

Part III. Administrative, Procedural, and Miscellaneous

Definition of Party and Allocation of Net Income or Proceeds for Purposes of Section 4965

Notice 2007-18

I Purpose

This notice provides guidance under section 4965 of the Internal Revenue Code (“Code”) to tax-exempt entities described in section 4965(c) that may be parties to prohibited tax shelter transactions. This notice also provides guidance to tax-exempt entities described in sections 4965(c)(1), (2), and (3) (referred to herein as Non-Plan Entities) subject to tax under section 4965(a) regarding the allocation to various periods of net income or proceeds attributable to a prohibited tax shelter transaction. In particular, this notice responds to written comments requesting guidance regarding the definition of the term “party to a prohibited tax shelter transaction” for purposes of section 4965 and related disclosure provisions and regarding the appropriate treatment of net income or proceeds received prior to the effective date of the section 4965(a) tax.

II Background

The Tax Increase Prevention and Reconciliation Act of 2005 (“TIPRA”), Pub. L. No. 109-222, 120 Stat. 345, enacted on May 17, 2006, designates certain transactions as prohibited tax shelter transactions and includes new entity-level and manager-level excise taxes and disclosure rules applicable to prohibited tax shelter transactions to which a tax-exempt entity is a party. TIPRA creates new section 4965 and amends sections 6033(a)(2), 6011(g), and 6652(c)(3) of the Code.

A. Imposition of Excise Tax on Certain Tax-Exempt Entities

Section 4965(a) requires Non-Plan Entities to pay an excise tax “for the taxable year in which the entity becomes [a party to a prohibited tax shelter transaction] and any subsequent taxable year in the amount determined under [section 4965(b)].” Non-Plan Entities include those entities

described in section 4965(c)(1) through (3) — *i.e.*, entities described in section 501(c), 501(d), section 170(c) (other than the United States), and Indian tribal governments (within the meaning of section 7701(a)(40)). Section 4965(e)(1) defines the term “prohibited tax shelter transaction” to mean (1) “any listed transaction,” and (2) “any prohibited reportable transaction.” A “listed transaction” is defined by cross-reference to section 6707A(c)(2). A “prohibited reportable transaction” means any confidential transaction under Treas. Reg. § 1.6011-4(b)(3) or any transaction with contractual protection under Treas. Reg. § 1.6011-4(b)(4) which is a reportable transaction as defined by section 6707A(c)(1). Pursuant to Revenue Procedure 2007-20, 2007-7 I.R.B. 517 (Feb. 2, 2007), transactions in which the refundable or contingent fee is related to tax credits under sections 42 and 45D of the Code will not be treated as reportable transactions for purposes of Treas. Reg. § 1.6011-4(b)(4) and, thus, will not be subject to section 4965.

B. General Computation Rule

Section 4965(b)(1) provides that, for a transaction other than a “subsequently listed transaction” as defined in section 4965(e)(2), the amount of the excise tax imposed on the Non-Plan Entity is computed based on the greater of (1) the entity’s net income “for the taxable year” attributable to the transaction or (2) 75 percent of the proceeds “received by the entity for the taxable year” which are attributable to the transaction.

C. Computation Rule for Subsequently Listed Transactions

Section 4965(e)(2) defines the term “subsequently listed transaction” as any transaction to which a tax-exempt entity is a party and which is determined by the Secretary to be a listed transaction at any time after the entity has become a party to the transaction, provided, however, that the transaction was not a prohibited reportable transaction at the time the entity became a party to the transaction.

Section 4965(b)(1) provides that, for a subsequently listed transaction, the

amount of the excise tax is based on the greater of (1) the entity’s net income for the taxable year which is attributable to the prohibited tax shelter transaction and is “properly allocable” to the period beginning on the later of the date the transaction is identified as a listed transaction or the first day of the taxable year, or (2) 75 percent of the proceeds received by the entity for the taxable year which are attributable to the prohibited tax shelter transaction and which are “properly allocable” to the period beginning on the later of the date the transaction is identified as a listed transaction or the first day of the taxable year.

