct or control the investment discretion of the investment manager that selected the investment which is determined to be a prohibited tax shelter transaction, or (2) the tax-exempt entity’s purpose in making the investment was specifically to participate in a prohibited tax shelter transaction.

2. We recommend that 4965 Guidance recognize that common forms of low-income housing tax credit transactions (including also new markets and historic credit transactions) are not appropriately included within the scope of section 4965.

3. We recommend that 4965 Guidance define listed and reportable transactions to exclude from the scope of section 4965 transactions that may be “substantially similar” to the listed transactions involving swaps and common financial products if the direct participation of the tax-exempt organization provides no special benefit to the counterparty that would not be provided by the participation of a taxable entity.

4. We recommend that 4965 Guidance provide that a tax-exempt entity’s receipt of a notice from an investment manager or other party that an investment may be a reportable transaction or otherwise potentially covered by section 4965 should not, in and of itself, establish that the tax-exempt entity’s participation in a transaction was “knowing” for purposes of the increased excise tax rate set forth in section 4965(b)(1)(B) or for purposes of determining whether a tax-exempt entity is a party to a prohibited tax shelter transaction.

## **Discussion**

### **1. Defining Who is a “Party” to a “Prohibited Tax Shelter Transaction.”**

**A. Background.** Section 4965 generally provides that a tax-exempt entity that becomes a “party” to a “prohibited tax shelter transaction”<sup>5</sup> is subject to an excise tax that is

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<sup>4</sup> Tax Increase Prevention and Reconciliation Act of 2005 Conference Report, H.R. Rep. No. 109-455, 109<sup>th</sup> Cong., 2d Sess. 113 (2006) (the “Conference Report”).

<sup>5</sup> A “prohibited tax shelter transaction” is defined in section 4965(e)(1) as (1) any “listed transaction” and (2) any “prohibited reportable transaction.” A “listed transaction” is defined in section 6707A(c)(2) and Regulation § 1.6011-4(b)(2) as a transaction that the Secretary of the Treasury has identified in published guidance as a tax avoidance transaction and any “substantially similar” transaction. A “prohibited reportable transaction” is (1) any “confidential transaction,” which is a transaction offered to a taxpayer under conditions of confidentiality and for which a taxpayer has paid an advisor a minimum fee; or (2) any transaction with “contractual protection,” which is a reportable transaction (as defined in section 6707A(c)(1)), with respect to

punitive in amount. In addition, an “entity manager” of the tax-exempt entity who approves its entering into the transaction and who knows or has reason to know that the transaction is a “prohibited tax shelter transaction” is subject to a separate penalty tax. While generally a tax-exempt entity is subject to the excise tax in addition to the excise tax that may apply to the entity manager, in the case of a pension plan or a tax-advantaged account,<sup>6</sup> only the entity manager is subject to the excise tax.<sup>7</sup>

The excise tax for the tax-exempt entity, where applicable, is generally the product of: (1) the highest corporate income tax rate under section 11 times (2) the greater of (a) the tax-exempt entity’s net income for the tax year attributable to the prohibited tax shelter transaction (after taking into account any other excise tax imposed with respect to the prohibited tax shelter transaction) and (b) 75% of the proceeds received by the tax-exempt entity for the tax year that are attributable to the prohibited tax shelter transaction.<sup>8</sup> If a tax-exempt entity (other than a pension plan or tax-advantaged account) is a party to a transaction that becomes a “listed transaction” only after the entity had become a party, the tax-exempt entity is nevertheless subject to the excise tax, but certain allocation rules apply in calculating the tax.<sup>9</sup>

A greater excise tax applies if the tax-exempt entity knew or had reason to know that the transaction was a prohibited tax shelter transaction at the time the tax-exempt entity became a party to the transaction. In that case, the tax is the greater of (a) 100% of the tax-exempt entity’s net income for the year attributable to the prohibited tax shelter transaction (after taking into account any other excise imposed with respect to such transaction) and (b) 75% of the proceeds received by the tax-exempt entity for the taxable year attributable to the prohibited tax shelter transaction.<sup>10</sup>

The excise tax for each entity manager is \$20,000 for each approval (or other act causing participation) of a prohibited tax shelter transaction.<sup>11</sup> For most employee benefit plan-

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which a taxpayer or a related party has a right to a full or partial refund of fees if all or part of the intended tax consequences from the transaction are not sustained. Section 4965(e)(1)(C); Reg. § 1.6011-4(b)(3), (4).

