August 11, 2006

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The Honorable Eric Solomon
Acting Deputy Assistant Secretary (Tax Policy)
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W
Washington, D.C. 20220

Ms. Galina Kolomietz
Office of Division Counsel
Associate Chief Counsel
Tax-Exempt and Government Entities
Internal Revenue Service
Washington, DC 20044

Re: Notice 2006-65 (Excise Taxes with respect to Prohibited Tax Shelter Transactions to which Tax-Exempt Entities are Parties and Related Disclosure Requirements)

Dear Mr. Solomon and Ms. Kolomietz:

On behalf of the Affordable Housing Tax Credit Coalition, I am pleased to respond to the Internal Revenue Service ("IRS") and Department of Treasury's request for comments presented in Notice 2006-65, 2006-31 I.R.B. 102, regarding the new Internal Revenue Code Section[1] 4965 and the amendments to Sections 6011(g), 6033(a)(2) and 6652(c)(3). The Affordable Housing Tax Credit Coalition is a trade association, based in Washington, DC, that has since 1988 represented the interests of most of the major participants in the low-income housing tax credit industry. Its members include housing credit syndicators, investors, developers, lenders, attorneys and accounting firms who practice extensively in this area.

[1] All Section references are to the Internal Revenue Code of 1986 ("Code"), unless otherwise noted.

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The Affordable Housing Tax Credit Coalition requests the IRS and Treasury publish guidance with respect to Section 4965 clarifying that the intent of the new Code section is not to dissuade or otherwise preclude the participation of tax-exempt entities in Congressionally-sanctioned programs, such as the Section 42 Low Income Housing Tax Credit (LIHTC). Without such guidance it is entirely possible that many tax-exempt entities that currently participate in LIHTC transactions would opt not to do so based on the possibility that their participation could lead to an excise tax liability of all of their net income generated by their participation in the creation or renovation of housing for low-income persons.

Legislative Background

The *American Jobs Creation Act of 2004* ("AJCA"), enacted on October 22, 2004, as Public Law 108-357, created a new penalty for any taxpayer who fails to include required information with respect to "reportable transactions." Section 6707A(c) provides that reportable transactions are transactions described under regulations prescribed under Section 6011, which regulations have been modified by IRS Notice 2006-6[2] and such transactions include: listed transactions; confidential transactions; transactions with contractual protection; loss transactions; and transactions involving a brief asset holding period. A transaction with contractual protection is defined as any transaction for which (1) the taxpayer has the right to full or partial refund of fees if the intended consequences from the transaction are not sustained, or (2) the fees are contingent on the intended tax consequences from the transactions being sustained.[3]

The *Tax Increase Prevention and Reconciliation Act of 2005* ("TIPRA"), enacted on May 17, 2006, as Public Law 109-222, established Section 4965 and amended Sections 6011, 6033 and 6652. In general, Section 4965 imposes an excise tax on certain tax-exempt entities that enter into "prohibited tax shelter transactions" (and managers of such entities that approve the entity's participation in the transaction). A prohibited tax shelter is a transaction that the Secretary of the Treasury determines is a listed transaction (as defined in Section 6707A(c)(2)) or "prohibited reportable transaction." A "prohibited reportable transaction" is either a confidential transaction or a transaction with contractual protection which is a reportable transaction (as defined in Section 6707A(c)(1)). Section 4965 defines applicable tax-exempt entities as those entities defined in Sections 501(c), 501(d) and 170(c) (not including the United States), and Indian tribal governments, tax qualified pension plans, individual retirement accounts, and similar tax-favored savings arrangements.

Under Section 4965, if a tax-exempt entity is party to a transaction during a taxable year and knows that the transaction is a prohibited tax shelter transaction at the time of the transaction, then the entity is subject to an excise tax for such year equal to the greater of: (1) 100 percent of the entity's net income with respect to the transaction (after taking into account any other applicable taxes with respect to such transaction) or (2) 75 percent of the proceeds received by the entity for the taxable year that are attributable to such transaction. If the tax-exempt entity is party to a transaction during the taxable year and did not know that the transaction is a prohibited tax shelter at the time the entity became party to the

[2] 2006-1 I.R.B. 413.
[3] Treas. Regs. Sec. 1.6011-4(b)(4).

transaction, the tax is the highest unrelated business taxable income rates (as defined in Section 11), which is under present law equal to 35 percent, multiplied by the greater of: (1) the entity's net income with respect to the prohibited tax shelter transaction (after taking into account any other applicable taxes with respect to such transaction) or (2) 75 percent of the proceeds received by the entity for the taxable year that are attributable to such transaction. Further, Section 4965 imposes a tax of $20,000 on any entity manager (as defined by Section 4965(d)) that approves or otherwise causes a tax-exempt entity to be a party to a prohibited tax shelter transaction at any time during the taxable year.

Under the amendment to Section 6011, any taxable party to a prohibited tax shelter transaction is required to disclose to any tax-exempt entity which is a party to such transaction that such transaction is such a prohibited tax shelter transaction.