D. Effective Date

Section 516(d) of TIPRA provides that section 4965 generally applies to taxable years ending after the date of enactment with respect to transactions entered into before, on, or after that date. However, “no tax under section 4965(a) . . . 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 the date of enactment.” The 90th day after the date of enactment was August 15, 2006.

Section 4965(f) authorizes the Secretary to promulgate regulations providing guidance “regarding the determination of the allocation of net income or proceeds of a tax-exempt entity attributable to a transaction to various periods, including before and after the listing of the transaction or the date which is 90 days after the date of the enactment of this section.”

On July 11, 2006, the Internal Revenue Service (“Service”) released Notice 2006-65, 2006-31 I.R.B. 102, which alerted taxpayers to the new provisions and solicited comments regarding these provisions. The Service received numerous written comments in response to Notice 2006-65. Many of the comments requested guidance regarding the circumstances under which a tax-exempt entity will be considered a “party” to a prohibited tax shelter transaction, as well as how the Service intends to exercise its allocation authority under section 4965(f), particularly with respect to transactions entered into prior to the enactment of section 4965.

The Service and the Treasury Department intend to issue further guidance under section 4965 and the related statutory provisions. Pending the issuance of further guidance, taxpayers may rely upon the guidance in this notice.

III Definition of Party

A. In General

For purposes of sections 4965, 6033(a)(2) and 6011(g), a tax-exempt entity is a party to a transaction if it (1) facilitates the transaction by reason of its tax-exempt, tax indifferent or tax-favored status; or (2) is identified in published guidance, by type, class or role, as a party to a prohibited tax shelter transaction.

Published guidance may identify which tax-exempt entities, by type, class or role, will not be treated as a party to a prohibited tax shelter transaction for purposes of sections 4965, 6033(a)(2) and 6011(g).

B. Examples

Example 1. A tax-exempt entity enters into a transaction ("Transaction A") with an S corporation. Transaction A is the same as or substantially similar to the transaction identified by the Secretary as a listed transaction in Notice 2004-30, 2004-1 C.B. 828. The tax-exempt entity's role in Transaction A is similar to the role of the exempt party, as described in Notice 2004-30. The tax-exempt entity purportedly receives the S corporation stock and, due to the tax-exempt entity's tax-exempt status, aids the S corporation and its shareholders in avoiding taxable income. The tax-exempt entity facilitates Transaction A by reason of its tax-exempt, tax indifferent or tax-favored status. Accordingly, the tax-exempt entity is a party to Transaction A for purposes of sections 4965, 6033(a)(2) and 6011(g).

Example 2. A tax-exempt entity is a partner in a partnership. The partnership has a number of other taxable and tax-exempt partners. The partnership enters into a number of transactions, including a transaction ("Transaction B") which is the same as or substantially similar to the transaction identified by the Secretary as a listed transaction in Notice 2002-35, 2002-1 C.B. 992 (as clarified and modified by Notice 2006-16, 2006-9 I.R.B. 538). The partnership participates in Transaction B in a role similar to the role of T, as described in Notice 2002-35, *i.e.*, the role of the taxpayer receiving the purported tax benefits from the transaction. The tax and economic consequences from Transaction B to the other partners are not dependent on the tax-exempt entity's tax-exempt, tax indifferent or tax-favored status. Accordingly, the tax-exempt entity does not facilitate Transaction B by reason of its tax-exempt, tax indifferent or tax-favored status. The tax-exempt entity also has not been identified, by type, class or role, as a party to a prohibited tax shelter transaction in published

guidance. Therefore, the tax-exempt entity is not a party to Transaction B for purposes of sections 4965, 6033(a)(2) and 6011(g).

The IRS and Treasury Department recognize that "party" as used in section 4965 applies more broadly than the term is defined for purposes of this interim notice. Accordingly, the IRS and Treasury Department will propose regulations that will define "party" under section 4965 to include a tax-exempt entity that enters into a prohibited tax shelter transaction that reduces such entity's liability for applicable Federal taxes (*i.e.*, employment taxes, excise taxes, and in appropriate cases unrelated business income tax).