<sup>6</sup> *E.g.*, a Coverdell education savings account, health savings account or qualified tuition plan.

<sup>7</sup> More specifically, both the tax-exempt entity and the entity manager are subject to the penalty if the entity is described in section 501(c), 501(d), 170(c) (other than the United States) or 7701(a)(40) (Indian tribal governments). Only the entity manager is subject to the penalty if the entity is a plan as described in section 4979(e)(1) through (3), a program described in section 529, certain deferred compensation plans described in section 457(b) or an arrangement described in section 4973.

<sup>8</sup> Section 4965(b)(1)(A).

<sup>9</sup> Section 4965(e)(2).

<sup>10</sup> Section 4965(b)(1)(B).

<sup>11</sup> Section 4965(b)(2).

type entities, this is the only applicable tax.<sup>12</sup> The tax is imposed on the entity manager only if the entity manager approves the entity's participation in a prohibited tax shelter transaction and "knows or has reason to know that the transaction is a prohibited tax shelter transaction."<sup>13</sup>

**B. Recommendation.** We recommend that 4965 Guidance provide (based on the language of the Conference Report<sup>14</sup>) that a tax-exempt entity's investments in collective investment vehicles be treated as making the tax-exempt entity a "party" to a "prohibited tax shelter transaction" only if either: (1) the tax-exempt entity has the ability to direct or control the investment discretion of the investment manager that selected the investment which is determined to be a prohibited tax shelter transaction, or (2) the tax-exempt entity's purpose in making the investment was specifically to participate in a prohibited tax shelter transaction.

**C. Explanation.** Section 4965(a)(1)(A) provides that the excise tax applies to a tax-exempt entity that "becomes a party" to a prohibited tax shelter transaction. The statute itself, however, provides no further definition of the term "party."

The Conference Report elaborates on the intent of this language as follows:

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<sup>12</sup> Some entities that are formed to provide various employee benefits appear to be subject to the entity level tax imposed by section 4965(a)(1), notwithstanding that no entity level tax is imposed on most employee benefit plan-type entities included in section 4965(c)(4) through (7). For example, a "voluntary employees' beneficiary association" (or "VEBA") described in section 501(c)(9), which serves to fund certain welfare benefits for employees, would be considered to be other than a "plan entity" for these purposes. The entity level tax also appears to apply to other entities intended to provide benefits to employees, such as supplemental unemployment benefit trusts described in section 501(c)(17), group legal service plans described in section 501(c)(20), black lung benefit trusts described in section 501(c)(21), and various other benefit plan type entities described in section 501(c). The rationale for the application of the section 4965 excise tax to these benefit plan entities, but not to those described in section 4965(c)(4) to (7), is not clear.

<sup>13</sup> In the past, there has been a chilling effect on the willingness of capable professionals to participate in the administration of benefit plan entities as a result of potential exposure to other excise taxes. For example, section 4975 imposes penalty excise taxes on account of certain relationships between employee benefit (and certain other) plans and "disqualified persons." In the Pension Protection Act of 2006, Congress amended section 4975 to liberalize these rules, arguably making it easier for benefit plans and benefit plan participants to obtain professional advice and management. *See, e.g.*, section 4975(d)(17) - (22), section 4975(f)(8). A clear definition of the "knowing" standard, perhaps similar to that found in the section 4958 regulations (Reg. § 53.4958-1(d)(4)), would hopefully avoid similar difficulties in obtaining investment advice from individuals and entities potentially subject to the entity manager tax imposed by section 4965(a)(2).

<sup>14</sup> Conference Report at 130.

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.<sup>15</sup>

It is quite common for tax-exempt entities – including private foundations, endowment funds of colleges and universities, and other charities – to invest in collective investment vehicles in order to receive the benefit of access to professional investment advice and to diversify their investment portfolios. Such investments are consistent with the purpose for which such entities are organized, and assist in raising much needed funds for the accomplishment of socially beneficial programs.

