June 7, 2005

The Honorable Charles E. Grassley
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Max S. Baucus
Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable William M. Thomas
Chairman
House Committee on Ways and Means
2208 Rayburn Office Building
Washington, DC 20515

The Honorable Charles B. Rangel
Ranking Member
House Committee on Ways and Means
2354 Rayburn Office Building
Washington, DC 20515

Re: Section 470 of the Internal Revenue Code

Gentlemen:

I am writing on behalf of the Section of Taxation of the American Bar Association concerning Section 470 of the Internal Revenue Code. The views expressed in this letter represent the position of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.1

Executive Summary

Section 470 is a loss deferral provision that was enacted as part of the American Jobs Creation Act of 2004 (P.L. 108-357, the “Act”).2 Section 470 was primarily designed to address concerns with certain sale-leaseback (“SILO”) transactions the Government considers abusive.3 These transactions typically involve a sale of property (such as a subway system) by a tax-exempt entity (such as a municipal transit authority) to a taxable entity, that, in turn, leases the property back to the tax-exempt entity. The

1 These comments were prepared by individual members of the Real Estate Committee and the Partnerships & LLCs Committee of the Section of Taxation, with input from individual members of the Capital Recovery and Leasing Committee. Principal responsibility was exercised by Jim Sowell, Carol Kulish, and Patrick Browne. Substantive comments were received from David Benz, Richard Blumenreich, Steve Frost, Eric Sloan, and David Weisblat. The comments were reviewed by Robert Liles of the Section’s Committee on Government Submissions and by Fred Witt, Council Director for the Committees on Partnerships & LLCs and Real Estate.

2 Unless otherwise noted, all “section” references are to the Internal Revenue Code of 1986, as amended (the “Code”), and all “Treas. Reg. §” references are to the Treasury regulations promulgated thereunder.

3 See H.R. REP. NO. 108-548, pt. 1, at 313 (2004) (the “House Report”). All references in these comments to the term “SILO transaction” are intended to be references to the type of leasing transaction that the Government considers to be abusive. These comments, however, do not address the merits of the Government’s arguments with regard to SILO transactions and no inference should be drawn as to our views with respect to such arguments or such transactions. Instead, these comments focus solely on issues relating to the application of section 470 to pass thru entities because of the application of section 168(h)(6) (discussed in detail in text infra).
taxable entity benefits from the cost recovery deductions associated with the property, while the tax-exempt entity typically receives an implicit fee for participating in the arrangement and continues to control the operation of the property. 4

As is explained in greater detail below, section 470 suspends the deduction of losses related to “tax-exempt use property” in excess of the income or gain from that property. “Tax-exempt use property” includes property that is leased to a tax-exempt entity. Importantly, however, as a result of the application of section 168(h)(6), 5 tax-exempt use property also includes property (whether or not leased) owned by a partnership that (1) has as partners both taxable and tax-exempt entities (including foreign persons) and (2) makes allocations to the tax-exempt partners that are “non-qualified.” As a result, a partnership that has a combination of taxable and tax-exempt (including foreign) partners and that makes nonqualified allocations is potentially subject to section 470, even if the partnership does not lease any property and even if the partnership is not engaged in a SILO-like transaction. 6 Section 470 also can apply if a tax-exempt entity (other than a foreign person) holds its partnership interest indirectly through a “blocker” entity, such as a corporation that is subject to U.S. taxation. 7

The statutory language, effective date (leases entered into after March 12, 2004), and legislative history of section 470 all focus on leasing transactions. The legislative history of the Act does not contain any discussion as to why section 470 was extended to partnerships that are not engaged in the kind of leasing transactions the Government considered abusive, what the intended scope of section 470 with respect to partnerships and other pass-thru entities is, or how the rules of section 470 are intended to apply to pass-thru entities. 8 Thus, as is explained below, there are many unanswered questions as to how section 470 applies to pass-thru entities.

Based on informal discussions with legislative and administrative staffs, we understand that, in drafting section 470, the staffs were concerned that partnerships with both taxable and tax-exempt entities as partners could use special allocations to effect synthetic SILO transactions. We respect this concern and agree that it is appropriate for the Government to ensure that partnerships cannot be used so as to achieve indirectly the same economic result that the Government sought to prevent directly through leasing transactions. In fact, the detailed comments below describe how a partnership could be structured so as to replicate the economics of a SILO transaction and explain how rules could be applied to address this concern.

We are very concerned, however, that section 470, as currently drafted, could be interpreted far more broadly than necessary to achieve the Government’s “anti-SILO” objective. That is, as drafted, section 470 could be interpreted as fundamentally altering the tax rules by imposing a new loss deferral regime on partnerships and other pass-thru entities based solely on the characteristics of their owners and the kinds of allocations the entities make, without regard to whether the entities actually are engaged in the kinds of SILO transactions Congress considers to be abusive or are being used to replicate those transactions. Such an interpretation would affect many thousands of pass-thru entities across a range of industries that are not engaged in, and are not being used to replicate, the kinds of transactions that Congress considers abusive.

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4 In certain situations, the taxable entity in a SILO transaction also may benefit from being able to utilize interest expense deductions associated with the property. For more information on SILO transactions, see, Congressional Research Service, Tax Implications of SILOs, QTEs, and Other Leasing Transactions with Tax-Exempt Entities, Nov. 30, 2004 (2005 TNT 40-57) (the “CRS Report”).

5 A discussion of section 168(h)(6) is included in our Detailed Comments infra.

6 As discussed below, section 470 also may apply to certain other pass-thru entities, but the scope of the entities to which it may apply is unclear.

7 Blocker entities are more fully discussed below in Part II.B.2.d of our Detailed Comments.

8 As a result, many partnerships and other pass-thru entities (as well as the practitioners advising them) were not aware of the potential application of section 470 to pass-thru entities that are not engaged in SILO transactions at the time the Act passed. Indeed, it is quite possible that some pass-thru entities that are not engaged in SILO transactions remain unaware of the potential application of section 470’s loss deferral regime.
We do not believe that Congress intended for section 470 to apply so broadly. As is explained in our Detailed Comments, section 470 includes an exception to its application in the case of certain leasing transactions; the legislative history indicates that this exception was enacted so as not to “inhibit” legitimate commercial leasing transactions. It is unlikely that Congress chose not to inhibit certain leasing transactions that do not raise “SILO concerns,” but was comfortable with inhibiting partnership arrangements that similarly do not raise SILO concerns. Further, it is hard to imagine that Members of Congress would impose a burdensome new loss deferral regime on numerous businesses across a host of industries without clear notice and without any articulated reason.

Moreover, we do not believe it is wise as a matter of tax policy to use section 470 as a means to fundamentally alter the general tax rules regarding losses of pass-thru entities unless those entities are being used to replicate the kinds of SILO transactions that Congress considered abusive. Subchapter K already contains rules that are designed to ensure that allocations of losses have substantial economic effect. The passive activity loss rules of section 469 and the at-risk rules of section 465 also prevent partners from deducting losses in many circumstances. Thus, we do not believe it is necessary to impose a new loss deferral rule that applies broadly in “non-SILO” situations.

Further, if Congress were to consider making fundamental changes to the subchapter K rules, we respectfully recommend that such changes only be made after providing adequate notice and opportunity for public comment (e.g., through the hearing process). We do not believe that section 470 should be used as a “back door” way to fundamentally change these rules -- particularly when (as noted above) it is highly unlikely that Congress viewed section 470 as addressing issues more broad than SILO transactions. Thus, we strongly believe that section 470 ought to apply only to partnerships that are used to effect the results that section 470 was intended to prevent.

We recognize that limiting the application of section 470 to situations in which pass-thru entities engage in, or are used to replicate, the kinds of SILO transactions with which Congress was concerned may require legislation. Thus, the discussion below includes a suggestion for amending section 470. Nonetheless, we also recognize that the Internal Revenue Service (the “IRS”) and the Department of the Treasury (“Treasury”) have broad authority to interpret section 470 in a reasonable manner so as to carry out the section’s underlying purpose. Thus, if legislation appropriately narrowing the application of section 470 with respect to pass-thru entities is not enacted, we have recommended that the IRS and Treasury adopt rules that, to the fullest extent possible, limit the application of the loss deferral rules of section 470 to those pass-thru entities that are engaged in, or are being used to replicate, SILO transactions. Further, if narrowing legislation is not enacted or the IRS and Treasury do not take steps through regulations to significantly narrow the scope of section 470, administrative guidance will be needed on a myriad of issues relating to the application of the current version of section 470 to pass-thru entities.

9 See House Report, at 314 (in setting forth the reasons for proposing section 470, the House Ways and Means Committee explained that changes to present law were essential, “provided that such changes do not inhibit legitimate commercial leasing transactions that involve a significant and genuine transfer of the benefits and burdens of tax ownership between the taxpayer and the tax-exempt lessee”). See discussion in Part I.B.2 of our Detailed Comments, infra.

10 It also is worth noting that, if Congress had intended to fundamentally alter the subchapter K rules relating to loss allocations, such a change in all likelihood would have been included with the revenue provisions relating to partnerships, rather than being “buried” in the leasing provisions.

11 Treas. Reg. § 1.704-1(b)(2) addresses both whether an allocation has “economic effect” and whether the economic effect of such allocation is “substantial.” The regulatory rules are very lengthy and complex. Note, also, that Treas. Reg. § 1.701-2 contains general anti-abuse rules relating to partnerships and partnership transactions.

12 In fact, the staff of the Joint Committee on Taxation (the “JCT”) has included changing the rules relating to allocations of non-recourse deductions as one of its options to improve tax compliance and to reform tax expenditures. See JOINT COMMITTEE ON TAXATION, Options to Improve Tax Compliance and Reform Tax Expenditures (JCS-02-05), at 161-63 (Jan. 2005). Although these comments do not address the substance of the JCT staff’s option with respect to allocating non-recourse deductions, we believe that it is appropriate, as a matter of tax policy, for such proposals to be publicized such that taxpayers can be aware of them and have the opportunity to comment upon them and such that Congress have the opportunity to understand fully the implications of significant legislative changes.
In Notice 2005-29 (the “Notice”), the IRS stated that, for taxable years of partnerships (and other pass-thru entities described in section 168(h)(6)(E)) that began before January 1, 2005, it would not apply section 470 to disallow losses associated with property treated as tax-exempt use property solely as a result of the application of section 168(h)(6). We commend the IRS for issuing the Notice and permitting a temporary moratorium on the application of section 470 to such partnerships and other pass-thru entities. The Notice also requests comments on certain topics with respect to the application of section 470 when a partnership or other pass-thru entity is treated as holding tax-exempt use property because of the application of section 168(h)(6). We address those topics below.

Our discussion begins with background regarding the relevant law and an explanation of the various problems associated with using section 168(h)(6) as a touchstone in identifying pass-thru entities that are used in such a manner so as to give rise to SILO-like concerns. We then set forth our Alternative Approaches. Very briefly, our Alternative Approaches include that:

- Section 470 be amended so that it applies only with respect to those pass-thru entities that are engaged in, or are being used to replicate, the kind of SILO transactions that Congress intended to prevent. We have included two potential approaches for legislation in this regard.
- If such legislation is not enacted, IRS and Treasury exercise the broad regulatory authority granted in section 470(g) so as to limit the application of section 470, in the pass-thru entity context, to those pass-thru entities that are engaged in, or are being used to replicate, SILO transactions. We believe that this interpretation is consistent with the Congressional intent underlying section 470.
- Further, if legislation is not enacted, IRS and Treasury will need to provide guidance on numerous issues and problems associated with section 470 in the pass-thru entity context.

DETAILED COMMENTS

I. Background Regarding Law

Section 470 was enacted in order to address Congressional concerns with certain SILO transactions that Congress considered abusive. We first provide some general background information regarding SILO transactions. We then discuss the statutory provisions of section 470. As that discussion reveals, in order to understand how the rules of section 470 apply, it is necessary to understand the rules of certain other statutory provisions -- i.e., sections 168(h) and 7701(e).

A. SILO Transactions

Some of the publicized versions of SILO transactions that have taken place involve public transit systems. A typical transaction involves the sale by a municipal transit authority of subway cars to taxable entities and a subsequent lease of those cars back to the transit authority. The transit authority continues to use and operate the subway cars just as it had before the transaction. The taxable entities, however, benefit from a reduction in the present value of their tax liabilities because they can take depreciation deductions with respect to the subway cars (i.e., the present value of the reduction of tax because of the deductions would exceed the present value of the tax on the income received from the lease). Also, the transit authority receives significant fees for its participation in, or involvement with, the transaction.  

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14 Id. at 797.
15 See CRS Report at CRS-3.
After enactment of section 470, the IRS issued a notice describing two SILO transactions and indicating that those transactions (and substantially similar transactions) are “listed transactions.”¹⁶ In effect, this notice indicates that the IRS will challenge SILO transactions that took place prior to the effective date of section 470 based upon general principles of tax law (including that the taxable entity in a SILO transaction does not, in substance, own the leased property and, therefore, cannot claim tax benefits as the owner). The transactions described in this notice are long and very complex. Nonetheless, they appear to possess the following common characteristics:

1. continued “use” of the property by the tax-exempt entity;
2. the equivalent of a fee paid to the tax-exempt entity for engaging in the transaction;
3. significant tax benefits provided to the taxable entity;
4. limited (or no) economic substance with respect to the investment of the taxable entity (i.e., resulting, in large part, from the absence of any risk of loss for the taxable entity pursuant to the terms of the arrangement and the failure of the taxable entity to take on even credit risk for the tax-exempt entity by virtue of defeasance of the tax-exempt entity’s obligations); and
5. assurances that the tax-exempt entity ultimately will regain ownership of the property.¹⁷

As we discuss below, we believe that these factors can be viewed as hallmarks of the kind of leasing transaction with which Congress was concerned. We suggest that these hallmarks be used, to the extent possible, in determining the kinds of arrangements involving pass-thru entities to which section 470 will apply.