IV Net Income and Proceeds

A. In general

For purposes of section 4965(a), the amount and the timing of the net income and proceeds attributable to the prohibited tax shelter transaction will be computed in a manner consistent with the substance of the transaction. In determining the substance of listed transactions, the Service will look to, among other items, the listing guidance and any subsequent published guidance relating to the transaction.

B. Allocation of net income / proceeds to a taxable year

In general, for purposes of section 4965(a), the net income and proceeds attributable to a prohibited tax shelter transaction must be allocated to a particular taxable year in a manner consistent with the Non-Plan Entity's established method of accounting for Federal income tax purposes. If the Non-Plan Entity has not established a method of accounting for Federal income tax purposes, the Non-Plan Entity must use the cash receipts and disbursements method of accounting ("cash method") provided for in section 446 of the Code to determine the amount and timing of net income and proceeds attributable to a prohibited tax shelter transaction solely for purposes of section 4965(a). If a Non-Plan Entity has established a method of accounting other than the cash method, the Non-Plan Entity may nevertheless use the cash method of accounting to determine the amount of the

net income and proceeds attributable to a prohibited tax shelter transaction entered into prior to the date of enactment of section 4965 and allocable to pre- and post-enactment periods.

If a Non-Plan Entity has not established a taxable year for Federal income tax purposes, the entity's taxable year for the purpose of determining the amount and timing of net income and proceeds attributable to a prohibited tax shelter transaction will be deemed to be the annual period the entity has used in keeping its books and records.

Any net income or proceeds attributable to a prohibited tax shelter transaction allocated to a taxable year ending on or before August 15, 2006 under this section IV, will not be subject to the excise tax imposed by section 4965(a).

C. Examples

Example 3. In 1999, X, a calendar year Non-Plan Entity using the cash method of accounting, entered into a lease-in/lease-out transaction ("LILO") substantially similar to the transaction described in Notice 2000-15, 2000-1 C.B. 826 (describing Rev. Rul. 99-14, 1999-1 C.B. 835, superseded by Rev. Rul. 2002-69, 2002-2 C.B. 760). In 1999, X purported to lease property to Y pursuant to a "head lease," and Y purported to lease the property back to X pursuant to a "sublease" of a shorter term. In form, X received \$268M as an advance payment of head lease rent. Of this amount, \$200M had been, in form, financed by a nonrecourse loan obtained by Y. X deposited the \$200M with a "debt payment undertaker." This served to defease both a portion of X's rent obligation under its sublease and Y's repayment obligation under the nonrecourse loan. Of the remainder of the \$268M advance head lease rent payment, X deposited \$54M with an "equity payment undertaker." This served to defease the remainder of X's rent obligation under the sublease. This amount inures to the benefit of Y and enables Y to recover its investment in the transaction and a return on that investment. In substance, the \$54M is a loan from Y to X. X retained the remaining \$14M of the advance head lease rent payment. In substance, this represents an accommodation fee for X's participation in the transaction.

According to the substance of the transaction, the head lease, sublease and nonrecourse debt will be ignored for Federal income tax purposes. Therefore, any net income or proceeds resulting from these elements of the transaction will not be considered net income or proceeds attributable to the LILO transaction for purposes of section 4965(a).

Under X's established cash basis method of accounting, any net income and proceeds received in 1999 and attributable to the LILO transaction are allocated to X's December 31, 1999, tax year for purposes of section 4965. Because the 1999 tax year is before the effective date of TIPRA, X will not be subject to any excise tax under section 4965 for the amounts received in 1999.

D. Special rule relating to taxable years that include August 16, 2006

In the case of the taxable year that includes August 16, 2006 (“the transition year”), the Service will treat the period beginning on the first day of the transition year and ending on August 15, 2006, and the period beginning on August 16, 2006, and ending on the last day of the transition year as short taxable years. This treatment is solely for purposes of allocating net income or proceeds under section 4965, and the Non-Plan Entity does not file tax returns with respect to these short taxable years or otherwise take the short taxable year into account for Federal tax purposes. Accordingly, the net income or proceeds that are properly allocated to the transition year in accordance with this section IV will be treated as follows:

- as allocable to the period ending on or before August 15, 2006, (and accordingly not subject to tax under section 4965(a)) to the extent such net income or proceeds would have been properly taken into account in accordance with this section IV by the Non-Plan Entity in the deemed short year ending on August 15, 2006; and
- as allocable to the period beginning after August 15, 2006, (and accordingly subject to tax under section 4965(a)) to the extent such net income or proceeds would have been properly taken into account in accordance with this section IV by the Non-Plan Entity in the short year beginning August 16, 2006.