Under the amendment to Section 6033, every tax-exempt entity that is a party to a prohibited tax shelter transaction is required to disclose to the IRS that the entity is party to such transaction and to disclose the identity of any other party to such transaction which is known by such tax-exempt entity.

Under the amendment to Section 6652, a penalty for the failure to comply with Section 6033 is established. The amount of the penalty is $100 for each day during which noncompliance occurs, with the total penalty not to exceed $50,000 with respect to any one disclosure. Section 6652 also authorizes the Secretary of the Treasury to make a written demand on any entity or manager subject to the penalty specifying a reasonable future date for required disclosure. Failure to comply with the Secretary's demand is subject to an additional penalty of $100 per day, with the total penalty not to exceed $10,000 with respect to any one disclosure.

Section 4965 is effective for taxable years ending after May 17, 2006, with respect to transactions before, on, or after May 17, 2006, except that no tax shall apply with respect to income or proceeds that are properly allocable to any period ending on or before August 15, 2006. The tax on knowing transactions does not apply to any prohibited tax shelter transaction to which a tax-exempt entity became a party on or before May 17, 2006. The disclosure provisions of Sections 6033 and 6652 apply to disclosures the due date for which are after May 17, 2006.

Regulatory Background

Revenue Procedure 2004-65[4] exempts certain transactions with contractual protection from the disclosure rules under Regulations Section 1.6011-4(b)(4). The Revenue Procedure notes that Regulations Section 1.6011-4(b)(8)(i) provides that a transaction will not be considered a reportable transaction, or will be excluded from any individual category of reportable transaction, if the Commissioner makes a determination by published guidance that the transaction is not subject to the reporting requirements of Regulations Section 1.6011-4. The Revenue Procedure concludes that transactions in which the refundable or contingent fee is related to the Section 51 Work Opportunity Credit, the Section 51A

[4] 2004-2 C.B. 965.

Welfare-to-Work Credit or the Section 45A(a) Indian employment credit are not to be taken into account in determining whether a transaction is a transaction with contractual protection.

On April 25, 2006,[5] the IRS published an internal memorandum with the subject of Low Income Housing Tax Credit Limited Partnerships. The memorandum provides criteria for processing applications for tax-exempt status for entities seeking to participate as a general partner in a Section 42 LIHTC limited partnership. The memorandum identifies a number of factors that may be used to ease the tax-exempt application process, though not necessary conditions for tax-exempt eligibility. Among the factors listed is factor 5(d), which focuses on "tax credit adjusters":

> If the formative documents require the applicant to make a payment to the investors in the event of a reduction in the amount of tax credits received by the LP or LLC (other than any reductions to the investor's capital contributions required under the agreement) from the amount expected at the time the agreement is signed, the agreement must limit the payments in one or more of the following ways:
>
> > (1) Where the formative documents include separate tax credit adjuster provisions due to (i) a permanent reduction in tax credits, (ii) a timing difference in tax credits where the projected tax credits for the first year must be delayed and taken in a later year(s), and/or (iii) ongoing shortfalls or credit recapture, limit payment under each separate adjuster provision to an amount that does not exceed the aggregate amount of developer and other fees (both payable and deferred) that the applicant (or any affiliate) is entitled to receive in connection with the project.
> >
> > (2) Provide that payments by the applicant will be treated as a capital contribution to the entity or as a loan, which shall take priority over any other distribution of residual assets to partners upon sale or refinancing of the property.

Discussion

Congress encourages the participation of tax-exempt entities in Section 42 LIHTC transactions. For example, in Section 42(h)(5) Congress mandates at least 10% of each state's LIHTC allocation authority be available for allocation to projects where "qualified nonprofit organizations" materially participate in the project.[6] In addition, each state's LIHTC allocation agency is permitted to create preferences for projects that involve

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[5] The April 25, 2006, Memorandum is from Joseph Urban, Acting Director, EO Rulings and Agreements, and it is to the Manager, EO Determinations (the "Urban Memorandum").

[6] Section 42(h)(5)(C) defines a qualified nonprofit organization as any organization if (i) such organization is described in Section 501(c)(3) or (4) and is exempt from tax under Section 501(a), (ii) such organization is determined by the State housing credit agency not to be affiliated with or controlled by a for-profit organization; and (iii) one of the exempt purposes of such organization includes the fostering of low-income housing.

significant non-profit participation. Moreover, nonprofit organizations are permitted the benefit of purchasing LIHTC projects after their compliance period for a minimum price that may be below the project's value.

As illustrated by the Urban Memorandum, it is established business practice for Section 42 LIHTC partnership agreements to contain tax credit adjuster clauses. Although the tax credits themselves provide an incentive for investors to invest in high-risk investments, tax credit adjusters are also necessary in order to provide the investor with the comfort that it is only paying for what will ultimately be delivered.