B. Section 470

1. In General

Section 470(a) generally provides that a “tax-exempt use loss” for a taxable year will not be allowed. Under section 470(b), any loss with respect to “tax-exempt use property” that is disallowed for a taxable year is treated as a deduction with respect to such property in the next taxable year. Thus, deferred deductions may be utilized in future years, but only to the extent that the property generates net income in those years. Section 470(e)(2) provides that rules similar to those of section 469(g) will apply if a taxpayer subsequently disposes of its entire interest in tax-exempt use property.¹⁸ Thus, under rules similar to the passive activity loss rules of section 469, the taxpayer generally will be able to deduct previously disallowed deductions and losses when it completely disposes of its interest in the property.

Section 470(c)(1) defines a “tax-exempt use loss” as, for any taxable year, the amount (if any) by which (A) the sum of the aggregate deductions¹⁹ (other than interest) directly allocable to “tax-exempt use property,”

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¹⁶ See Notice 2005-13, 2005-9 I.R.B. 630. A detailed discussion of Notice 2005-13 is beyond the scope of these comments. As such, these comments do not express any view regarding when a leasing transaction may or may not be “abusive.” See supra note 2.

¹⁷ Cf. Notice 2004-67, 2004-41 I.R.B. 600, 601 (setting forth “listed transactions” for purposes of Treas. Reg. §§ 1.6011-4(b)(2), 301.6111-2(b)(2), and 301.6112-1(b)(2) that include lease-in/lease-out (“LILO”) transactions that are the same as or substantially similar to the transactions described in Rev. Rul. 2002-69, 2002-2 C.B. 760, modifying and superseding Rev. Rul. 99-14, 1999-1 C.B. 835). The CRS Report explains that in a LILO transaction, a predecessor to a SILO transaction, a taxable entity purports to lease property from a tax-indifferent entity and then simultaneously purports to sublease such property back to the tax-indifferent entity. The tax-indifferent entity continues to enjoy the leased property as it did before the transaction, and the taxable entity defers its income tax liability by deducting rental payments, amortizing certain transaction costs, and possibly deducting interest payments. See CRS Report, at 8-10.

¹⁸ Section 470(c)(3) provides that section 470 applies before the application of section 469.

¹⁹ The legislative history of section 470 indicates that deductions related to a lease of tax-exempt use property include depreciation or amortization expense, maintenance expense, taxes, and the cost of acquiring an interest in, or lease of, property. See H.R. CONF. REP. NO. 108-755, at 644 n. 608 (2004) (the “Conference Report”). The legislative history of section 470, however, also provides that section 470 applies to any deduction directly allocable to any tax-exempt use property “and a proper share of other deductions that are not directly allocable to such property (e.g., interest expense not directly allocable, general overhead, etc.).” S. REP. NO. 108-192, at 199 n. 394 (2003) (the “Senate Report”). The applicable statutory language
plus the aggregate deductions for interest properly allocable to such property, exceeds (B) the aggregate income from such property. Section 470(c)(2) provides that the term “tax-exempt use property” has the meaning given to such term by section 168(h), with certain modifications; these modifications expand the section 470 definition of tax-exempt use property to include, among other things, certain specified intangible assets.\(^{20}\)

The section 168(h) definition of tax-exempt use property is discussed in detail below in Part I.C.3.a.i. Section 168(h)(1) generally defines tax-exempt use property as tangible property that is leased to a tax-exempt entity. Section 168(h)(6) indicates that the term also includes a portion of any property owned by a partnership that has both taxable and tax-exempt (including foreign) partners and that makes allocations to a tax-exempt partner that are not qualified allocations.

2. Exception for Certain Leases

Section 470(d) provides that section 470 does not apply to any “lease of property” that meets the following general requirements: (1) not more than an “allowable amount of funds” is subject to certain arrangements or set aside to satisfy the lessee’s obligations or options under the lease; (2) the lessor makes a substantial equity investment in the leased property; (3) the lessee does not bear more than a minimal risk of loss with respect to the leased property; and, (4) if the lessee has the option to purchase the property, there is a fair market value purchase price (determined at the time of exercise) for certain property with a class life of more than seven years.\(^{21}\) The legislative history of section 470 indicates that Congress excluded leases that meet these requirements from the application of section 470 because it concluded that these leases did not create SILO concerns, and it did not want to “inhibit” legitimate commercial transactions.\(^{22}\)

Notably, section 470 does not provide any exception to the application of section 470 in situations in which partnerships are considered to have tax-exempt use property solely by virtue of section 168(h)(6) (i.e., because they have both taxable and tax-exempt partners and make allocations to tax-exempt partners that are not qualified). The absence of any exception creates a paradoxical situation in which leasing transactions, in effect, are treated more favorably than partnership arrangements -- even though it was Congressional concern with leasing transactions that led to the enactment of section 470. That is, even though section 470 includes an exception for certain “non-abusive” leases, it does not include any exceptions for situations in which partnerships are not involved in any “abusive” leasing activity and are not otherwise being used to replicate SILO transactions, but instead are subject to section 470 merely because of the characteristics of their partners and of their allocations. The exception of section 470(d) and the legislative history, however, clearly indicate that Congress did not intend to inhibit legitimate commercial transactions. Thus, we do not believe that Congress intended to impose a new loss deferral regime on partnerships that are not engaged in, or being used to replicate, SILO transactions, any more so than it intended to impose such rules on legitimate commercial leasing transactions.

3. Regulatory Authority

set forth in the 2003 Jumpstart Our Business Strength (JOBS) Act, to which the Senate Report relates, is the same as the relevant language set forth in the Act.

\(^{20}\) In addition, the flush language of section 470(c) provides that the term “tax-exempt use property” does not include “property which would (but for this sentence) be tax-exempt use property solely by reason of section 168(h)(6) if any credit is allowable under section 42 or 47 with respect to such property.” Thus, this provision provides relief from section 470 for partnerships with respect to property that qualifies for the section 42 low-income housing tax credit or the section 47 rehabilitation tax credit.

\(^{21}\) Section 470(d)(1)-(4).

\(^{22}\) See House Report, at 314. The legislative history of section 470 describes the section 470(d) exception as relating to “a lease of property to a tax-exempt party” that meets the following requirements: (1) the tax-exempt lessee does not monetize its lease obligations; (2) the taxpayer-lessee makes and maintains a substantial equity investment in the leased property; and (3) the tax-exempt lessee does not bear more than a minimal risk of loss. See Conference Report, at 644-50; House Report, at 316-18; and JOINT COMMITTEE ON TAXATION, Description of Revenue Provisions Contained in the President’s Fiscal Year 2005 Budget Proposal (JCS-3-04), at 282-83 (Feb. 2004).
Section 470(g) provides the IRS and Treasury with broad regulatory authority to issue regulations carrying out the purpose of the anti-SILO rules of section 470. Specifically, section 470(g) provides that:

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including regulations which –

(1) allow in appropriate cases the aggregation of property subject to the same lease, and
(2) provide for the determination of the allocation of interest expense for purposes of this section.

C. Sections 168 and 7701(e)

Section 470 defines “tax-exempt use property” by reference to section 168(h) (subject to certain modifications mentioned above). Thus, in order to understand the rules of section 470, it is important to understand the rules of section 168(h). Understanding section 168(h), in turn, requires knowledge of section 7701(e). Both what is now section 168(h) and section 7701(e) were enacted as part of the Deficit Reduction Act of 1984 (P.L. 98-369, the “1984 Act”) to respond to certain Congressional concerns about depreciation and tax-exempt entities. Sections 168(h)(1) and 7701(e) arose out of concerns relating to transactions that, in substance, constitute leases; however, section 168(h)(6) relates to a different set of concerns.

We first provide some general background about the depreciation rules. Then, we discuss the Congressional concerns about “tax-exempt use” that led to the enactment of sections 168(h) and 7701(e). Next, we describe the rules of sections 168(h) and 7701(e), discussing the “leasing” rules of sections 168(h)(1) and 7701(e) and then the special rules of section 168(h)(6). Finally, we briefly describe a qualified allocation standard used in section 514(c)(9); this discussion is relevant to our discussion of Alternative Approaches.

1. General Background Regarding Depreciation

The accelerated cost recovery rules for certain tangible property are set forth in section 168. Specifically, section 168(a) provides that the depreciation deduction for tangible property is determined by using the “applicable depreciation method,” the “applicable recovery period,” and the “applicable convention.” Section 168(e) provides rules for classifying property. Section 168(f) provides that section 168 does not apply to certain types of property, including: (1) property that the taxpayer elects to exclude that is depreciated under the unit-of-production method or another method not expressed in a term of years; (2) certain public utility property; (3) certain films and video tape; (4) certain sound recordings; and (5) certain property placed in service in “churning transactions.”

Section 168(g) sets forth an “alternative depreciation system” for certain property. The cost recovery rules of section 168(g) generally are less generous (i.e., there are longer recovery periods) than the rules applicable to other property under the accelerated cost recovery rules of section 168. One of the types of property that is subject to this regime is “tax-exempt use property.” This term is defined in section 168(h).

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23 Section 168(b) defines the “applicable depreciation method.”
24 Section 168(c) defines the “applicable recovery period.”
25 Section 168(d) defines the “applicable convention.”
26 In 1981, Congress enacted the Accelerated Cost Recovery System, providing favorable accelerated depreciation rules as an incentive for certain taxpayers to acquire and use capital property. These rules were later modified as part of the Tax Reform Act of 1986 (P.L. 99-514) to provide
2. **Congressional Concerns with Tax-Exempt Use**

Prior to the 1984 Act, tax-exempt entities were not entitled to depreciation deductions or investment tax credits with respect to property that they owned. Also, the investment tax credit was not available for property “used” (such as through a lease) by a tax-exempt entity in connection with its tax-exempt function (the “nontaxable use restriction”). This nontaxable use restriction, however, did not apply with respect to accelerated cost recovery system (“ACRS”) depreciation.

In the 1984 Act, Congress sought to bolster the nontaxable use restriction relating to the investment tax credit and to bring ACRS depreciation within the same general regime with respect to tax-exempt entities. As is indicated in the following statement from the JCT explanation of the 1984 Act, Congress intended to prevent tax-exempt entities from indirectly benefiting from tax incentives from which they could not benefit directly:

> The Congress believed that reform of the tax law was essential, insofar as it related to property used by tax-exempt entities under a lease, a lease formulated as a service contract, or other similar arrangements. When tax-exempt entities used property under these arrangements, they paid reduced rents that reflected a pass-through of investment tax incentives from the owner of the property. Tax-exempt entities thereby benefited from investment incentives for which they did not qualify directly and effectively gained the advantage of taking income tax deductions and credits while having no corresponding liability to pay any tax on income from the property. In this way, investment incentives that were intended to reduce the tax on taxable entities were turned into unintended benefits for tax-exempt entities, including foreign entities.\(^{27}\)

> To this end, Congress sought to emphasize the importance “of providing tax-reducing incentives [such as the investment tax credit and ACRS depreciation] to those who are subject to the income tax and denying them to those who are not . . .”\(^{28}\) Because tax-exempt entities generally operate for a public purpose, Congress believed that aid conveyed to such entities through the Federal system in furthering such purpose should be readily quantifiable. As indicated in the 1984 Blue Book, Congress believed that, “with Federal aid conveyed through the tax system, it was very difficult to discover what tax-exempt purposes were Federally assisted, by how much they were assisted, and whether the assistance was rendered in ways consistent with other objectives of public policy.”\(^{29}\)

Accordingly, in 1984, Congress decided to provide for less rapid depreciation of property used by tax-exempt entities by defining “tax-exempt use property” in what is now section 168(h), and requiring that such property be depreciated under section 168(g). Similarly, because of historic problems relating to circumvention of the nontaxable use restriction through “lease-like” arrangements in the context of the investment tax credit and fear that similar structures might be used to circumvent section 168(h), Congress enacted section 7701(e) to treat such arrangements as actual leases and to thereby eliminate these problems.

3. **The Rules of Sections 168(h) and 7701(e)**

generally for longer depreciable lives (although such lives still are shorter than those currently available under the alternative depreciation system of section 168(g)).


\(^{28}\) *Id.* at 44.

