# New Tax Shelter Penalties for Tax-Exempt Parties and Their Managers

The recently enacted Tax Increase Prevention and Reconciliation Act of 2005 imposes potentially confiscatory excise taxes on tax-exempt investors that are parties to "prohibited tax shelter transactions," as well as an excise tax on managers who knowingly cause tax-exempt parties to become involved in these transactions. Depending on circumstances, the manager-level tax may affect in-house managers, external managers, and, possibly, the managers of investment funds in which the tax-exempt party invests.

Although presumably aimed at preventing tax-exempts from acting as accommodation parties in tax shelter transactions, the Act by its terms has a much broader scope. Excise taxes are imposed on tax-exempt parties on a "no fault" basis, regardless of whether a transaction was disclosed to the IRS and regardless of whether the investor knew that a transaction was "prohibited."

The new rules took effect upon enactment (May 17, 2006) and will require prompt and ongoing attention by those responsible for investments covered by the new rules.

## What transactions are targeted by the Act?

Two types of transactions are included in the term "prohibited tax shelter transaction": listed transactions and prohibited reportable transactions.

- Listed transactions: These are transactions specifically identified by the IRS as tax avoidance transactions *as well as "substantially similar" transactions*. (Listed transactions that have been identified by the IRS to date are summarized on the IRS web site at http://www.irs.gov/businesses/corporations/article/0,,id=120633,00.html.) Although many of the transactions identified by the IRS (e.g., abusive transfers of compensatory stock options) are not relevant to tax-exempt parties or their managers, some listed transactions involve perceived abuses related to variations on otherwise legitimate investment practices.
    - For example, Notice 2002-35 "listed" a particular form of notional principal contract (swap) being exploited to produce an allegedly abusive mismatch of deductions and income (taxpayers were claiming current interest deductions but deferring rather than accruing the inclusion of offsetting non-contingent payments by the counterparty at the end of the term). There are, however, many non-abusive forms of swaps, and it may be difficult to know whether the IRS would view a particular transaction as falling within the scope of the Notice.

  Because the penalties under the Act are potentially so severe, the term "listed transaction" includes not only transactions *actually* listed but also "substantially similar" transactions, and there is no opportunity under the statute to challenge the new tax on the ground that a transaction (although "listed") is legitimate, many tax-exempt parties and their managers may have cause to worry even about commercially routine dealings.

- Prohibited reportable transactions: This category includes only *confidential transactions and transactions with contractual protection*. These terms are not defined in the Act, but existing guidance under related provisions provides, in general, that: (a) a confidential transaction is one offered under conditions of confidentiality, for which a taxpayer pays an advisor a specified minimum fee; and (b) a transaction with contractual protection is one where the taxpayer has the right to a refund of fees (or the fees are contingent) depending on the realization of intended tax consequences. One point to note is that the tax-exempt investor must simply be a "party to" the confidential transaction or the transaction with contractual protection for the tax to apply. For this reason, tax-exempt parties and their managers may find themselves driven to require assurances from other parties to an investment that they would previously not have considered necessary.

## Which tax-exempt parties are subject to the investor-level tax?

Under the Act, any charity or other tax-exempt entity described in Section 501(c) of the Internal Revenue Code must pay an excise tax if it is a "party to" a prohibited tax shelter transaction. The same treatment applies to Section 170(c) entities such as city, state and local governments, religious associations or organizations described in Section 501(d), and Indian tribal governments.

The investor-level tax does not apply to other tax-exempt parties - including, most notably, pension funds - but it does apply to VEBAs (welfare benefit funds), which derive their exemption from Section 501(c)(9) of the Code.

## What is the investor-level tax imposed on a tax-exempt party?

A tax-exempt party could be subject to the following taxes under the Act:

- <u>No fault</u>: A tax-exempt party subject to the investor-level tax must pay an excise annually at the highest marginal corporate rate (currently 35%) on the *greater* of: (a) its total after-tax net income (determined without regard to this excise tax) attributable to the transaction for the year, or (b) 75% of its proceeds received from the transaction for the year. The tax also applies to listed transactions designated by the IRS *after* the investment has been made - but, in general, only for periods after the transaction has been "listed."
- <u>Knowledge</u>: A tax-exempt party that knew or had reason to know that the transaction was prohibited is subject instead to a confiscatory tax each year equal to the greater of: (a) 100% of its net income attributable to the transaction for the year, or (b) 75% of its proceeds from the transaction for the year. The tax for "knowing" participation does not apply with respect to any transaction to which a tax-exempt investor became a party on or before May 17, 2006.

Thus, a tax-exempt party may be subject to a significant tax with respect to an investment even if it has no knowledge that the investment was prohibited - and regardless of whether the investment is actually abusive.

## How does the Act affect managers?

"Entity managers" of a broad range of tax-exempt parties - including those subject to the investor-level tax *but also including pension plans* - are subject to a $20,000 tax for each approval of or other act causing participation in a "prohibited tax shelter transaction." Unlike the investor-level tax, the manager-level tax applies only if the manager *knows or has reason to know* that the transaction is prohibited.

The Act defines "entity manager" differently for different types of tax-exempt parties. Although future IRS guidance may clarify the statutory definitions, we believe it advisable for now to treat the term "entity manager" as including external investment managers of both pension funds and charities (*e.g.*, hospital and university endowments) as well as, in certain cases, internal personnel with officer, director or trustee-type authority or responsibility. Depending on circumstances, it is possible that the term may also be construed to include managers of investment funds deemed to be managing a tax-exempt party's assets by reason of investment in the fund by the tax-exempt party.

## Disclosure requirements

Supporting the new excise tax regime is a set of disclosure obligations.

- Tax exempt parties: A tax-exempt party, even one not subject to the investor-level tax (such as a pension fund), must disclose participation in prohibited tax shelter transactions. Failure by a tax-exempt party to file a required disclosure results in a penalty of $100 per day ($50,000 maximum for any one disclosure), with additional penalties if there is continued failure after a demand from the IRS.
- Taxable parties: A taxable party to a prohibited tax shelter transaction must disclose the prohibited nature of the transaction to tax-exempt participants. (Nothing in the Act suggests, however, that the failure of a taxable participant to satisfy its disclosure obligation would affect the "no fault" liability of a tax-exempt party subject to the investor-level tax.)

## Effective date

The Act's new tax regime took effect immediately upon enactment (May 17, 2006), *including as to transactions entered into prior to enactment*, for taxable years ending after the date of enactment However, the statutory language states that "no tax [under the new rules] . . . shall apply with respect to income or proceeds that are properly allocable to any period ending on or before the date which is 90 days after such date of enactment." On the face of the language, it appears that this relief provision may *not* apply to the manager-level tax, which is not tied to income or proceeds.

## Contact information

If you have any questions about the new excise tax and penalties, please contact one of the undersigned or another member of the Tax & Benefits Department.

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