Example 4. B, a Non-Plan Entity using the cash method of accounting, has an annual accounting period that ends on December 31, 2006. B became a party to a prohibited tax shelter transaction on March 15, 2006. On that date, B received a payment of \$600,000 as an accommodation fee for its involvement in the transaction. B received no other proceeds or income attributable to this transaction in 2006. Under B’s method of accounting, the payment received by B on March 15, 2006, is taken into account in the deemed short year ending on August 15, 2006. Accordingly, solely for purposes of section 4965, the payment is treated as allocable solely to a period ending on or before August 15, 2006, and is not subject to the excise tax imposed by section 4965(a).

Example 5. The facts are the same as in Example 4, above, except that B received an additional payment of \$400,000 on September 30, 2006. Under B’s method of accounting, the payment received by B on September 30, 2006, is taken into account in

the deemed short year beginning on August 16, 2006. Accordingly, solely for purposes of section 4965, the payment is treated as allocable to a period beginning after August 15, 2006, and is subject to the excise tax imposed by section 4965(a).

V Request For Comments

The Service anticipates issuing further guidance under section 4965 and related statutory provisions and invites comments from the public regarding all aspects of these provisions and, in particular, regarding the definition of the term “party to a prohibited tax shelter transaction” for purposes of section 4965 and related disclosure provisions, the appropriate method for allocating net income or proceeds (including, specifically, with respect to governments) to various periods, including pre- and post-listing periods for subsequently listed transactions, and the definition of the term “proceeds” for section 4965 purposes. Written comments should be submitted by March 23, 2007. Send submissions to: CC:PA:LPD:PR (Notice 2007–18), Room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (Notice 2007–18), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically to notice.comments@irs.counsel.treas.gov (Notice 2007–18).

VI Drafting Information

The principal author of this notice is Galina Kolomietz of the Office of Division Counsel/Associate Chief Counsel (Tax-Exempt and Government Entities). For further information regarding this notice, contact Ms. Kolomietz at (202) 622–6070 (not a toll-free call).

Weighted Average Interest Rates Update

Notice 2007–20

This notice provides guidance as to the corporate bond weighted average interest

rate and the permissible range of interest rates specified under § 412(b)(5)(B)(ii)(II) of the Internal Revenue Code. In addition, it provides guidance as to the interest rate on 30-year Treasury securities under § 417(e)(3)(A)(ii)(II).

CORPORATE BOND WEIGHTED AVERAGE INTEREST RATE

Sections 412(b)(5)(B)(ii) and 412(l)(7)(C)(i), as amended by the Pension Funding Equity Act of 2004 and by the Pension Protection Act of 2006, provide that the interest rates used to calculate current liability and to determine the required contribution under § 412(l) for plan years beginning in 2004 through 2007 must be within a permissible range based on the weighted average of the rates of interest on amounts invested conservatively in long term investment grade corporate bonds during the 4-year period ending on the last day before the beginning of the plan year.

Notice 2004–34, 2004–1 C.B. 848, provides guidelines for determining the corporate bond weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability. That notice establishes that the corporate bond weighted average is based on the monthly composite corporate bond rate derived from designated corporate bond indices. The methodology for determining the monthly composite corporate bond rate as set forth in Notice 2004–34 continues to apply in determining that rate. See Notice 2006–75, 2006–36 I.R.B. 366.

The composite corporate bond rate for January 2007 is 5.89 percent. Pursuant to Notice 2004–34, the Service has determined this rate as the average of the monthly yields for the included corporate bond indices for that month.

The following corporate bond weighted average interest rate was determined for plan years beginning in the month shown below.