\(^{29}\) *Id.* at 46.
Sections 168(h)(1) and 7701(e) provide rules that relate to transactions that constitute leases to tax-exempt entities (or that are economically similar to leases to tax-exempt entities). Section 168(h)(6), however, has a different focus.

a. Leasing Rules

i. Section 168(h)(1)

Section 168(h)(1) defines certain property as “tax-exempt use property” for purposes of section 168(g). Under section 168(h)(1)(A), tax-exempt use property generally is “that portion of any tangible property (other than nonresidential real property) leased to a tax-exempt entity.” With respect to nonresidential real property, section 168(h)(1)(B) provides that only the portion of the property leased to a tax-exempt entity in a “disqualified lease” is tax-exempt use property.\(^{30}\) Section 168(h) excludes certain property from the definition of tax-exempt use property, such as certain short-term leases,\(^{31}\) property used in an unrelated trade or business of a tax-exempt entity,\(^{32}\) and certain leases of high-technology equipment.\(^{33}\) In addition, tax-exempt use property does not include property that is predominantly used by the tax-exempt entity (directly or through a partnership in which such entity is a partner) in an unrelated trade or business the income of which is subject to tax under section 511.\(^{34}\)

Section 168(h)(5) provides a special rule for determining whether property constitutes tax-exempt use property when the property is leased to a partnership or other pass-thru entity. In such a case, the determination of whether any portion of the property is tax-exempt use property is made by treating each tax-exempt entity partner’s proportionate share of the property as being leased to the partner.\(^{35}\)

For purposes of section 168(h), a tax-exempt entity includes a governmental entity (including agencies and instrumentalities thereof), an organization (other than a certain kind of cooperative) that is exempt from income tax under chapter 1 of the Code (i.e., sections 1 through 1400L), certain foreign persons or entities, and certain tribal governments.\(^{36}\)

ii. Section 7701(e) -- Service Contracts as Leases

Congress enacted section 7701(e) in conjunction with section 168(h) to address its concern that parties might circumvent the restrictions on tax-exempt entity leasing by entering into “service contracts” that were

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30 Section 168(h)(1)(B)(ii) defines a “disqualified lease” as any lease of nonresidential real property to a tax-exempt entity if: (i) part or all of the property was financed (directly or indirectly) by an obligation the interest on which is exempt from tax under section 103(a) and such entity (or related entity) participated in such financing; (ii) there is a fixed or determinable purchase price or sale option that involves such entity (or related entity) or there is an equivalent of such an option; (iii) the lease has a term of more than 20 years; or (iv) the lease occurs after a sale (or other transfer) of the property by, or lease of the property from, such entity (or related entity) before such sale (or other transfer) or lease.

31 Section 168(h)(1)(C).

32 Section 168(h)(1)(D).

33 Section 168(h)(3). Section 470(c)(2)(A), however, overrides the tax-exempt use property exclusions in section 168(h)(1)(C) and section 168(h)(3), for purposes of section 470, with respect to short-term leases and leases of high-technology equipment, respectively.

34 Section 168(h)(1)(D).

35 Section 168(h)(5)(A) provides that a “proportionate share” is determined in the same manner as in section 168(h)(6) (described below in Part I.C.3.b). Section 168(h)(5)(C) provides a rebuttable presumption that the partners of a foreign partnership (or beneficiaries of any other foreign pass-thru entity) are not U.S. persons.

36 Section 168(h)(2)(A). Section 168(h)(2)(B) provides that a foreign person or entity is not treated as a tax-exempt entity with respect to any property if more than 50 percent of the gross income for the taxable year derived by the foreign person or entity from the use of such property is: (1) subject to tax under chapter 1 of the Code; or (2) included under section 951 in the gross income of a U.S. shareholder for the taxable year with or within which ends the taxable year of the controlled foreign corporation (“CFC”) in which such income was derived.
economically similar to leases. Prior to the 1984 Act, the Court of Claims decided a case adverse to the Government where property made available by a taxable entity to a tax-exempt entity under a service contract was held to qualify for certain tax benefits that would not have been available had the property been made available under similar terms pursuant to a lease.\textsuperscript{37} In order to address the Government’s concern with this outcome, section 7701(e)(1) was enacted to provide that a service contract can be treated as a lease if certain requirements are met. Specifically, section 7701(e)(1) provides as follows:

\begin{quote}
A contract which purports to be a service contract shall be treated as a lease of property if such contract is properly treated as a lease of property, taking into account all relevant factors, including whether or not –

(A) the service recipient is in physical possession of the property,

(B) the service recipient controls the property,

(C) the service recipient has a significant economic or possessory interest in the property,

(D) the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract,

(E) the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and

(F) the total contract price does not substantially exceed the rental value of the property for the contract period.
\end{quote}

All facts and circumstances, including the factors set forth in section 7701(e)(1), are to be considered in determining whether a service contract should be treated as a lease.\textsuperscript{38} The legislative history of section 7701(e) contains an extensive discussion of these factors and numerous examples illustrating their application.\textsuperscript{39}

iii. Section 7701(e)(2) -- Partnerships as Leases

Congress also was concerned that taxable and tax-exempt entities might use partnerships or other pass-thru entities to replicate leasing arrangements. In order to prevent taxpayers from circumventing the nontaxable use restriction through pass-thru entities that resembled leases, Congress enacted section 7701(e)(2). This section provides that:

\begin{quote}
An arrangement (including a partnership or other pass-thru entity) which is not described in paragraph (1) shall be treated as a lease if such arrangement is properly treated as a lease, taking into account all relevant factors including factors similar to those set forth in paragraph (1).
\end{quote}

\textsuperscript{37} See Xerox Corp. v. United States, 656 F.2d 659 (Ct. Cl. 1981). As described above, at the time that section 168(h) was enacted, the investment tax credit was unavailable with respect to property “used by” a tax-exempt organization in an exempt function. Property leased by a tax-exempt entity was considered to be “used by” such entity for this purpose. However, if such property were used by a tax-exempt entity as an integral part of a service contract with a taxable entity, the investment tax credit would remain available to the taxable entity. See S. Rep. No. 98-169, pt. 1, at 118-22 (1984) (the “1984 Senate Report”); H.R. Rep. No. 98-432, at 1151 (1984) (the “1984 House Report”); and 1984 Blue Book, at 39.


The legislative history accompanying section 7701(e)(2) indicates that the provision applies “to any arrangement, other than a service contract, under which a tax-exempt entity or any other entity directly or indirectly (e.g., by use of a taxable subsidiary to serve as a partner in a partnership) obtains the use or benefits of property.” The legislative history also provides an example of a partnership that would be recharacterized as a lease under section 7701(e)(2).

Thus, it is possible to characterize a partnership as a lease under section 7701(e)(2) if the facts and circumstances support such a characterization. If a partnership arrangement is recharacterized as a lease to a tax-exempt entity, the rules of section 168(h)(1) can apply to treat the partnership property as tax-exempt use property.

b. Partnerships and Qualified Allocations -- Section 168(h)(6)

Section 7701(e)(2) did not resolve all of the Congressional concerns regarding partnerships, depreciation, and tax-exempt entities. Accordingly, the 1984 Act also included section 168(h)(6). Section 168(h)(6) applies to partnerships between tax-exempt and taxable entities where non-pro rata allocations are made to tax-exempt partners.

Although not explicit in the legislative history of the 1984 Act, it would appear that section 168(h)(6) is not aimed at a surrogate leasing transaction that conveys tax benefits from a tax-exempt entity to a taxable entity. Instead, section 168(h)(6) adopts something of an aggregate view of partnerships in invoking the nontaxable use restriction with respect to tax-exempt entities. In effect, when a tax-exempt entity is a partner in a partnership, under an aggregate view, that entity would be treated as “using” the portion of the partnership’s

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40 1984 Blue Book at 69.
41 Id. at 69-70. Under the example, E, a tax-exempt hospital, and T, a partnership composed of members of E’s medical staff, formed a joint venture to acquire and operate certain sophisticated medical equipment. The equipment was to be used solely to aid in diagnosing diseases of E’s patients and would be located on E’s premises. Each joint venturer was to contribute equal amounts of cash and to lend equal amounts of money to the venture and was to share equally in the profits, losses, and cash flows of the venture. E would have ultimate responsibility for the debt service obligations with respect to the entire property. The day-to-day business of the joint venture was to be managed by a representative of each joint venturer. The joint venture was to have a seven-year term, approximately two years shorter than the expected useful life of the medical equipment. T had a “put” right whereby, within six months of termination, T could require E to purchase its interest in the joint venture at fair market value, with such amount being adjusted upwards if fair market value was less than a specified amount (which was intended to provide T with a return of its equity, together with a guaranteed return, taking into account the net profits received during the joint venture).

In concluding that the joint venture was more properly classified as a lease, the legislative history listed the following factors as being indicative of a leasing arrangement:

(a) although no payments are required to be made by E to T, T will be compensated through payments made by E’s patients and by the terms of the put, (b) E has control of T’s interest in the property because E has an equal voice in the operation and maintenance of the entire property, (c) E has a possessory interest in T’s interest because the property will be used under the agreement for a substantial portion of the property’s useful life and E bears the risk that the property will decline in value by virtue of the put held by T, (d) T does not have the right to use the property to provide services to anyone other than a patient of E, and (e) all other relevant facts, including the facts that the use of the property is integrally related to E’s tax-exempt function, that E has guaranteed the repayment of the total acquisition indebtedness, and that the property will be operated only by E’s employees. Given the totality of the facts and circumstances, the fact that T bears the risk of substantially diminished receipts is mitigated by E’s obligation to fulfill T’s debt service requirements and does not provide a basis for a contrary conclusion.

See also 1984 Senate Report, at 147-48; and 1984 House Report, at 1160-61. We are aware of little authority applying section 7701(e)(2). See P.L.R. 8604066 (Oct. 30, 1985) (explaining that none of the five relevant factors in the non-exclusive six-factor test of section 7701(e)(1) supported recharacterizing the partnership as a lease under section 7701(e)(2); the non-relevant factor in the ruling was the sixth factor set forth in section 7701(e)(1)(F)).
property that is attributable to its interest. The tax-exempt entity cannot benefit from depreciation deductions where the activity does not generate unrelated business taxable income (“UBTI”); consequently, as long as the deductions attributable to the tax-exempt partner’s share of partnership property are not being shifted to the taxable partners via non-pro rata allocations, no partner is deriving any improper tax benefit. However, if items of depreciation attributable to the portion of the property that is, in effect, used by the tax-exempt entity are shifted to taxable parties through partnership allocations, the concerns raised by the nontaxable use restriction are implicated.

In order to address these apparent concerns, section 168(h)(6) provides that property owned by a partnership that is not otherwise tax-exempt use property can be treated as tax-exempt use property if the partnership’s partners and allocations have certain characteristics. Specifically, section 168(h)(6)(A) provides:

For purposes of this subsection, if - -

(i) any property which (but for this subparagraph) is not tax-exempt use property is owned by a partnership which has both a tax-exempt entity and a person who is not a tax-exempt entity as partners, and

(ii) any allocation to the tax-exempt entity of partnership items is not a qualified allocation,

an amount equal to such tax-exempt entity’s proportionate share of such property shall (except as provided in paragraph (1)(D)) be treated as tax-exempt use property.

Section 168(h)(6)(B) further provides that an allocation of partnership items is a “qualified allocation” if two requirements are met. First, the allocation to a tax-exempt partner of its distributive share of partnership items must be made in the identical percentage with respect to each partnership item (generally referred to as a “straight-up” allocation) and such distributive share must remain the same during the entire period the tax-exempt entity is a partner in the partnership. Second, the allocation must have substantial economic effect within the meaning of section 704(b)(2). For purposes of the qualified allocation rule, items allocated under section 704(c) are not taken into account.

Section 168(h)(6)(C)(i) provides that a tax-exempt entity’s “proportionate share” of any property owned by a partnership generally is determined on the basis of the entity’s share of partnership items of income or gain (excluding gain allocated under section 704(c)), whichever results in the largest proportionate share. Section 168(h)(6)(C)(ii) provides that if the share received by the tax-exempt entity varies during the period such entity is a partner in the partnership, the highest share received by such entity is its proportionate share.

For purposes of section 168(h)(6), certain taxable entities that are “controlled” by tax-exempt entities can also be considered tax-exempt entities.

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42 Cf. Rev. Rul. 78-268, 1978-2 C.B. 10 (where electric generating facility was held by taxable and tax-exempt entities as tenants in common, the portion held by the tax-exempt party was not entitled to the investment tax credit because of the nontaxable use restriction; the portion held by taxable entities was entitled to the investment tax credit); 1984 Blue Book, at 68-69 (citing Rev. Rul. 78-268 for the proposition that section 168(h)(6) would not affect property co-owned by a tax-exempt entity through an arrangement that was not classified as a partnership); and Treas. Reg. § 1.701-2(e)(1) (aggregate treatment imposed where appropriate to carry out the purposes of any provision of the Code or the regulations thereunder).

43 Section 168(h)(6)(B) further provides that an allocation of partnership items is a “qualified allocation” if two requirements are met. First, the allocation to a tax-exempt partner of its distributive share of partnership items must be made in the identical percentage with respect to each partnership item (generally referred to as a “straight-up” allocation) and such distributive share must remain the same during the entire period the tax-exempt entity is a partner in the partnership. Second, the allocation must have substantial economic effect within the meaning of section 704(b)(2). For purposes of the qualified allocation rule, items allocated under section 704(c) are not taken into account.

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43 Section 168(h)(6) also sets forth other rules, including: (i) the determination of whether property is used in an unrelated trade or business of a tax-exempt entity, which determination is made without regard to section 514 (relating to unrelated debt-financed income) (section 168(h)(6)(D)); and (ii) the treatment of certain “tax-exempt controlled entities” as tax-exempt entities for purposes of section 168(h)(6) (section 168(h)(6)(F)).