Although sometimes these vehicles may be “mutual funds,” as mentioned in the above-quoted excerpt from the Conference Report, more often today these investments are in the form of partnerships, limited liability companies, or other entities providing for the pooling of tax-exempt entity investor funds with the funds of other investors in order to achieve access to a particular investment manager, greater efficiency, and access to investment opportunities that might not be available to smaller investors. These vehicles typically do not provide the investors with control over the selection of particular investments; indeed, in so-called “fund-of-funds” investments, the investment manager does not select the particular investments in which the funds of the tax-exempt entity and other investors will be invested, but rather deploys the resources of the pooled fund into the hands of various other investment managers to pursue a particular investment strategy.

The emphasis in the Conference Report on the role that the purpose of the tax-exempt entity’s investment plays in determining whether the tax-exempt entity is a “party” to the transaction indicates that Congress did not intend for new section 4965 to be read so broadly as

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<sup>15</sup> Conference Report at 131.

to disrupt ordinary investment transactions of tax-exempt entities.<sup>16</sup> Section 4965 is a “no-fault” excise tax; if a tax-exempt entity is a “party” to a transaction, a tax will apply even if the tax-exempt entity did not know that the transaction was a prohibited tax shelter transaction or, in the case of subsequently listed transactions, even if the transaction was not a prohibited tax shelter at the time the tax-exempt entity made its investment.<sup>17</sup> Knowledge is relevant in determining the amount of the tax, but only for purposes of determining whether the tax should be imposed at the higher rate provided for transactions in which the tax-exempt entity’s participation is “knowing.”<sup>18</sup>

The Conference Report, however, recognizing the potential unfairness of applying the tax to common, collective investment transactions in which the tax-exempt entity was an unknowing participant in any prohibited tax shelter transaction selected by the investment manager of the collective entity, indicated that the tax-exempt entity’s purpose *is* relevant in determining whether a tax-exempt entity is a “party” to a transaction.<sup>19</sup> Thus, in the mutual fund example in the Conference Report, Congress was evidently of the view that, where a tax-exempt entity has no control over the subsequent investments by the fund manager, as would be the case for mutual fund investors, it would be inappropriate to subject the tax-exempt entity to the excise tax where the tax-exempt entity managers had no knowledge or reason to know that its funds would be used to invest in a transaction that is a prohibited tax shelter transaction, and no way to prevent such investment.

The principles expressed in the Conference Report support our recommendation that tax-exempt entities participating in collective investment vehicles – whether they be mutual funds, partnerships, or other alternative investment structures – are not “parties” to a prohibited tax shelter transaction where there are no facts and circumstances indicating that the purpose of the tax-exempt entity’s investment was specifically to participate in a prohibited tax shelter transaction.<sup>20</sup> Such facts and circumstances could include the facts that the tax-exempt entity

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<sup>16</sup> *Id.*

<sup>17</sup> Section 4965(b)(1)(A).

<sup>18</sup> Section 4965(b)(1)(B).

<sup>19</sup> Conference Report at 131.

<sup>20</sup> Under the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), and the related prohibited transaction provisions of section 4975, issues have historically arisen regarding the question of when, in the case of an investment in an entity by employee benefit (or certain other) plans, the assets of the entity are in effect deemed to constitute “plan assets” of the investing plans. *See* 29 C.F.R. § 2510.3-101. Under Department of Labor regulations, in general terms, if less than 25% of each class of equity interest in an entity is held by plans, the entity’s assets are not considered plan assets (i.e., only the interest in the entity is a plan asset subject to ERISA and section 4975). A similar approach might be considered under section 4965. Thus, where the percentage ownership of an entity by tax-exempt organizations is sufficiently small, the tax-exempt organizations would not be charged with participating in a prohibited tax shelter transaction entered into by the entity.

has no control over the selection of investments by the manager of the collective investment vehicle, and that the tax-exempt entity managers do not have actual knowledge or reason to know that the collective investment vehicle will invest in a transaction that is a prohibited tax shelter transaction.

## **2. Recognition That Low Income Housing and Similar Credit Transactions Are Not “Prohibited Tax Shelter Transactions.”**

**A. Background.** Section 42 provides a credit for investments in low-income housing. As the Service has recognized,<sup>21</sup> exempt organizations are frequent participants in transactions designed to qualify for the section 42 credit. Indeed, section 42(h)(5) requires that a minimum of 10% of the low-income housing tax credits allocated to each state be set-aside for low-income housing projects sponsored by qualified nonprofit organizations.

