

New Excise Tax Threatens Housing Not-for-Profits - Immediate Guidance from the IRS is Needed

By Michael J. Novogradac, CPA

Early this year Congress enacted a new excise tax on tax-exempt entities (and their managers), and this new tax has the potential to disrupt the participation of housing not-for-profits in low-income housing tax credit (LIHTC) partnerships. Immediate guidance is needed from the Internal Revenue Service (IRS) to prevent this potential disruption. Action is needed from all parts of the LIHTC community to impress upon the Internal Revenue Service (IRS) the importance of clarifying guidance.

Background

This new excise tax under IRC Section 4965 became law on May 17, 2006, and on July 11, 2006 the IRS issued IRS Notice 2006-65, an implementation Q & A. (See the September 2006 issue of the *LIHTC Monthly Report* for a detailed analysis.)

In general, IRC Section 4965 assesses an excise tax on tax-exempt entities (and their managers) that participate in "prohibited tax shelter transactions." The definition of a prohibited tax shelter transaction includes transactions with "contractual protection."

The definition "contractual protection" is the same as that used for determining if a transaction is a "reportable transaction" under Section 6011. (See the April 2005 issue of the *LIHTC Monthly Report* for a discussion of reportable transactions.) Many commentators believe that a significant risk exists that tax credit adjusters or other guarantees commonly provided in LIHTC transactions may satisfy the definition of "contractual protection." Under the reportable transaction rules, many entities were unable to determine with certainty whether their transactions had contractual protection and thereby made a "protective filing." In a protective filing, an entity notifies the IRS that the transaction may be reportable transaction.

The Penalties

Section 4965 assesses for four different excise taxes:

- 1) Tax on a tax-exempt entity participating in a prohibited tax shelter. If a tax-exempt entity

participates in a prohibited tax shelter transaction, then an excise tax is due equal to 35 percent of the greater of: (i) the entity's net income with respect to the transaction or (ii) 75 percent of the proceeds received.

- 2) Tax on a tax-exempt entity **knowingly** participating in a prohibited tax shelter. If a tax-exempt entity knew or had reason to know that the transaction was a prohibited tax shelter transaction at the time the entity became a party to the transaction, then the tax is the greater of: (i) 100% of the entity's net income with respect to the transaction or (ii) 75 percent of the proceeds received.
- 3) Tax on the tax-exempt entity for nondisclosure. A tax-exempt entity that fails to comply with the disclosure requirements is subject to a tax of \$100 for each day during which such failure continues, not to exceed \$50,000.
- 4) Tax on managers approving an entity's participation in a prohibited tax shelter. Each manager that approves a tax-exempt entity's participation is subject to a tax of \$20,000 per approval.

Potential Consequences

As a result of the potential risk to tax-exempt entities and their managers, and given the lack of guidance, tax-exempt entities are assessing their continued participation in the LIHTC program. Some are concluding that the risk is too great to continue to participate. Others believe that the IRS will issue clarifying guidance that will allow them to continue to participate in LIHTC transactions. This belief that the IRS will issue clarifying guidance is based, in part, on the clear congressional intent that tax-exempt entities participate in the LIHTC program. This intent is demonstrated in many ways, including in IRC Section 42(h)(5), which mandates that at least 10 percent of each state's LIHTC allocation authority be made available for allocation to projects where "qualified non-profit organizations" materially participate in the

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project, and in the ability of not-for-profit organizations to purchase LIHTC projects after the compliance period for a minimum price that may be below the project's actual value.

Actions Needed

In response Notice 2006-65, the Affordable Housing Tax Credit Coalition and Novogradac & Company LLP both wrote comment letters to the IRS. Those letters strongly urged the IRS to issue guidance specifically exempting the LIHTC program from the provisions of IRC Section 4965 and the notice. Many other organizations also submitted comment letters requesting exemption for the LIHTC program, as well as other community development tax credits, namely the historic tax credit and new markets tax credit.

The IRS has not yet issued guidance on this topic, but we are hopeful that the current cloud of

uncertainty hanging over the industry can be resolved favorably in the near future. According to the *BNA Daily Tax Report*, IRS chief counsel Donald Korb on Oct. 24 told the audience at the Tax Executives Institute Inc.'s annual conference that the IRS was working to issue guidance "soon" on limiting the required tax shelter disclosures. Such rules may limit the definition of "contractual protection", thereby reducing the risk of an excise tax on tax-exempt entities participating in LIHTC transactions.

Until guidance is issued, tax-exempt entities should be certain to develop a policy as to how they will respond to the uncertainty that exists today. They should also discuss these rules with their LIHTC partners and should inquire as to whether their LIHTC partners are reporting the transactions to the IRS as "reportable transactions." ❖