

New Tax Shelter Reporting Requirements and Penalties Enacted by Congress

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The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), enacted earlier this year, may expose tax-exempt entities and their managers—potentially including outside investment managers—to significant new penalties for engaging in “prohibited tax shelter transactions.” This term is broad and includes some transactions that have not been deemed abusive by the IRS. TIPRA also creates new disclosure and reporting requirements for parties to such transactions.

The legislation is intended to address recent criticism that some tax-exempt entities serve as “accommodation parties” in tax shelter transactions. Concerns have been raised that the legislation has numerous ambiguities, and its potential scope is excessively broad.

New Excise Tax and Disclosure Requirements

TIPRA enacted a two-tier excise tax that applies to a wide range of tax-exempt entities, including benefit plans, that engage in “prohibited tax shelter” transactions. Prohibited tax shelter transactions include “listed” transactions, any transactions “substantially similar” to listed transactions, and certain “reportable” transactions. In cases of “knowing participation,” organizations could be subject to an excise tax at the greater of 100% of its net income or 75% of the proceeds from the covered transaction, with no defense for reasonable cause. The legislation will apply to both current and past transactions to the extent such transactions generate income after August 15, 2006. Because the definition of a prohibited tax shelter transaction is quite broad, it is possible that penalties could be applied against transactions that have not been deemed abusive by the IRS and the entity managers who approve such transactions.

TIPRA also requires tax-exempt entities to disclose their participation in prohibited tax shelter transactions to the IRS, under procedures that have not yet been announced, and requires others that participate in the prohibited tax shelter transactions to disclose to tax-exempt entities that such transactions may be covered by TIPRA.

Detailed Description of the New Provisions

A tax-exempt entity that is a party to either a “listed” or “reportable” transaction will be subject to the new penalty and disclosure requirements. The possibility that common business transactions may be

inadvertently swept up in these new provisions is particularly troubling in light of their no-fault nature.

Listed transactions are defined as:

1. Transactions the IRS has announced through guidance that are considered potentially abusive. Currently listed transactions are described in Notice 2004-67 and can be found on the IRS website (<http://www.irs.gov/businesses/corporations/article/0,,id=120633,00.html>);
2. Transactions that are substantially similar to currently listed transactions; and
3. “Subsequently listed” transactions the IRS determines are potentially abusive at a point in the future after the exempt organization becomes a party.

While many transactions currently listed by the IRS as abusive are not relevant to tax-exempt entities, such entities do engage in legitimate transactions that have arguably similar elements to certain listed transactions. In particular, some taxpayers have raised concerns about investments in notional principal contracts (“swaps”) because a particular form of such transaction was listed by the IRS in Notice 2002-35. While there are many nonabusive forms of swaps, it is unclear when the IRS would determine that a particular investment is “substantially similar” to the listed transaction (although the IRS has provided some additional guidance in this regard with Notice 2006-16).

TIPRA also applies to reportable transactions, which include:

1. Transactions that are sold by a tax advisor under conditions of confidentiality for a minimum fee; and
2. Transactions in which a party has a contractual right to a partial or full refund of fees if anticipated tax consequences are not realized. Tax-exempt entities should be aware that some agreements with investment managers may fall within this category if there is an agreement in place to refund fees where unrelated business income tax is generated.

A tax-exempt entity that participates in a prohibited tax shelter transaction will be subject to a 35% excise tax on the greater of the net income or 75% of the gross proceeds received from the transaction. If a tax-exempt entity knowingly or with reason to know enters into a listed transaction, the excise tax amount is increased to 100%.

Entity managers may also be subject to a penalty of \$20,000 if they know or have reason to know the approved transaction was prohibited. Generally, the entity manager is the person with authority or responsibility similar to that exercised by an officer, director, or trustee of an organization. In the case of qualified pension plans, IRAs, and similar arrangements, the entity manager is the person who approves or otherwise causes the organization to become a party to the prohibited tax shelter transaction. Thus, in some cases, the entity manager could be an outside investment manager of endowments and pension funds.

The excise tax penalties on organizations and entity managers for engaging in prohibited tax shelter transactions will apply to taxable years ending after May 17, 2006, with respect to transactions before, on, or after such date but only with regard to income or proceeds that are properly allocable to

dates beginning 90 days following enactment, which was August 15, 2006. The higher excise tax for knowingly entering into a listed transaction only applies to transactions in which the organization becomes a party after May 17, 2006.

Taxable organizations also have new obligations to disclose to tax-exempt entities the status of such transactions, and tax-exempt entities must report their involvement in prohibited tax shelter transactions to the IRS under the new legislation. Failure to disclose such a transaction to the IRS will result in a \$100 per-day penalty (up to \$50,000) for the tax-exempt organization and, in some cases, a \$100 per-day penalty (up to \$50,000) for an entity manager. The disclosure requirements in TIPRA are effective for disclosures that are due after May 17, 2006.

With regard to the disclosure requirements, TIPRA requires disclosure if the tax-exempt entity has been “a party to any prohibited tax shelter transaction.” The statute does not provide when the disclosure must occur or whether it applies to transactions already in existence before the enactment of TIPRA. At present, the IRS has not provided any guidance as to how or when such disclosure must occur. For example, it is unclear whether a public charity would be required to disclose its participation in a prohibited tax shelter transaction as part of a publicly available filing such as the Form 990 or, under separate legislation, Form 990-T annual information return. [See our recent LawFlash](#) describing important new charitable provisions included in the Pension Protection Act of 2006.

The Treasury Department is expected to provide initial guidance soon on what types of confidential transactions and transactions with contractual protections would be considered prohibited tax shelter transactions. Comments provided to the IRS have, among other things, requested additional guidance on what types of activities constitute participation in a transaction and proposed that tax-exempt entities be provided an opportunity to unwind, rescind, or correct any transaction subsequently listed as a prohibited tax shelter transaction.

Tax-exempt entities that participate in Section 42 low income housing tax credit transactions have expressed concern that tax credit guarantees generally provided to other transaction participants might fall within the TIPRA definition of a prohibited tax shelter transaction. A coalition of such entities has asked Treasury to clarify that their transactions would not be affected by TIPRA through the issuance of a safe harbor listing of transactions that would not fall within the definition of prohibited tax shelter transactions. Until guidance is issued, we recommend that organizations seek advice before entering into a transaction under conditions of confidentiality or in which a party is provided a right of full or partial refund if anticipated tax consequences are not realized.

If you have any questions about how TIPRA will affect your organization, please contact any of the following attorneys from our Tax-Exempt Organizations and Tax Practices:

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