44 Section 168(h)(6)(B) (flush language).

45 Section 168(h)(6)(D) provides that, for purposes of section 168(h)(6), the determination of whether property owned by a partnership that has both tax-exempt and taxable entities as partners is used in an unrelated trade or business is made without regard to section 514. Accordingly, if a tax-exempt partner would be subject to tax on partnership income as UBTI as a result of the unrelated debt-financed rules under section 514 (including the fractions rule), this fact will not prevent the property from being treated as tax-exempt use property under section 168(h).

46 Section 168(h)(6)(F). This provision also applies for purposes of section 168(h)(5).
Section 168(h)(6)(E) provides that rules similar to the special partnership rules of section 168(h)(6)(A), (B), (C), and (D) (described above) also apply in the case of “any pass-thru entity other than a partnership and in the case of tiered partnerships and other entities.” No guidance has been issued regarding how section 168(h)(6) applies in the case of tiered partnerships or how it applies to pass-thru entities other than partnerships.

The temporary regulations under what is now section 168(h) make clear that section 168(h)(6) can apply by virtue of the mere existence of a partnership with non-pro rata allocations and taxable and tax-exempt entities as partners; that is, no lease need exist with respect to partnership property. Specifically, Question 26 of the temporary regulations (which are organized in question and answer format) addresses the interaction of the leasing rules of section 168(h)(1) and the partnership rules of section 168(h)(6). Question 26, in effect, suggests that a partnership first determines whether any property is tax-exempt use property because it is leased to a tax-exempt party. Then, to the extent the partnership has property that is not considered tax-exempt use property under the “leasing rules,” the partnership applies the partnership rules of section 168(h)(6) to determine the extent to which such property constitutes tax-exempt use property.47

4. Liberalization of Qualified Allocation Standard in Another Context

When Congress enacted what is now section 168(h) in 1984, it also imported the qualified allocation rule set forth in section 168(h)(6) to another section of the Code. The rules of this other section -- section 514(c)(9)(E) -- are relevant to the Alternative Approaches that are set forth later in our comments.

As background, in 1969, Congress provided rules in section 514 causing income related to debt-financed property to be treated as UBTI.48 In 1980, Congress enacted section 514(c)(9) as an exception to UBTI treatment for debt-financed real estate held by certain “qualified organizations.” In 1984, Congress expanded the types of entities that constituted qualified organizations and, at the same time, provided that the exception to UBTI would not apply to property held by a partnership unless (1) all of the partners were qualified organizations, or (2) each allocation to a partner who was a qualified organization was a qualified allocation within the meaning of section 168(h)(6). This limitation prevented a qualified organization from both avoiding UBTI with respect to its share of partnership property and shifting deductions attributable to its share to other partners who could utilize the deductions in offsetting taxable income.

Apparent recognizing that requiring “qualified allocations” under section 168(h)(6) inhibited many

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47 Question 26 provides, in relevant part:

Q-26. Can property be treated as tax-exempt use property under both the general rule of section 168(j)(3) [now section 168(h)(1)] and the partnership provisions of section 168(j)(9) [now section 168(h)(6)]? A-26. Yes. For example, a tax-exempt entity may be a partner in a partnership that owns a building 60 percent of which is tax-exempt use property because it is leased to an unrelated tax-exempt entity under a 25-year lease. The status of the remaining 40 percent depends on whether or not allocations under the partnership agreement are qualified under section 168(j)(9) [now section 168(h)(6)]. If the allocations are not qualified under section 168(j)(9) [now section 168(h)(6)], the tax-exempt entity’s proportionate share (as determined under section 168(j)(9)(C) [now section 168(h)(6)(C)]) of the remaining 40 percent will be tax-exempt use property.

See also 1984 Conference Report, at 791-92 (explaining the interaction of former sections 168(j)(3) and (j)(9), which are now sections 168(h)(1) and (h)(6), respectively); and 1984 Blue Book, at 70-71 (same).

48 The debt-financed property rules generally were aimed at the following transaction. A tax-exempt entity would purchase property from an existing business and lease the property back to that business. In buying the property, the tax-exempt entity would borrow the purchase price and subsequently pay off the principal and interest on the loan solely out of rental income received from the leaseback. Thus, the tax-exempt entity, with little or no investment, would obtain, after a period of years, unencumbered title to the property. This was possible only because the rental income received by the charitable organization was exempt from tax. The sellers, on the other hand, usually received a higher purchase price for the property than would have been possible in a sale to a taxable entity and were able to convert what might otherwise be ordinary income into capital gain on the “sale” of the property to the tax-exempt organization.
legitimate business deals, in the Tax Reform Act of 1986 (the “1986 Act”), Congress amended section 514(c)(9) to permit disproportionate partnership allocations under the exception to the debt-financed income rules so long as the principal purpose of the allocations “was not the avoidance of income tax.” The legislative history accompanying the 1986 Act sets forth an example in which a partnership elected 40-year straight-line depreciation with respect to leased real estate.\(^{49}\) Under the example, if the partnership failed to meet the qualified allocation rule under section 168(h)(6) by reason of the allocation of an increased share of loss or deduction to the exempt organization in order to meet the substantial economic effect requirement of section 704(b)(2), the non-tax avoidance test would be satisfied.

Less than one year after adopting the subjective “non-tax avoidance” test, Congress voted to replace that test with an objective test that has come to be known as the “fractions rule.” Section 514(c)(9)(E)(i) provides that: (i) no distributive share of overall partnership loss allocable to a taxable partner may exceed such partner’s smallest distributive share of partnership income for any taxable year; (ii) no distributive share of overall partnership income allocable to a tax-exempt partner may exceed such partner’s smallest distributive share of overall partnership loss for any taxable year; and (iii) each partnership allocation must have substantial economic effect within the meaning of section 704(b). Subsequent regulations have liberalized this provision somewhat, permitting qualified organizations, among other things, to receive “reasonable” preferred returns and guaranteed payments, and to receive “chargebacks” of income to offset prior disproportionate allocations of losses.\(^{50}\)

Although the fractions rule has been criticized as having significant flaws that inhibit legitimate economic arrangements with tax-exempt entities,\(^{51}\) the rule is significantly more flexible than the qualified allocation rule under section 168(h)(6). It is unclear why Congress did not make similar changes to section 168(h)(6) when it was amending section 514(c)(9). One can speculate, however, that, because the depreciable lives of many assets (and particularly real estate) were substantially lengthened under the 1986 Act, use of the alternative depreciation system under section 168(g) was no longer viewed as sufficiently penal to warrant expending political capital to push for such a change.

II. Problems with Using Section 168(h)(6) as a Touchstone for Applying Section 470

As was discussed above, section 470 potentially can apply to a partnership (or other pass-thru entity) for one of two reasons: (1) the partnership is engaged in a “covered” leasing transaction described in section 168(h)(1) (and not exempt under section 470(d)), or (2) the partnership has tax-exempt use property as a result of the application of section 168(h)(6). We believe that it is entirely appropriate to use section 168(h)(1), as limited by section 470(d), to apply section 470 to a partnership (or other pass-thru entity) that is engaged in a covered leasing transaction. In our view, there is no policy reason to treat a pass-thru entity that engages in such a transaction any differently from any other kind of entity that engages in such a transaction. Further, although section 168(h)(1) applies to a broad variety of leases (including those leases that have nothing to do with SILO transactions), section 470(d) carves back the application of section 168(h)(1) for purposes of section 470 to exclude certain leases that do not bear the hallmarks of SILO transactions.

Nonetheless, we have significant concerns with the application of section 470 to pass-thru entities by virtue of the application of section 168(h)(6). Our concerns fall into three broad categories. First, we believe that section 168(h)(6) is the wrong “touchstone” for identifying those pass-thru entities that are being used to


\(^{50}\) See Treas. Reg. § 1.514(c)-2(d) and (e).

\(^{51}\) See, e.g., N.Y. St. Bar Assoc. (Tax Section), Report on Section 514(c)(9)(E) Concerning Investments in Leveraged Real Estate Partnerships by Pension Trusts and Other Qualified Organizations, reprinted at 97 TNT 34-39 (Feb. 20, 1997).
replicate SILO transactions. Second, because we believe section 168(h)(6) is the wrong touchstone, we believe that using it causes section 470 to be applied to an overly broad universe of pass-thru entities -- that is, because of the application of section 168(h)(6) and the lack of any exception comparable to that in section 470(d)), section 470 potentially applies to a plethora of pass-thru entities that are engaged in legitimate commercial activities and that are not being used to replicate SILO transactions. Third, there are a host of problems and unanswered questions that arise when section 470 is applied to pass-thru entities by virtue of section 168(h)(6). We have described each of these concerns in detail below.

Because of our significant concerns regarding the use of section 168(h)(6) to identify those pass-thru entities that are subject to section 470, we suggest that the reference to section 168(h)(6) be abandoned as a frame of reference for section 470. Nonetheless, we respect the concern that it may be possible to structure partnership arrangements so as to replicate the economics of the kind of SILO transaction that Congress intended to prevent. Thus, we have included Alternative Approaches that are designed to address our concerns with the current statutory formulation, while applying the loss deferral regime to those pass-thru entities that might be structured so as to replicate SILO transactions.

A. Section 168(h)(6) Is the Wrong Touchstone

We do not believe that section 168(h)(6) is the appropriate touchstone for defining an abusive partnership arrangement for section 470.

As a threshold matter, section 168(h)(6) applies if two objective requirements are met (i.e., a mix of taxable and tax-exempt partners and allocations to a tax-exempt partner that are not qualified allocations); however, these factors are present in a host of partnership arrangements that are not being used to replicate SILO arrangements. Although these two factors may be ingredients in the kind of leasing transaction that the Congress considers abusive, they are in no way determinative of such a transaction. As was indicated in the discussion at Part I.A above, factors that can be indicative of a SILO arrangement that the Government considers abusive are the continued “use” of property by the tax-exempt entity, the equivalent of a fee paid to the tax-exempt entity for engaging in the arrangement, significant tax benefits to the taxable entity, limited (or a lack of) economic substance with respect to the investment of the taxable entity, and certain assurances that the tax-exempt entity ultimately will regain ownership of the property. Section 168(h)(6), however, can apply to a partnership even if none of these factors is present.

The fact that section 168(h)(6) does not function to define a “synthetic” SILO transaction is not surprising given the different purposes underlying sections 168(h)(6) and 470. Section 168(h)(6) is only concerned about ensuring that the benefits of accelerated depreciation are not enjoyed with respect to partnership property that a tax-exempt entity is considered as owning by virtue of owning an interest in the partnership; section 168(h)(6) is not focused on whether the tax-exempt entity, as a practical matter, is continuing to use property in the same way it would have if it had not entered into the partnership arrangement. In other words, section 168(h)(6) is focused on theoretical use in the aggregate sense (i.e., a tax-exempt partner is treated as using the portion of the partnership property that is attributable to its interest). By contrast, in order to address SILO concerns, we suggest that section 470 should be focused on actual use (or control over use) of property by a tax-exempt entity, given that such use (or control over use) would be critical in replicating the kind of leasing transaction that the Government considers abusive.

In addition, section 168(h)(6) represents a very blunt and ill-crafted instrument for determining tax-exempt “use.” Where a tax-exempt entity is a partner and the partnership shifts all of its depreciation deductions with respect to the partnership property to taxable partners, one could appropriately view the tax-exempt entity as “using” its share of the partnership property (by virtue of its status as a partner), but shifting the tax benefits to a taxable entity in a manner consistent with a lease (where the owner-lessee obtains all of the tax benefits related to the property). Conversely, if all of the depreciation deductions with respect to partnership
property were allocated to the tax-exempt entity and away from the taxable partners, section 168(h)(6) still would apply. This is because all that is required to invoke section 168(h)(6) is that partnership allocations not be entirely “straight-up” to the tax-exempt entities. There is no requirement that there actually be a shifting of benefits from a tax-exempt entity to a taxable entity -- which is an essential element in the kind of leasing transaction that the Government considers abusive.

Similarly, section 168(h)(6) determines the tax-exempt entity’s relative “use” of the property by reference to the “highest share” of income or gain that the tax-exempt entity may receive. In many arrangements, particularly those involving preferred returns for the tax-exempt entity, looking to the “highest share” of partnership income or gain that a tax-exempt partner may receive will dramatically overstate the portion of the property that the tax-exempt entity should be deemed to “use.”

Finally, it is important to recognize that even section 168(h)(1) does not perfectly identify the universe of leasing transactions that gave rise to Congressional concerns in the SILO transaction context. As was indicated above, section 168(h)(1) was designed to ensure that tax-exempt entities could not indirectly benefit from accelerated depreciation through leases. As such, section 168(h)(1) focuses on leasing transactions in general and covers a broad universe of leases; it is not limited to those leases of questionable economic substance. Nonetheless, in apparent recognition of the broad scope of such section, Congress carved back the application of section 168(h)(1) in the context of the anti-SILO rules by providing an exception for certain “legitimate” leasing arrangements that is set forth in section 470(d).