Exempt organizations also are often encouraged to participate in low-income housing transactions by the availability of grant programs, real property tax exemption, and various state credit allocation rules awarding special consideration to nonprofit organizations. Exempt organizations also frequently participate in partnerships qualifying for additional credits, such as the credit for historic rehabilitation expenditures provided by section 47. Transactions qualifying for the new markets tax credit provided by section 45D for investments in qualified community development organizations also often involve tax-exempt organizations devoted to low-income community revitalization.

**B. Recommendation.** We recommend that 4965 Guidance recognize that Congress did not intend that common low-income housing tax credit transactions (including also new markets and historic credit transactions) be included in the scope of section 4965.

**C. Explanation.** In the past, participants in low-income housing transactions (and transactions involving the section 45D or 47 credits) have often made reportable transaction disclosures to the Service because of uncertainty as to the application of the definition of transactions with “contractual protection”<sup>22</sup> to provisions common in most low-income housing transaction partnerships providing for the refund of certain amounts if the low-income housing credits are not as anticipated. It is common for the general partner (which often is a tax-exempt entity or an entity controlled by a tax-exempt entity) of a low-income housing partnership operating a low-income housing project qualifying for the section 42 credit to provide guarantees to the investor that a certain amount of credits will be available. If the promised credits are not achieved (perhaps because the investment in the project is less than anticipated, or if various conditions are not met by the general partner for qualification for the credit), certain fees

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<sup>21</sup> See, e.g., Rev. Proc. 96-32, 1996-1 C.B. 717 (providing safe-harbor guidelines for exempt organizations providing low-income housing); Memorandum from Joseph Urban, Acting Director, EO Rulings and Agreements, for Manager, EO Determinations, dated April 25, 2006 (providing guidelines for processing applications for exemption from organizations engaged in low-income housing tax credit limited partnerships).

<sup>22</sup> Reg. § 1.6011-4(b)(4).

normally received by the general partner will be refunded, such as the development fee, the management fee, or some combination of other fees. Similar provisions are common in transactions involving historic and new markets tax credits.

Similarly, in transactions where various low-income housing projects are “packaged” into larger investment partnerships, it is common for a certain level of credits and other tax benefits to be guaranteed by a credit-worthy party who receives a fee for such guaranty. The existence of such guarantees results in a reduced cost for obtaining equity investors in the tax credit partnerships, thereby lowering the rents which must be charged to make such projects financially viable, as required for approval of such projects by state housing credit agencies. If the promised credits are not realized and passed through the investment partnership to the tax credit investor, then the investor receives a payment to assure that the guaranteed return is received.

Although there are good arguments that the “fees” refunded to the investors in either of the above situations are not “fees” for making or providing a statement as to the potential tax consequences of a transaction,<sup>23</sup> it is common for taxpayers to file reportable transaction disclosures with respect to both types of partnerships because of the potential penalties involved and the ability to avoid such penalties with disclosure.<sup>24</sup> Taxable parties are likely to provide similar disclosures to tax-exempt entities under new section 6011(g) in order to avoid penalties.

The Code and Service pronouncements recognize the importance of the participation of exempt organizations in low-income housing and similar credit transactions. Accordingly, the Service should exercise its regulatory authority to make certain that such participation is not precluded as an unintended consequence of section 4965.

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<sup>23</sup> Reg. § 1.6011-4(b)(4)(ii) defines “fees” as amounts paid “to any person who makes or provides a statement . . . as to the potential tax consequences that may result from the transaction.” An investor who does not receive the promised tax benefit does not receive a refund of fees paid for specific tax advice, but rather receives a refund of some or all of the investment made by the investor, which may be paid out of amounts received by the developer or the sponsor of the guaranteed fund for investment in low-income housing partnerships. The Treasury recently proposed new regulations with respect to reportable transactions. AJCA Modifications to the Section 6011 Regulations, 71 Fed. Reg. 64488 (Nov. 2, 2006); AJCA Modifications to the Section 6111 Regulations, 71 Fed. Reg. 64496 (Nov. 2, 2006); AJCA Modifications to the Section 6112 Regulations, 71 Fed. Reg. 64501 (Nov. 2, 2006). Prop. Reg. § 1.6011-4(b)(4)(ii) is unchanged from the existing regulations.