The codification of the broad set of rules under Section 4965, if applicable to Section 42 LIHTC transactions, appears to be contrary to Congress' more focused affirmative rules sanctioning and encouraging non-profit participation in the Section 42 LIHTC, especially since there is no legislative history to establish the existence of any Congressional concern regarding the participation of tax-exempt entities in such transactions. In addition, one feature of the Section 42 LIHTC program is the substantial oversight and monitoring conducted by state housing credit agencies, which provides assurances that the project sponsors are developing and operating these properties in a manner which satisfies Congressional intent and broad public policy goals for the provision of affordable housing for low-income households. In fact, the same argument likely could be made for other tax credit programs that are participated in significantly by tax-exempt entities, such as the New Markets Tax Credit program under Section 45D and the Historic Rehabilitation Tax Credit program under Section 47. In fact, each of these programs have, aside from the IRS, significant compliance oversight (Section 42 – state agencies, Section 45D – CDFI Fund of the Treasury Department, Section 47 – National Park Service).

Although it is not entirely clear whether transactions that include "tax credit adjuster provisions" (as described in the Urban Memorandum) are transactions with contractual protection, it is clear that the level of participation by tax-exempt entities in even the most plain-vanilla Section 42 LIHTC transactions will be significantly diminished if there is not guidance published in the immediate future providing that Section 42 LIHTC transactions are not prohibited reportable transactions or transactions with contractual protection.

Due to the lack of clarity regarding whether the tax credit adjuster provisions give rise to obligations to file Forms 8886, Reportable Transaction Disclosure Statement, many participants in Section 42 LITHC transactions have filed protective Forms 8886 to ensure compliance with the changes to Section 6011 made by AJCA. This, however, is not a palatable option under Section 4965, as the excise tax is imposed merely by participation in the transaction.

Moreover, other business structures common in the Section 42 LIHTC industry may be regarded as amounting to contractual protection. Some, although not all, syndication firms, provide a guarantee to their investors if some or all of the expected tax benefits are not realized (these are commonly referred to as "Guaranteed Fund" transactions). Under Section 4965, the mere participation by a tax-exempt entity in such a Guaranteed Fund transaction could be regarded as one providing contractual protection even though it is not the exempt

entity providing the guarantee. This would make it impossible for tax-exempt entities to become involved in transactions in which the syndicator provides a guarantee, thus removing this investment option from consideration by both syndicators, who may wish to invest in such worthy projects, and by project sponsors who are exempt organizations, who may otherwise find the best transaction terms in a given situation to be offered in a Guaranteed Fund.

Congress creates tax incentives to stimulate investments that would otherwise not be made. In fact, with regard to transactions involving the Section 42 LIHTC, Treasury and the IRS have acknowledged the high level of risk associated with the program and promulgated Regulations Section 1.42-4(a), expressly providing that the otherwise requisite profit motive for a transaction, under Section 183, is not applicable to disallow losses, deductions or credits attributable to the ownership and operation of a low-income housing project. Thus, investors in Section 42 LIHTC transactions may base their investment decision solely upon the projected tax benefits.

Policy Recommendation

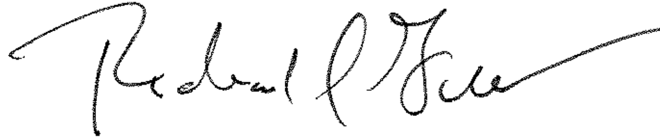
The Affordable Housing Tax Credit Coalition recommends that the IRS and Treasury, in addition to providing guidance regarding the application of Section 4965, provide a list of transactions, such as Section 42 LIHTC transactions, that are not transactions with contractual protection or otherwise reportable transactions. Our recommendation is for such guidance to be published imminently in the form of either a revenue procedure, similar to Revenue Procedures 2004-65, 2004-66,[7] 2004-67,[8] and 2004-68,[9] or a notice, similar to Notices 2004-67,[10] 2006-6 and 2006-16,[11] and later to incorporate a comprehensive list of permissible transactions in the form of a regulation. In addition, we believe that similar exemptions should be provided for Section 45D New Markets Tax Credit transactions and Section 47 Historic Rehabilitation Tax Credit transactions. In transactions utilizing the tax credits under Sections 45D and 47, nonprofit involvement is accounted for. Indeed, in the new markets tax credit transactions, nonprofit entities which are Community Development Entities have been allocated a significant amount of the national credit allocations.

Further, while the IRS and Treasury are considering how to apply the rules under Section 4965, we respectfully request the issuance of interim guidance pursuant to the regulatory authority under Section 4965(f) providing that the rules under Section 4965 will not be applied to net income or proceeds allocated to or received by a tax-exempt entity until temporary regulations are issued.

[7] 2004-2 C.B. 966.
[8] 2004-2 C.B. 967.
[9] 2004-2 C.B. 969.
[10] 2004-2 C.B. 600.
[11] 2006-9 I.R.B. 538.

If you have any questions or would like to discuss further our comments, please contact the undersigned at 202-585-8730.

Sincerely,



Richard S. Goldstein
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cc:
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