Section 168(h)(6) likewise identifies a broad universe of arrangements. As was indicated above, this generally makes sense in the context of the depreciation rules given that Congress was merely trying to identify those situations in which a tax-exempt entity was benefiting indirectly from the accelerated depreciation rules designed to benefit taxable entities; it was not trying to identify those situations in which a partnership arrangement has the hallmarks of a synthetic SILO transaction. However, while Congress narrowed the scope of the leasing rules through section 470(d) in the SILO context, it neglected to carve back the application of section 168(h)(6) to properly limit the scope of section 470 only to situations in which pass-thru entities are being used to replicate SILO transactions.

B. Using Section 168(h)(6) as the Touchstone for Pass-Thru Entities Causes Section 470 to Apply Overbroadly to Entities That Are Not Engaged in the SILO Abuse Congress Intended to Prevent

Because section 168(h)(6) is the wrong touchstone for identifying pass-thru entities that are being used to replicate SILO transactions, it should be no surprise that using it to identify abusive arrangements does not work well. Simply put, section 168(h)(6) casts too broad of a net. Although using section 168(h)(6) as a touchstone will cause section 470 to apply in abusive cases, using it also can cause section 470 to apply to a multitude of pass-thru entities that are engaged in legitimate commercial transactions. We will first illustrate the kind of pass-thru entity to which we believe section 470 should be applied -- a partnership that has been structured in such a manner so as to replicate a SILO transaction. Then, we will show, through a series of examples, the kinds of pass-thru entities to which section 470 could be applied due to the application of section 168(h)(6), even though such entities are not engaged in the kind of abuses that motivated the enactment of “anti-SILO” legislation. As indicated in our discussion of Alternative Approaches, we believe that section 470 should be amended so that it will apply only to those partnerships that are engaged in, or that are being used to replicate, the kind of leasing transactions that Congress intended to deter.

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52 We note, however, that the qualified allocation rule does seem overly broad in its definition of the targeted situations; especially where deductions are shifted from taxable entities to tax-exempt entities. See supra text accompanying note 48.

53 Note that we are not aware of any pass-thru entities that have been structured so as to replicate SILO transactions. The above example was created for purposes of these comments and is not based upon any experience with an actual similar transaction.
1. Illustration of How a Partnership Could Be Used to Replicate a SILO Transaction

To illustrate the defining factors of a SILO, as discussed above in Part I.A., assume that a local government (“Municipality”) owns and operates a subway system. A taxable corporation (“Taxpayer”) approaches Municipality and proposes that the parties engage in the following transaction.

Municipality and Taxpayer form a limited partnership, with Taxpayer as the general partner and Municipality as the limited partner. Municipality contributes the subway system, valued at $105 million, to the partnership. Taxpayer contributes capital of $15 million to the partnership, but, as the general partner, is liable for all recourse debts of the partnership.

The partnership borrows $90 million on a recourse basis from an unrelated lender. The borrowing is secured by the subway system. The 5.5-percent, 15-year loan requires annual interest-only payments. The partnership distributes all of the loan proceeds to Municipality. Municipality guarantees the debt but does not waive its right of subrogation against Taxpayer as the general partner. Municipality sets aside $90 million of the distributed proceeds in an escrow account for the benefit of the lender to satisfy its obligation under the guarantee and for the benefit of Taxpayer to satisfy Municipality’s obligation under an option, which is described below. The $15 million of proceeds contributed by Taxpayer also is held in escrow at the partnership level.

Municipality enters into an irrevocable, 15-year management contract with the partnership providing Municipality with sole authority to operate the subway system. In connection with the management contract, Municipality assumes responsibility for all liabilities arising in connection with the subway system (e.g., torts, etc.). Thus, Municipality can continue to operate the subway system in the same manner as it did prior to the formation of the partnership and continues to bear responsibility for liabilities that may occur with respect to the subway system.

The partnership agreement provides that Municipality and Taxpayer will divide income from the subway operations equally, except that all deductions with respect to depreciation will be specially allocated to Taxpayer. Taxpayer also will be specially allocated any gain on a disposition of the subway system first to charge back previously allocated depreciation. Thereafter, gain with respect to disposition of the subway system will be allocated equally between Municipality and Taxpayer.

Distributions of “Operating Cash Flow” are made on a pro rata basis with respect to the partners. Operating Cash Flow is defined to include distributions from operations after the payment of interest on the loan and after funds have been set aside in escrow each year equal to 1/15th of the $75 million portion of the loan that is not initially covered by the partnership escrow (i.e., $5 million per year).

The partnership will liquidate in accordance with positive capital accounts, as determined under section 704(b). However, Municipality has a “call” option to purchase Taxpayer’s partnership interest upon termination of the partnership for a fixed price of $20 million, reduced by distributions received during the term of the partnership. This fixed price is expected to exceed Taxpayer’s projected “booked-up” capital account, based upon the expected fair market value on the exercise date, and would provide Taxpayer with a return of its $15 million (taking into account prior distributions), plus a pre-determined after-tax return on that investment. Taxpayer will have a simultaneous “put” at a fixed price of $15 million (also taking into account prior distributions).

The escrow accounts of Municipality and the partnership will operate in the following manner. A portion of the $90 million held in the Municipality’s escrow account will be released as such amounts are replaced with amounts contributed to the partnership’s escrow account up to the amount necessary to satisfy the partnership’s debt obligation (i.e., an additional $75 million). Such amounts also will be released as Taxpayer
receives distributions that would reduce the price that Municipality would be required to pay under the “put” option described above. The Municipality’s escrow account will not fall below the amount necessary to return Taxpayer’s original investment through the “put” option, as reduced by distributions received from the partnership.

Those are the key elements of the transaction. Nonetheless, it may be helpful to “play the example” out and see how the transaction would be treated and how events might unfold in the future. In terms of the tax treatment of the arrangement thus far, Municipality would be treated as having undertaken a disguised sale of 85.7 percent of the subway system to the partnership under section 707(a)(2)(B) in connection with the formation of the partnership. Accordingly, the partnership will have a fair market value basis of $90 million with respect to an 85.7-percent interest in the subway system and will depreciate that interest as newly acquired property over a 15-year period. (Assume that the subway system is all 15-year property.)

In each year, assume that the partnership earns $22 million of gross income and has $15.67 million of deductions, excluding depreciation. After annual depreciation of $6 million ($90 million divided by 15 years), the partnership has annual net income equal to $330,000. Assuming that cash flow of the partnership is equal to its gross income minus deductions other than depreciation, $1,330,000 will be divided equally ($665,000 to each) and distributed to Municipality and Taxpayer each year. The remaining $5 million of positive cash flow will be placed in escrow each year for the benefit of the lender. As such amount is placed in escrow by the partnership, a like amount will be released from Municipality’s escrow account.

Based upon the allocation provisions, $6 million in depreciation deductions would be allocated to Taxpayer annually. The remaining $6.33 million of income would be divided equally between Municipality and Taxpayer, so that each would have $3.16 million of annual income. Combining Taxpayer’s income and the special allocation of depreciation would result in a net loss equal to $2.84 million per year to Taxpayer.

Although Taxpayer contributed only $15 million in capital to the partnership, as a general partner with an unlimited deficit restoration obligation, it is entitled to allocations of loss from the partnership in excess of its contributed capital. The deductions will not be limited under section 704(d) to the extent that the general partner has basis attributable to debt allocated under section 752. The passive activity loss rules under section 469 would prevent many taxpayers from deducting these losses. Section 469, however, does not apply to C corporations other than certain closely-held corporations, so a number of taxpayers will not be affected by this provision.

54 The contribution of property and related distribution of cash would be recast as a sale under section 707(a)(2)(B) and the regulations thereunder. Although Treas. Reg. § 1.707-5(b) provides an exception for certain debt-financed distributions, none of the distribution to Municipality is protected by this provision because all of the recourse liabilities are allocated to Taxpayer, as general partner. See Treas. Reg. § 1.752-2(f), Ex. 4 (relating to limited partner guarantees where the right of subrogation is not waived).

55 $21 million of the income is attributable to the operation of the subway and $1 million is attributable to a return on the investment of Taxpayer’s $15 million contribution.

56 Treas. Reg. § 1.752-2(f), Ex. 4 (unless limited partner guaranteeing partnership debt waives right of subrogation against general partner, general partner will continue to be treated as bearing the risk of loss with respect to partnership debt). See also Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3) (discussing the deficit restoration obligation in determining whether an allocation has economic effect for purposes of Treas. Reg. § 1.704-1(b)(2)(ii)(a)).

57 The at-risk rules under section 465 also might prevent many taxpayers from deducting these losses. Because the debt is recourse to the partnership, Taxpayer, as the general partner, presumably will be considered to bear the risk of loss with respect to such debt for purposes of section 752. Treas. Reg. § 1.752-2(f), Ex. 4. Under section 465, however, the standard is somewhat different in determining whether a taxpayer’s amount at risk will include such debt. For purposes of section 465, a partner will not be considered at risk with respect to recource liabilities of the partnership to the extent that the taxpayer is protected against loss for such amounts. Section 465(b)(4); Prop. Reg. § 1.465-24(a)(2). Under the arrangement described in this example, if section 465 applies to Taxpayer, the IRS could certainly argue that Taxpayer is protected against loss with respect to the partnership debt and thus should not be treated as at risk with respect to such amounts.

58 See sections 469(a)(2)(B) and (C). Section 465 similarly excludes C corporations other than those that meet certain “closely-held” standards. Section 465(a)(1)(B).
Based upon the above-described assumptions, over the 15-year term of the partnership, the Taxpayer would be allocated losses equal to $42.6 million ($2.84 multiplied by 15 years). The Taxpayer’s allocated losses exceed its $15 million contributed capital by $27.6 million, and it received distributions equal to $9.975 million ($665,000 x 15); thus, the Taxpayer would have a $37.575 million “negative tax capital account” (i.e., its share of section 752 liabilities in excess of tax basis -- these liabilities “funded” the excess deductions).

At the end of the fifteenth year, assume that the subway system is still valued at $105 million. The partnership would be unwound, with Municipality exercising its “call” option to purchase Taxpayer’s interest in the partnership. Taking into account prior distributions of $9.975 million, the “call” price would equal $10.025 million. Taxpayer would recognize gain equal to $47.6 million (the amount of its negative tax capital account plus the exercise price on the option). To the extent attributable to previously allocated depreciation of personal property, the gain would be recaptured as ordinary income. The remainder would be capital gain.

The partnership would pay off the $90 million in debt with funds held in escrow, and Municipality would regain full ownership of the subway system in liquidation of the partnership.

The net effect of this transaction would be as follows. In exchange for a $15 million capital investment, Taxpayer received loss allocations spread out over 15 years totaling $42.6 million, together with $20 million in distributions and sales proceeds with respect to its partnership interest, with an amount equal to all of the losses and the cash received in excess of its original contribution being recognized as income (probably some capital and some ordinary) in the fifteenth year.

Municipality received: (1) $90 million, with $75 million of such amount released from escrow equally over the 15-year period and a further portion released as partnership distributions are made to Taxpayer, plus (2) additional cash distributions totaling $9.975 million, minus (3) the $10.025 million exercise price paid in the fifteenth year, for a total of $89.95 million. Municipality would have absorbed $95 million of taxable income during this period. Had Municipality operated the subway directly during this time, it would have earned $80 million. The investment return on Taxpayer’s $15 million capital contribution accounted for $15 million of the partnership’s income ($1 million per year), that Municipality would not have earned were it not for its investment in this partnership. Accordingly, Municipality, in effect, earned a $9.95 million fee for participating in the venture ($89.95 million proceeds received, less $80 million which it would have received from operating the subway system directly).

This transaction has the hallmarks of the kind of SILO transaction Congress intended to prevent through the enactment of section 470. That is, the transaction, in effect, transfers tax benefits associated with the property (e.g., depreciation deductions) from the tax-exempt entity to the taxable entity; the tax-exempt entity receives an implicit fee for participating; the tax-exempt entity maintains effective control of the “sold” property and continues to use such property; the taxable entity is protected from loss through the terms of the arrangement and the effective defeasement of the tax-exempt entity’s obligations under the debt and option; and the tax-exempt entity effectively is assured, through the put and call arrangement, that it will retain the property upon termination of the venture. We recognize that this transaction could be attacked under the general subchapter K and/or common law anti-abuse rules. While we believe that the rules in subchapter K generally

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59 See, e.g., Treas. Reg. § 1.701-2 (authorizing the IRS in Treas. Reg. § 1.701-2(b) to recast a partnership transaction if the partnership is “formed or availed of” in connection with a transaction, a principal purpose of which is to reduce tax substantially in a manner that is inconsistent with the intent of subchapter K); Treas. Reg. § 1.704-1(b)(2) (requiring that allocations under the partnership agreement have “substantial economic effect”; for purposes of measuring “economic effect,” Treas. Reg. § 1.704-1(b)(2)(ii)(h) defines “partnership agreement” to include arrangements among partners, including puts, options, and other buy-sell agreements, and any other “stop-loss” arrangement; where a partner is protected against risk of loss through options, etc., as is Taxpayer in the example, allocations of loss may not satisfy the “economic effect” requirement); Treas. Reg. § 1.752-2(i)(3) (permitting the IRS to ignore an obligation of a partner in allocating liabilities if there is a plan to circumvent or avoid the obligation); A.S.A. Investerings P’ship v. Comm’r, 201 F.3d 505 (D.C. Cir. 2000) (reasoning that, for a partnership to exist for U.S. federal tax purposes, the parties
provide additional protection in the context of partnership transactions beyond traditional common law doctrines, we believe that the transaction described in this example is the kind of partnership arrangement that Congress intended to discourage through the enactment of section 470 and that it is appropriate to apply section 470 in this context.