<sup>24</sup> These disclosures, while prudent on the part of taxpayers exposed to substantial penalties, are duplicative of required filings disclosing the details of the transactions pursuant to the Code provisions providing for the relevant credit under section 42 (Form 8609), section 45D (Form 8874), and section 47 (Form 3468).

### 3. Identification of Prohibited Tax Shelter Transactions.

**A. Background.** Sophisticated tax-exempt entities, such as private foundations and university endowments, may enter into equity swaps and other notional principal contract (“NPC”) transactions involving contingent payments as part of a diversified investment strategy, consistent with modern approaches to portfolio management. As described below, IRS Notices have identified certain swap transactions as “listed transactions.”<sup>25</sup> The scope of what transactions are covered is, however, still subject to some uncertainty,<sup>26</sup> and tax-exempt entities participating in equity swaps and credit default swaps receive numerous protective disclosures as a result of this uncertainty. This uncertainty creates concerns for tax-exempt organizations under the automatic excise tax regime of section 4965.

In identifying the “prohibited tax shelter transactions” for purposes of section 4965, Congress used definitions under existing law with respect to tax shelter reporting.<sup>27</sup> The goals and the consequences of new section 4965 and the tax shelter reporting rules from which the definitions are drawn are quite different, however, and the combination could produce undesirable and unintended results.

Prior to the enactment of section 4965, in the context of Regulation section 1.6011-4(b)(2), the consequence of entering into a “listed transaction” was the triggering of a disclosure obligation on the taxpayer’s return. Accordingly, taxpayers and their advisors often dealt with the uncertainty as to whether financial products were “substantially similar” to “listed transactions” by filing a protective disclosure statement with the taxpayer’s tax return.

After receiving numerous disclosure filings from taxpayers for “common transactions, such as total return swaps, that are entered into for *bona fide* tax purposes,” the Service issued Notice 2006-16<sup>28</sup> in an effort to “narrow the scope of reportable transactions that might be perceived substantially similar to the transaction described in Notice 2002-35.”<sup>29</sup>

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<sup>25</sup> See <http://www.irs.gov/businesses/corporations/article/0,,id=120633,00.html> (last visited January 8, 2007) for a list of the relevant transactions.

<sup>26</sup> See, e.g., Gina Biondi and Maureen Hughes, *The Impact of the Tax Shelter Regulations on Private Investment Funds*, Taxation of Financial Products, Summer 2003, 41, 43-46.

<sup>27</sup> Section 4965(e)(1), defining “prohibited tax shelter transaction” by cross reference to the definitions of “listed transaction” and certain “prohibited reportable transactions” under section 6707A.

<sup>28</sup> 2006-9 I.R.B. 538.

<sup>29</sup> Notice 2002-35, 2002-1 C.B. 992, identifies as a “listed transaction” an NPC with a term of more than one year where the taxpayer is required to make periodic payments to a party at regular intervals of one year or less based on a fixed or floating rate index. In return, the counterparty is required to make a single payment at the end of the term of the NPC that consists of a relatively large noncontingent component and a relatively small contingent component. The taxpayer deducts the periodic payments currently but does not accrue income with respect to the nonperiodic payment until the year the taxpayer actually receives the payment from the

Notice 2006-16 excludes from Notice 2002-35 those NPC's that involve a contingent non-periodic payment where either the taxpayer uses a method of accounting for the NPC that takes the contingent non-periodic payment into account over the life of the NPC under a reasonable amortization method or the taxpayer uses certain specified tax accounting methods involving either hedging transactions or an annual "mark-to-market."<sup>30</sup> In addition, the Notice relieves a taxpayer from making a filing by reason of the taxpayer's interest in a pass-through entity that engages in a transaction described in Notice 2002-35 where the pass-through entity files the appropriate disclosure statement and acknowledges its filing to the taxpayer.

Notice 2006-16 does not exclude total return swaps entered into for *bona fide* non-tax purposes from the scope of Notice 2002-35 where such transactions do not meet the criteria of Notice 2006-16. Thus, taxpayers and their advisors will presumably continue, post Notice 2006-16, to file protective disclosure statements in those numerous transactions that are not excluded by Notice 2006-16.