2. Illustration of Partnerships Not Used to Replicate SILO Transactions to Which Section 470 Nonetheless Could Apply

In stark contrast to the example described above, there are many situations in which pass-thru entities are not being used to engage in, or to replicate, SILO transactions but nonetheless could be subject to section 470 because of the application of section 168(h)(6). Pass-thru entities, like other entities, often look to tax-exempt entities (including foreign parties) as a source of capital. Further, it is common for partnerships and certain other pass-thru entities to make allocations that are not “straight up,” given the economic arrangement among the parties. Thus, as is illustrated in the following examples, section 470 potentially could be interpreted as applying to a large number of pass-thru entities in a variety of industries, notwithstanding the fact that they are not engaged in, or being used to replicate, SILO transactions.

2.a. Example -- Real Estate Partnership

A typical structure in the real estate context involves one or more tax-exempt entities (e.g., pension funds) and a developer entering into a partnership (generally, a limited partnership or limited liability company taxed as a partnership), with the tax-exempt entity or entities providing the capital to acquire land and construct property. The developer will provide some minimal amount of capital, but primarily will provide services and know-how in undertaking the development (commonly referred to as “sweat equity”).

Because the tax-exempt entity undertakes most of the financial risk by providing all or most of the capital, the tax-exempt entity will receive a “preferred return” with respect to its capital. That is, the tax-exempt entity will receive some rate of return with respect to its investment before the developer starts to participate in the profits of the venture. As the profit with respect to the development increases beyond certain threshold amounts (commonly referred to as “hurdles”), the developer generally will obtain an increasingly larger share of the profits to reward it for its role in the success of the venture.

While the allocations in connection with such a venture would not be “qualified allocations” under section 168(h)(6), these allocations are not tax motivated. Instead, they merely reflect the economic deal of the parties, consistent with the risks and rewards that should be expected by parties in the relative positions of the capital provider and service provider.

2.b. Example -- Securities Partnerships

In many situations, a traditional securities partnership will look much like the traditional real estate partnership described above. That is, one or more tax-exempt entities will enter into a partnership, providing virtually all of the capital, and another party experienced in investment management will contribute minimal capital and will manage the securities portfolio. The tax-exempt entity or entities will receive a preferred return on the contributed capital. After a threshold return has been met for the tax-exempt investors (and sometimes after the initial capital plus the return has been returned to the investors), the investment manager-partner will

must, in good faith and with a business purpose, intend to join together in the present conduct of an enterprise and to share in the profits or losses of the enterprise).

Note that, in most situations, taxable entities will invest money side-by-side with the tax-exempt investors, on the same economic terms with those investors. The examples refer only to the tax-exempt partners in an effort to show a typical role for a tax-exempt investor in the various partnerships.
begin to participate in the profit from the investments. (The investment manager-partner’s share is generally referred to as a “carried interest.”)

As with the real estate partnership, the non-pro rata allocations in the typical securities partnership merely reflect the economic deal of the parties. The party providing the money to undertake the investments receives a preference on the first amounts of income to reward it for making it possible to acquire the investments. If the investments are successful, the investment manager-partner will ultimately share in the profits as a reward for its role in generating those profits.

c. Example -- Foreign Partnership

Many large U.S. corporations enter into joint ventures with foreign partners in connection with foreign operations. In fact, in some countries, it is required (practically or legally) to have a resident partner with some threshold ownership to do business in the country. Given that the local-country partner may not be an active participant in the venture or otherwise may not contribute to the success of the venture in a manner that is consistent with its “proportionate” ownership, there may be limitations placed on the return that the local-country partner may earn. These limitations would cause the allocations of the partnership to the foreign partner to not be “qualified allocations,” within the meaning of section 168(h)(6)(B).

Because the operations of such a partnership would be conducted outside the United States, only the income allocated to the U.S. partners would be subject to U.S. tax. Note, however, that the return of the local-country partner presumably would be fully taxable in that partner’s resident country. Nonetheless, the foreign partner would be treated as a “tax-exempt entity” under section 168(h)(2) because that partner’s share of the income is not subject to tax in the United States. Clearly, a SILO-like result cannot be accomplished through a partnership if all of the partners are fully taxable on the income of the partnership. This will be the case even if some of the income is taxable in a jurisdiction other than the United States.

d. Example -- Operating Partnership

Sometimes, a tax-exempt entity will provide capital to an operating partnership. This may occur indirectly through a tax-exempt entity’s ownership in an investment fund that acquires an interest in an operating business. (The investment fund would have an economic structure much like the securities partnership described above.) Alternatively, if an active business operating through a partnership is in need of capital, a tax-exempt entity may advance money directly to such an entity in exchange for a preferred equity interest. This preferred equity interest often will have many of the characteristics of subordinated debt.

The tax-exempt entity will almost always make its investments in operating businesses through taxable U.S. corporations. These entities are generally referred to as “blocker” corporations because they “block” the UBTI generated by the operating business from passing through to the tax return of the tax-exempt entity. There is no tax avoidance involved, as the blocker corporation is fully subject to tax on such income. The use of the blocker corporation simply allows the tax-exempt entity to isolate the income and expenses associated with the investment in a separate entity and to pay tax at the blocker corporation level, rather than having to calculate UBTI and file a return at the tax-exempt entity level.

Section 168(h)(6)(F) treats “tax-exempt controlled entities” as if they were tax-exempt, even where such entities are fully subject to U.S. tax. Accordingly, section 168(h)(6), and hence section 470, would apply to operating partnerships by virtue of tax-exempt investments through blocker corporations. This result is incongruous in the context of the anti-SILO rules of section 470; it is hard to see how a SILO transaction could be replicated through a partnership where the tax-exempt entity holds its interest through a taxable entity. Section 168(h)(1)(D) would exempt these arrangements from section 168(h), and hence section 470, if the
income were subject to tax as UBTI at the tax-exempt entity level. Nonetheless, the same amount is subject to tax when the tax-exempt entity owns its interest through a taxable blocker corporation.

e. Example -- Tiered Partnerships

Tax-exempt entities will often hold indirect interests in assets through multiple tiers of partnerships. Take, for example, one of the situations discussed above, where a tax-exempt entity holds an equity interest in an investment partnership and that investment partnership, in turn, makes an investment in a lower-tier partnership operating a business. The investment partnership may hold only common equity in the operating partnership in a situation in which it wants to share in all of the “upside” (and will share in all of the “downside”) with respect to a business that it thinks will be very successful. In fact, the partners in the lower-tier operating partnership may share in all items of partnership income, gain, loss, and deduction proportionately.

As described above, however, tax-exempt entities investing in the upper-tier investment partnership almost certainly will not share in the items of that partnership on a pro rata basis. Accordingly, section 168(h)(6)(E) may cause a portion of the lower-tier operating partnership’s property to be treated as “tax-exempt use property,” thus causing section 470 to limit the losses with respect to such property. That is, as discussed above in Part I.B.1, section 470 disallows losses with respect to any “tax-exempt use property,” and the lower-tier operating partnership may be considered to hold such property by virtue of the characteristics of its upper-tier indirect partners and their allocations. Disallowance of losses at the lower-tier partnership level, however, would affect all direct and indirect partners of the lower-tier partnership, many of whom may have no reason to know or suspect that there are non-pro rata allocations anywhere in the structure. In addition, given that many investment funds are understandably protective with respect to the identity of their investors and their participation structures, it may not be possible for the lower-tier partnership to obtain the information necessary to calculate the loss disallowance at that level.

f. Example -- Publicly-Traded Partnership

We note that many publicly-traded partnerships that qualify for pass-through treatment under section 7704(c) have preferred partnership interests outstanding. As a result, the partners may not share in the same proportionate amount of the partnership’s items of income, gain, loss, and deduction from year to year. Accordingly, to the extent that tax-exempt entities (including foreign persons) invest in these publicly-traded partnerships, these partnerships are seemingly subject to section 470 (regardless of whether the tax-exempt entities hold common or preferred interests). Such a result is incongruous given that a publicly-traded partnership clearly is not a vehicle that is likely to be used in a SILO-like transaction. Further, a publicly-traded partnership would bear a tremendous administrative burden in determining what portion of its property constitutes tax-exempt use property, given that tax-exempt investors may “come and go” throughout the course of a year.

g. Example -- REIT

It is unclear whether a REIT is a pass-thru entity that may be subject to section 470. If a REIT were treated as a pass-thru entity for purposes of section 470, then a REIT with preferred stock outstanding would be subject to section 470 if it had any tax-exempt owners. Nonetheless, as is explained below in Part II.C.2, this result would be incongruous given that a REIT cannot be used to replicate a SILO transaction.61

C. Other Issues and Unanswered Questions Regarding Application of Section 470 to Pass-Thru Entities

We also have concerns regarding a number of additional issues with respect to applying section 470 to a pass-thru entity because of the application of section 168(h)(6). The Notice also asked for comments on certain specific issues. The discussion below addresses the following issues:

- What is the effective date of section 470 with respect to an entity that is subject to section 470 solely because of the application of section 168(h)(6)?
- If such entity is not a partnership, to what extent does (or should) section 470 apply?
- Does section 470 operate so as to disallow losses on a property-by-property basis? Should property be allowed to be aggregated in determining tax-exempt use losses?
- Are tax-exempt use losses arising from property held by pass-thru entities determined at the entity level or the owner level?
- Does section 470 apply with respect to all partnership property?
- How does section 470 affect like-kind exchanges and involuntary conversions when pass-thru entities lease property in commercial transactions?
- How does section 470 apply to tiered partnerships?
- What other issues need to be considered with respect to pass-thru entities?

Note that many of these problems and issues would be eliminated, or at least significantly mitigated, if section 470 were amended statutorily or (effectively) through regulations to apply only to those partnerships that are engaged in the abuses Congress intended to stop in enacting section 470. (See our discussion of Alternative Approaches, below.) The following discussion, however, is based on current law and does not take into account possible legislative changes.

1. Effective Date

Section 470 was added to the Code by section 848 of Part III of Subtitle A of Title VIII of the Act. The Act was signed into law on October 22, 2004. Section 849 of the Act generally provides that the amendments made by Part III apply to “leases entered into after March 12, 2004.” The legislative history of the Act similarly indicates that section 470 applies to leases entered into after March 12, 2004. Neither the legislative history nor the Act indicates how this effective date applies in a situation in which a partnership has tax-exempt use property solely because of the application of section 168(h)(6). As a result, there is considerable uncertainty about the effective date of section 470 in such a situation.

For taxable years that began before January 1, 2005, the Notice mitigated the effective date concerns by providing the temporary moratorium (described in the Executive Summary, above). Nonetheless, once the moratorium period passes, pass-thru entities will need to know when and how to apply section 470. Possible options for clarifying the effective date in the pass-thru context include making section 470 effective for losses with respect to property acquired by pass-thru entities after either March 12, 2004 (the effective date applicable to leases) or October 22, 2004 (the date of enactment of the Act). Keying the effective date off the date

62 Section 849 of the Act provides some exceptions to this effective date that are not relevant to this discussion. One of the exceptions relates to qualified transportation property, as defined by section 849(b)(2) of the Act. See section 849(b)(1) of the Act. Another exception relates to the effective date of section 470 for certain intangible property. See section 849(b)(4) of the Act. We note, however, that section 5511(a) of Highway Reauthorization and Excise Tax Simplification Act of 2005 would repeal the exception in section 849(b)(1) of the Act for “qualified transportation property” by repealing sections 849(b)(1) and (2) of the Act and would redesignate sections 849(b)(3) and (4) of the Act as sections 849(b)(1) and (2).

63 See Conference Report, at 647 and 650.
Depending upon how the effective date is clarified, guidance may be needed on the impact of events such as modifications or improvements to property, the entry of new partners, and amendments to partnership agreements. For example, if the effective date were based on the property’s acquisition date, to what extent would property acquired prior to the effective date be treated as subject to section 470 if improvements were made after the effective date? Similar questions arise in the context of whether intangible property held by a partnership prior to the effective date (such as a process or patent) can become subject to section 470 as a result of subsequent events (e.g., as a result of further research and development). Further, could property acquired before the effective date become subject to section 470 if the partnership did not make disqualified allocations to tax-exempt partners prior to the effective date, but subsequently began to make such allocations (either because of the entry of tax-exempt partners or because of an amendment to the partnership agreement affecting how allocations are made)?

In addition, guidance may be needed regarding the effective date if, as is discussed in Part II.C.3 below, pass-thru entities are allowed to aggregate property for purposes of determining the amount of tax-exempt use loss. For example, assume a pass-thru entity is allowed to treat a business unit as a single piece of property to determine the amount of tax-exempt use loss. Assume further that the taxpayer acquired substantially all of the property in the business unit prior to the effective date, but acquired a small amount of property (e.g., a few calculators and paper clips) after that date. How would the effective date apply? Would there be a de minimis rule such that the subsequent acquisition would be ignored or would the acquisition of any amount of property cause the entire business unit to be treated as acquired after the effective date?

Finally, depending upon how the effective date is clarified, guidance may be needed regarding the impact of a technical termination of a partnership under section 708(b)(1)(B). That is, assume a partnership acquired all of its property prior to the effective date. Within a 12-month period after the effective date, there is a sale or exchange of 50 percent or more of the partnership interests, so that the partnership is treated as having terminated, contributing all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership. To apply certain provisions of the Code, the acquisition of property by the new partnership is ignored. If the effective date of section 470 is based on when the property is acquired, should the new partnership be subject to section 470 or is the new partnership, in effect, treated as merely a continuation of the old partnership for purposes of section 470?

64 See section 31(g) of the 1984 Act; 1984 Conference Report, at 794; and 1984 Senate Report, at 152.

65 In the context of section 168(h)(1), Treas. Reg. § 1.168-1T, Q-31, generally provides that, under section 31(g)(20)(B)(ii) of the 1984 Act, a “substantial improvement” is treated as separate property for purposes of the effective date, but the grandfathered portion remains grandfathered. Any improvement to land, however, is treated as separate property. See also 1984 Senate Report, at 132; 1984 House Report, at 1147-48; and 1984 Blue Book, at 53.

66 Cf. Treas. Reg. § 1.168(i)-4 and 1984 Blue Book, at 57 (discussing that regulations be promulgated relating to changes in use of depreciable property under former section 168(f)(13), now section 168(i)(5)).


68 See, e.g., Treas. Reg. § 1.708-1(b)(4), Ex. (iii) (illustrating that section 704(c) will not apply to the deemed contribution of property to the new partnership); Treas. Reg. § 1.704-3(a)(3)(i) (same); Treas. Reg. § 1.704-4(c)(3) (section 704(c)(1)(B) will not apply in connection with deemed distribution of new partnership interests); Treas. Reg. § 1.737-2(a) (section 737 will not apply in connection with deemed distribution of new partnership interests); and Treas. Reg. § 1.743-1(h)(1) (a partner continues to have the same basis adjustment under section 743(b) with respect to property in the new partnership regardless of whether the new partnership makes a section 754 election). Questions also may arise regarding how to apply an effective date based upon when property is acquired by a partnership when a single-member limited liability company that is disregarded for Federal tax purposes becomes classified as a partnership for Federal tax purposes due to the admittance of a second owner after the effective date (i.e., if the partnership has both a taxable and a tax-exempt party as partners and makes allocations to the tax-exempt party that are not qualified allocations).

69 Cf. T. Evans, Terminating Partnership Terminations, 2001 TNT 43-122 (Mar. 5, 2001) (arguing for eliminating adverse tax consequences resulting from partnership terminations under section 708(b)(1)(B)).
2. Application to Pass-Thru Entities Other Than Partnerships

As was indicated above, section 168(h)(6)(E) provides that rules similar to those in section 168(h)(6)(A), (B), (C), and (D) will apply in the case of any pass-thru entity other than a partnership. Neither section 168(h)(6)(E) nor section 470, however, provides a definition of “pass-thru entity” for purposes of these sections. Moreover, there is no universal definition of a “pass-thru entity” that applies for all purposes of the Code. Thus, it is unclear what pass-thru entities other than partnerships are subject to section 470. In fact, the Notice requests comments regarding what types of entities other than partnerships should be considered pass-thru entities for purposes of section 470.

Moreover, there is no universal definition of a “pass-thru entity” that applies for all purposes of the Code. Thus, it is unclear what pass-thru entities other than partnerships are subject to section 470. In fact, the Notice requests comments regarding what types of entities other than partnerships should be considered pass-thru entities for purposes of section 470.

A number of other Code sections refer to “pass-thru entities.” Some of these Code sections (or the regulations thereunder) define the term, others do not. Where the term is defined, there are some sections in which REITs, RICs, and S corporations are treated as pass-thru entities; however, there are other sections in which some or all of these entities are not treated as pass-thru entities. Thus, it appears as if the definition of pass-thru entity is a function of the particular purpose of the Code section at issue. For example, section 67(c)(1) provides the IRS with authority to issue regulations prohibiting the indirect deduction through pass-thru entities of amounts that would not be allowable as deductions if paid or incurred directly by an individual. Section 67(c)(3) indicates that section 67(c)(1) does not apply to REITs -- a result that makes sense given that REITs do not pass through items of deduction.

For purposes of section 470, we recommend that S corporations, RICs, or REITS not be treated as pass-thru entities. None of these entities is a suitable vehicle for creating a synthetic SILO transaction. S corporations are not suitable vehicles because the S corporation rules require items of income, loss, and deduction to be allocated on a per-share, per-day basis, and S corporations can only have one class of stock; thus, losses and deductions cannot be allocated “disproportionately” to taxable shareholders. Similarly, a RIC or a REIT is not a suitable vehicle because such an entity does not pass through items of loss and deduction and, therefore, cannot be used to “funnel” deductions to taxable entities. We strongly recommend that these entities not be treated as pass-thru entities for purpose of the anti-SILO rules of section 470, given that they are not suitable vehicles for replicating the kinds of leasing transactions with which Congress was concerned in enacting section 470.

3. Application on a Property-by-Property Basis

As was indicated above, section 470(c)(1) defines tax-exempt use property by reference to the cost recovery rules of section 168(h). The cost recovery rules, by their very nature, relate to particular pieces of

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70 But see 1984 Blue Book, at 68 (parenthetically indicating that a trust is a pass-thru entity for purposes of former section 168(j)(9), now section 168(b)(6)).
72 See, e.g., section 1(h)(10) (defining a pass-thru entity, for purposes of section 1(h), as including RICs, REITs, S corporations, estates, and trusts); Treas. Reg. § 1.67-2T(g)(1) (defining a pass-thru entity, for purposes of section 67, as including S corporations, partnerships, and real estate mortgage investment conduits); section 267(e)(2) (defining a pass-thru entity, for purposes of section 267, as a partnership and an S corporation); section 1202(g)(4) (defining a pass-thru entity, for purposes of section 1202, as including RICs, S corporations, and partnerships); section 263A(i)(1) (not defining a pass-thru entity); section 355(d)(9) (not defining a pass-thru entity); and section 1355(d)(flush language) (not defining a pass-thru entity).
73 See, e.g., section 67(c)(3) (specifically excluding REITs from the definition of a pass-thru entity for purposes of section 67); and section 860E(e)(6)(B) (defining a pass-thru entity, for purposes of section 860E, as including RICs, REITs, and partnerships, but not including S corporations).
74 Cf. supra note 69.
75 See also supra note 60.
property; that is, they set forth the applicable depreciation method, recovery period, and convention for different types of property. Thus, the relevant statutory provisions suggest that the determination of what constitutes tax-exempt use property and the amount of the tax-exempt use loss is made on a property-by-property basis.

Nonetheless, applying section 470 on a property-by-property basis would impose substantial administrative burdens on pass-thru entities in many situations in which section 470 is implicated solely because of the application of section 168(h)(6). Section 470(c)(1) defines the term “tax-exempt use loss” for any taxable year as the excess of (1) the sum of the aggregate deductions (other than interest) directly allocable to tax-exempt use property plus the aggregate deductions for interest properly allocable to the property, over (2) the aggregate income from the property. Thus, it would be necessary to determine the amount of income and deduction relating to each piece of property. Although it may be relatively simple to determine what income and deductions are allocable to a particular lease, in many other contexts determining how much income and loss is attributable to a particular piece of partnership property (in a section 168(h)(6) context) may be difficult, if not impossible.

For example, consider a situation in which an operating partnership has a combination of taxable and tax-exempt partners and makes allocations that are not qualified to the tax-exempt partners. The operating partnership is engaged in legitimate commercial activity and is not engaged in, or being used to replicate, a SILO transaction. If section 470 is not legislatively modified so as to exclude this case, the operating partnership may have to attempt to determine how much income and how many deductions are attributable to each piece of property. Assuming the partnership holds a variety of assets ranging from office furniture to trucks to inventory to manufacturing equipment to intangible property, how can the partnership possibly determine how much income and what deductions are attributable to each desk, each truck, the inventory items, etc.?

As another example, consider a situation in which a real estate partnership leases units in apartment buildings to thousands of individual tenants. Is each rental unit treated as a separate piece of property? If so, would the partnership have to allocate deductions to each individual unit? Requiring such an effort would impose a tremendous administrative burden.

The Notice asked for comments regarding the extent to which property held by pass-thru entities should be aggregated to determine tax-exempt use losses. Given the administrative burdens and practical issues that can be presented in certain situations with a property-by-property approach, we support the notion of allowing a pass-thru entity to elect to aggregate property for purposes of determining tax-exempt use losses. Aggregation could be allowed on a business-unit basis or any other reasonable method (based on the particular facts and circumstances), provided the method is employed consistently. We note, however, that the amount of tax-exempt use loss (measured by reference to the difference between deductions and income) may be different when determined on an aggregate basis than when computed on a property-by-property basis.

We do not believe, however, that allowing for elective aggregation is a perfect solution. As was indicated above at Part II.C.1 above, an aggregation approach can raise additional complexities if the effective date is clarified to relate to the date a pass-thru entity acquired the property. Further, use of an aggregation approach may raise other issues. For example, what happens if the pass-thru entity disposes of an individual piece of property that has been treated as part of a larger “unit” for purposes of determining the tax-exempt use loss? Would the entity not be treated as having disposed of its entire interest in property under section 470(e)(2) until such time as the entity disposes of the entire larger unit? Instead, as is explained below, we believe the better solution is to modify section 470 by legislation so that the burden of complying with the loss deferral rules falls only on those partnerships that are engaged in, or have been used to replicate, SILO transactions.

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76 Cf. Treas. Reg. §§ 1.469-4(g) and 1.197-2(g)(1)(i)(A).
4. Level of Disallowance

The Notice requested comments regarding whether tax-exempt use losses arising from property held by pass-thru entities in the section 168(h)(6) context are determined at the entity level or at the owner level. As is explained below, it appears that section 470 provides that such losses are determined at the entity level. The temporary regulations under section 168 also suggest that such losses are determined at the entity level.77

As discussed above, section 470 provides that tax-exempt use losses are determined by comparing the deductions allocable to tax-exempt use property with the income from the property. In the section 168(h)(6) context, any tax-exempt use property will be owned by the partnership; thus, this comparison seemingly must take place at the partnership level. Further, section 470(b) generally provides that any tax-exempt use loss that is disallowed with respect to tax-exempt use loss property is treated as a deduction with respect to the property in the succeeding taxable year. Given that section 168(h)(6) causes property of a pass-thru entity to constitute tax-exempt use property, this deduction will be with respect to the pass-thru entity’s property. This, too, is consistent with determining the tax-exempt use loss at the entity level.

While the conclusion that the loss disallowance occurs at the partnership level seems inescapable under the statute, we would like to point out that the entity-level disallowance causes problems. A loss that is disallowed at the partnership level is something of an anomaly in subchapter K. Coordinating basis adjustments and the disallowed loss will present significant difficulties. For instance, will a partner’s basis in its partnership interest be reduced under section 705(a)(2)(B) when the loss is incurred but disallowed, or instead, will the loss reduce the partner’s basis under section 705(a)(2)(A) when it is actually taken by the partnership?78 Also, how will the basis adjustment rules under sections 734(b) and 743(b) operate in a situation where the inside basis of partnership property has been reduced by a loss that is still deferred at the partnership level? Seemingly, a positive basis adjustment to such property, where a deferred loss still exists with respect to the same property, creates a potential for duplication of losses.79 Beyond the rules of subchapter K, where a corporation owns an interest in a partnership that has losses limited under section 470, it is not clear how the loss disallowance will affect earnings and profits that flow out to the corporation.80 Further, as is explained in Part II.C.7 below, applying the loss disallowance rule at the partnership level creates issues in the context of tiered partnerships. As a final example, disallowing losses at the entity level could open the door to “trafficking” in losses (e.g., partners could sell interests in partnerships that have tax-exempt use losses to new partners that are interested in being able to use those losses when the partnership disposes of the property in the future).

5. Scope of Partnership Property Covered

There is considerable uncertainty as to what types of partnership property can be considered tax-exempt use property in a situation in which a partnership is subject to section 470 solely because of the application of section 168(h)(6). As was indicated above, section 168(h)(1) provides a definition of tax-exempt use property

77 See Treas. Reg. § 1.168(j)-1T, Q&A 26.
78 See Rev. Rul. 96-10, 1996-1 C.B. 138 (addressing adjustment to basis in partnership interest under section 705 where the loss on the sale of partnership property is disallowed under section 705(b)(1) and subsequent gain is not recognized under sections 267(d) and 705(b)(1)) and Rev. Rul. 96-11, 1996-1 C.B. 140 (addressing adjustment to basis under section 705 where a partnership makes a charitable contribution of property with basis lower than fair market value; disparity potentially created because charitable deduction is greater than basis of property contributed).
79 Cf. Treas. Reg. § 1.705-2 (addressing artificial loss creation scenario where a corporate partner purchases an interest in a partnership that holds stock of such purchaser and the partnership has no section 754 election; nonrecognition of gain under section 1032 upon a sale of the stock could give rise to an increase in partnership interest basis under section 705, thereby creation of an artificial loss upon a subsequent disposition of the partnership interest); and Notice 99-57, 1999-2 C.B. 693 (announcing the intention of the IRS to issue regulations under section 705, i.e., Treas. Reg. § 1.705-2).
80 Treas. Reg. §1.312-7(b)(1) (earnings and profits are reduced for “recognized” losses; a loss (other than a wash sale loss) that is disallowed may be “recognized,” even though it is not allowed as a deduction).
that applies when tangible property is leased to a tax-exempt entity. Importantly, section 168(h)(1), by its terms, only applies to tangible property. As was also explained above, for purposes of section 470, section 470(c)(2) modifies the definition of tax-exempt use property to include, among other things, certain specified intangible assets, such as section 197 intangibles. Nonetheless, section 470(c)(2) does not include other intangible assets, such as stock or securities, among the assets added.