**B. Recommendation.** We recommend that 4965 Guidance define listed and reportable transactions to exclude from the scope of section 4965 transactions that may be "substantially similar" to the listed transactions involving swaps and common financial products if the direct participation of the tax-exempt organization provides no special benefit to the counterparty that would not be provided by the participation of a taxable entity.<sup>31</sup>

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counterparty. In addition, the taxpayer intends to report any gain realized upon the termination of the NPC as capital gain.

Reg. § 1.446-3(f)(2)(i) requires that a non-periodic payment must be recognized over the NPC's term in a manner that reflects the NPC's economic substance. The Notice requires that this treatment be applied separately to the NPC's non-contingent component, irrespective of whether that component is based on a fixed or floating interest rate. The perceived abuse is presumably the timing mismatch whereby the taxpayer would obtain current ordinary deductions and would defer (and receive as capital gain) the related income. The Notice identifies transactions "that are the same as, or substantially similar to," the transaction described in the Notice as "listed transactions."

<sup>30</sup> The specified regimes are under section 475 (mark-to-market election for certain dealers or traders in securities or commodities); Reg. § 1.446-4 (accounting for hedging transactions); Reg. § 1.988-5(a) (foreign currency hedging transactions); and Reg. § 1.988-2(e) (accounting for currency swaps).

<sup>31</sup> We do not believe that a corresponding change to the regulations under section 6011 (*see* Prop. Reg. § 1.6011-4(b)(2)) needs to be made for all transactions which may be deemed "substantially similar" to the listed transactions regarding swaps and common financial products. However, if it were deemed necessary to do so, the objectives of obtaining information with respect to transactions substantially similar to listed transactions could be obtained by classifying these "substantially similar" transactions as "transactions of interest," as defined in Prop. Reg. § 1.6011-4(b)(6), rather than as listed transactions.

**C. Explanation.** Unlike a taxable party engaging in a listed transaction, a tax-exempt entity in the context of section 4965 cannot protect itself from penalties by making a protective disclosure. Therefore, if a tax-exempt entity enters into an equity swap or any other kind of NPC that involves a back-end contingent payment, the tax-exempt entity and its entity managers would, in the absence of clarifying guidance, be exposed to uncertainty as to whether the transaction could be considered “substantially similar to” the listed transaction described in Notice 2002-35, and therefore a prohibited tax shelter transaction under section 4965.

As discussed above in connection with the Conference Report language regarding the determination as to whether a tax-exempt organization is a “party” to a prohibited tax-shelter transaction, Congress expressed some concern that ordinary and routine collective investment transactions of tax-exempt organizations should not be precluded by section 4965. In the complex world of sophisticated financial products, it is a serious challenge for tax-exempt organizations to identify all of the financial products which might be “substantially similar” to one or more listed transactions. For purposes of collecting information regarding potentially abusive tax shelters, however, the Service understandably wishes to – and should – keep the definition of “listed transactions” subject to a broad interpretation.

We do not believe, however, that a broad definition of “listed transactions” necessarily requires an expansive definition of the transactions subject to tax under section 4965. The Service has broad authority under section 6011 to define, among other things, “reportable” and “listed” transactions. Indeed, exercising this authority, the Service has proposed creation of a new category of reportable transactions, “transactions of interest,”<sup>32</sup> which are transactions which the Service and the Treasury believe have the potential for tax avoidance but have not been identified as listed transactions because the Service and Treasury have not yet collected sufficient information to make an informed decision as to whether the transactions should be designated as listed or reportable transactions.<sup>33</sup> We thus urge the Service to exclude from the definition of “listed” and “reportable” transactions for purposes of section 4965 swaps and common financial products if the direct participation of the tax-exempt organization provides no benefit to the counterparty that would not be provided by the participation of a taxable entity.

Consistent with our suggestions above regarding the treatment of collective investment transactions by tax-exempt organizations, this exclusion should also require that the tax-exempt organization have no knowledge that the transaction was a prohibited tax shelter transaction and no intent to avoid any federal tax. Consistent with our recommendations with respect to collective investment vehicles, we also recommend that the mere receipt of a protective notice from, for example, the counterparty to a swap transaction, will not necessarily be deemed to provide the tax-exempt organization with “knowledge” sufficient to classify the transaction as a prohibited tax-shelter transaction, as discussed below.

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<sup>32</sup> Prop. Reg. § 1.6011-4(b)(6).

<sup>33</sup> 71 Fed. Reg. 64488.

#### **4. Impact of a Tax-Exempt Entity’s Receipt of a Notice That a Transaction Is Potentially Covered by Section 4965.**

**A. Background.** Section 6011(g), as amended by TIPRA, provides that a taxable party to a prohibited tax shelter transaction shall disclose to any tax-exempt entity that is also a party that such transaction is a prohibited tax shelter transaction. Penalties apply for noncompliance.<sup>34</sup>

Prior to the adoption of section 4965, in order to comply with section 6707A, which requires taxpayers to disclose participation in reportable transactions and listed transactions, many taxpayers made protective disclosures, even though it was not clear that such transactions were either reportable or listed, since the penalties for nondisclosure were severe and could be avoided by disclosure. Taxable entities that are subject to the new disclosure obligations under section 6011(g) will likely adopt this protective disclosure approach. Indeed, various market participants are already circulating notices to tax-exempt entities that particular transactions may be “prohibited tax shelter transactions.”

**B. Recommendation.** We recommend that 4965 Guidance provide that a tax-exempt entity’s receipt of a notice from an investment manager or other party that an investment may be a prohibited tax shelter transaction or otherwise potentially covered by section 4965 should not, in and of itself, establish that the tax-exempt entity’s participation in a transaction was “knowing” for purposes of the increased excise tax rate set forth in section 4965(b)(1)(B). Similarly, we recommend that 4965 Guidance provide that a tax-exempt entity’s receipt of such a notice should not *per se* establish that the entity or an entity manager knew or should have known that a transaction was a prohibited tax shelter transaction for purposes of determining whether the entity is a “party” to the transaction. Rather, all facts and circumstances should be taken into account.

**C. Explanation.** If past history regarding the practices of taxable parties is any guide, such parties will provide protective notices to tax-exempt entities in order to avoid the section 4965 excise tax in cases where there is any question whether a transaction could potentially be a prohibited tax shelter transaction. As a result, tax-exempt entities are likely to receive notices for transactions that were not intended to be within the definition of a prohibited tax shelter transaction (e.g., low income housing tax credit transactions), as well as for transactions that may be within the definition. Because it is anticipated that providing protective notices with respect to prohibited tax shelter transactions will become common practice, such a notice to a tax-exempt entity may not be a meaningful indicator that a transaction is necessarily a prohibited tax shelter transaction.

The Conference Report indicates that the conferees intended that a tax-exempt entity or entity manager, in order to know or have reason to know that a transaction is a prohibited tax shelter transaction, “must have knowledge of sufficient facts that would lead a reasonable person to conclude that the transaction is a prohibited tax shelter transaction.”<sup>35</sup> A

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<sup>34</sup> Section 6707.

<sup>35</sup> Conference Report at 130.

tax-exempt entity's receipt of a notice should be a factor in this factual test. But because of the anticipated number of protective notices, the notice should not be treated as establishing *per se* a tax-exempt entity's "knowing" participation for purposes of the higher tax rate under section 4965.

The Conference Report further indicates that "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."<sup>36</sup> Whether a tax-exempt entity is a party "will be informed by whether the entity or entity manager knew or had reason to know" that the entity's investment would be used in a prohibited tax shelter transaction.<sup>37</sup> Consistent with the Conference Report, a tax-exempt entity's receipt of a notice should comprise only one factor in the facts and circumstances test for analyzing whether the entity or entity manager knew or had reason to know, for purposes of determining whether the entity is a party to a prohibited tax shelter transaction. The fact that a tax-exempt entity received a notice should not be determinative; rather, all facts and circumstances should be taken into account.

### **Conclusion**

Notice 2006-65 provides helpful immediate guidance in interpreting section 4965. The additional 4965 Guidance suggested by these Comments will further the appropriate goal of Congress to deter the participation of tax-exempt entities in tax shelters, while at the same time permitting continuation of useful and socially beneficial routine investment activities, as well as the important and Congressionally sanctioned participation of such organizations in low-income housing transactions.

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<sup>36</sup> *Id.* at 131.

<sup>37</sup> *Id.*