In a situation in which a partnership is subject to section 470 as a result of the application of section 168(h)(6), tax-exempt use property is defined differently. Section 168(h)(6) applies to “any property” owned by a partnership that is not otherwise tax-exempt use property, as long as the partnership meets certain requirements with respect to its ownership and its allocations. That is, section 168(h)(6) literally applies to all property, while section 168(h)(1) applies only to tangible property plus certain property added by section 470(c)(2). Thus, a literal reading of sections 470 and 168(h)(6) seemingly produces the conclusion that section 470 can apply to a broader universe of property in a section 168(h)(6) context than in a section 168(h)(1) context.

This result, however, is incongruous. Why should section 470 apply to a broader category of property when a partnership with tax-exempt partners is holding property than when a taxable entity is leasing property to a tax-exempt entity? Moreover, regardless of the language used in drafting section 168(h)(6), it is clear that, as a practical matter, the section only applies to property that is subject to depreciation; that is, section 168(h)(6) serves to ensure that certain types of property are depreciated under the alternative cost recovery system, rather than under the “regular” cost recovery rules. Thus, section 168(h)(6) arguably has no practical meaning when applied to other than recovery property. Indeed, the very fact that section 470(c)(2) adds particular kinds of intangible property to the list of property covered by section 470 suggests that section 168(h) only covers depreciable property.

In addition, both sections 470 and 168 arguably are “all about” depreciable property. Section 168(a) provides recovery rules for tangible property, while section 168(h) ensures that certain kinds of tangible property are subject to the alternative depreciation system. Section 470 goes hand in hand with section 168 and was designed, at least in large part, to address concerns about taxpayers using leasing transactions to transfer the benefits of depreciation. Thus, it can be argued that section 470 should be read as being limited to depreciable property (subject to the modifications specifically set forth in section 470(c)).

6. Application to Like-Kind Exchanges and Involuntary Conversions

Sections 1031 and 1033 generally provide that no gain or loss is recognized with respect to a “like-kind” exchange or an “involuntary conversion” that meets certain requirements. Section 470(e)(4), however, contains special rules that can deny like-kind exchange and involuntary conversion treatment (and modify the basis results that otherwise would occur) in certain situations. For example, section 470(e)(4)(A) generally provides that sections 1031(a) and 1033(a) do not apply if either of the following two requirements is met:

1. the exchanged property is tax-exempt use property subject to a lease that was entered into before March 13, 2004, and the lease would not have met the requirements of section 470(d) had such requirements been in effect when the lease was entered into; or

(2) the replacement property “is tax-exempt use property subject to a lease which does not meet the requirements” of section 470(d). 82

These special rules clearly were drafted with a view to situations in which a taxable person leases property to a tax-exempt person in a leasing transaction that is not described in section 470(d). It is not at all clear, however, how and whether these rules apply in a situation in which a pass-thru entity is engaged in legitimate commercial leasing activity but is subject to section 470 solely because of the application of section 168(h)(6). There appears to be no tenable policy reason for denying like-kind exchange or involuntary conversion treatment in a situation in which a pass-thru entity is not engaging in (or being used to replicate) the kind of SILO transaction that Congress intended to prevent. Nonetheless, it would be helpful if administrative or legislative guidance made clear that the like-kind exchange and involuntary conversion rules continue to apply in those situations in which a pass-thru entity is not engaged in the kind of SILO transaction that Congress intended to prevent.

7. Application to Tiered Partnerships

As was indicated above, section 168(h)(6)(E) provides that rules similar to those of section 168(h)(6) apply to tiered entities. Nonetheless, no guidance has been issued regarding tiered entities in the section 168(h) context. Thus, it is not clear how to apply section 470 when a “lower-tier” partnership has other pass-thru entities as partners.

For example, consider a situation in which a lower-tier partnership’s partners include only taxable persons and other partnerships. Those other partnerships, in turn, are owned by taxable persons and other partnerships. These partnerships, in turn, are owned by other partnerships. And so on. And so on. There could be many levels of upper-tier partnerships. Nonetheless, in order for the lower-tier partnership to determine whether any of its losses are disallowed under section 470, it seemingly must determine to what extent it has (or does not have) any tax-exempt use property. This determination, in turn, seemingly requires the lower-tier partnership to ascertain the proportionate ownership of its interests by tax-exempt investors (taking into account indirect ownership through the upper-tier partnerships) and whether any allocations in any of the upper-tier partnerships are non-qualified allocations. In many cases, the lower-tier partnership simply will not have this information. Further, under current law, there is no mechanism for the lower-tier partnership to obtain all the needed information about the characteristics of partners and the types of allocations going all the way up the chain. Yet this information is needed if the focus is on disallowing losses at the partnership level.

From an administrative perspective, one solution could be to adopt rules based on a modified version of the “independent chain approach” set forth in the tiered-partnership rules for determining permitted allocations under the unrelated debt-financed rules of section 514(c)(9) and Treas. Reg. § 1.514(c)-2. 83 Under these modified rules, a lower-tier partnership would not be subject to the current version of section 470 if all of its allocations were qualified allocations (even if there were direct or indirect allocations to tax-exempt entities that were not qualified higher up the chain); instead, the loss deferral rules would be applied higher up the chain. Note that such an approach will not always yield identical results to applying the loss disallowance rules at the lower-tier level; different partners may end up bearing the economic burden of the loss deferral rules in different amounts than would be the case if the rules were applied at the lower-tier level. Nonetheless, such an approach would mitigate, to some extent, the information problems described above associated with applying

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82 Section 470(e)(4)(B) also sets forth rules for determining a lessor’s basis in replacement property in situations in which section 1031 or 1033 does apply. These special basis rules only apply for purposes of section 470. Specifically, section 470(e)(4)(B) generally provides that, in the case of property acquired by “the lessor” in a transaction to which section 1031 or 1033 applies, the basis of such property for purposes of section 470 equals the lesser of: (1) the fair market value of such replacement property at the beginning of the lease term, or (2) the amount that would be the lessor’s adjusted basis if section 1031 or 1033 had not applied to such transaction.

83 See Treas. Reg. § 1.514(c)-2(m)(1); Treas. Reg. § 1.514(c)-2(m)(2), Ex. 3.
section 470 at the lower-tier level. This approach, however, would require detailed reporting up the chain so that the upper-tier partnerships would have the relevant income and deduction amounts with respect to the lower-tier partnership properties so as to apply section 470.

8. Other Issues

There are a host of other issues that arise with respect to the application of the current version of section 470 to pass-thru entities as a result of section 168(h)(6). For example:

- Taxpayers will need more guidance than what is set forth in the temporary section 168 regulations\(^\text{84}\) regarding what allocations are “qualified allocations” within the meaning of section 168(h)(6)(B). For example, taxpayers will need clear rules regarding such matters as reverse section 704(c) allocations, disproportionate guaranteed payments, allocations of nonrecourse deductions under Treas. Reg. §1.704-2, and tracking allocations.\(^\text{85}\)
- Guidance will be needed clarifying the timing for determining whether a partnership has tax-exempt use property; that is, whether the determination is made annually, such that property could be tax-exempt use property in one year, but not in the next, depending upon the characteristics of the partners and the allocations.\(^\text{86}\)
- Guidance will be needed regarding how to allocate interest expense to property and how to determine what other deductions are “directly allocable” to property.
- Consideration will be needed of the treatment of taxable blocker entities and foreign persons that are fully taxable on partnership income in foreign jurisdictions.\(^\text{87}\) It is unclear to us what policy objective is accomplished, in the context of anti-SILO rules, by treating these entities as, in effect, tax-exempt entities.
- Consideration will be needed of such issues as the treatment of inventory. Inventory generally is high-turnover property and would be ill-suited to effect a SILO transaction.

The above list is not intended to be comprehensive. Other issues exist and more certainly will emerge, particularly if section 470 is not amended before the moratorium provided by the Notice expires.

ALTERNATIVE APPROACHES

In light of the potentially broad application of section 470 to a host of pass-thru entities that are not engaged in, or being used to replicate, the kind of leasing transactions Congress intended to prevent, as well as the other significant problems associated with the current statutory provision, we strongly believe that section 470 should be amended so that it applies with respect to pass-thru entities only to the extent such entities are engaged in, or are being used to replicate, SILO transactions. As we discussed at length above, we believe that

\(^{84}\) See Treas. Reg. § 1.168(j)-1T.

\(^{85}\) See, e.g., May 6, 1988 letter from the American Bar Association’s Section of Taxation addressing the section 704(b) regulations, reprinted at 88 TNT 111-42 (May 25, 1988); June 25, 1986 letter from the American Bar Association’s Section of Taxation addressing the section 704(b) regulations, reprinted at 86 TNT 133-40 (July 7, 1986).

\(^{86}\) Cf. 1984 Blue Book, at 57 (stating that regulations needed under former section 168(f)(13), which is now section 168(i)(5), addressing the treatment of property, the tax ownership of which has not changed, but which either becomes or ceases to be tax-exempt use property after having been placed in service by the taxpayer).

\(^{87}\) Obviously, the task of crafting rules to capture situations where a foreign person will be subject to adequate foreign tax presents some difficulties. Section 1(h)(11)(C)(i)(II) references countries with which the United States has entered into an income tax treaty, which indicates that the United States has sufficient respect for that country’s taxing system. This standard seems to draw the line too narrowly, as there are numerous additional jurisdictions where taxpayers would similarly be subject to an adequate level of tax. Senators Dorgan and Levin recently introduced legislation to treat certain CFCs established in tax havens as domestic corporations (S. 779). This proposed legislation lists numerous jurisdictions that were determined by the Organization for Economic Cooperation and Development to be tax-havens. The list of countries set forth in this legislation may also provide a benchmark for jurisdictions where “taxable” residents still would be treated as “tax-exempt” for purposes of applying section 470.
such an approach is consistent both with the Congressional intent that section 470 not inhibit legitimate commercial arrangements and with sound tax policy. Nonetheless, if section 470 is not so amended, we also have provided comments regarding those issues on which administrative guidance would be needed under the current statutory provision.

I. Alternative Approaches with Respect to Legislation

We have summarized below two possible approaches as to how section 470 could be amended to prevent SILO transactions in the pass-thru context while not impeding legitimate commercial arrangements. Both these approaches involve modifying the statute so that section 168(h)(6) would not be the touchstone for determining whether or not a pass-thru entity is being used to replicate a SILO transaction. Both approaches are also predicated on characterizing certain pass-thru arrangements that bear the hallmarks of synthetic SILO transactions as leases to tax-exempt entities to which section 470 would apply by virtue of section 168(h)(1).

The first approach applies the rules of section 7701(e)(2), in conjunction with the rules of section 168(h)(1), to identify those situations in which pass-thru entities are used to replicate SILO transactions. We believe that this approach has merit. Indeed, to the extent that a legislative solution is “in the works” but has not yet been enacted by the time the moratorium provided by the Notice expires, we believe that the IRS and Treasury could extend the moratorium on applying section 470 because of the application of section 168(h)(6) pending the enactment of such legislation and use section 7701(e)(2) to police any concerns about ongoing SILO transactions (e.g., through issuing notices indicating how partnership arrangements that replicate SILO transactions could be attacked under sections 7701(e)(2), 168(h)(1), and 470).

Nonetheless, we believe that both the Government and taxpayers would face significant uncertainty regarding how to apply the rules of section 7701(e)(2), together with those of sections 168(h)(1) and 470, in the context of SILO transactions. Thus, we believe the better approach instead would be to formulate a new special rule for partnerships that sets forth objective standards to be used in determining whether partnership property will be treated as leased to a tax-exempt entity for purposes of section 470.

A. Possible Section 7701(e)(2) Approach

Under this approach, the definition of tax-exempt use property for purposes of section 470 would be determined without regard to the application of section 168(h)(6). Section 470(c)(2) currently defines tax-exempt use property by reference to section 168(h), but without regard to sections 168(h)(1)(C) and (3). Thus, section 470(c)(2)(A) could be amended to define tax-exempt use property without regard to paragraphs 1(C), (3), and (6) of section 168(h). As we discussed above, using section 168(h)(6) as the touchstone for defining an “abusive” arrangement is inappropriate, causes an overly broad universe of pass-thru entities to be covered, and raises a host of unanswered questions regarding the application of section 470 to pass-thru entities.

Nonetheless, even without the reference to section 168(h)(6), section 7701(e)(2) still can be applied to treat a partnership as a lease of property to a tax-exempt entity in appropriate cases (i.e., such that section 470 can apply because of the reference to section 168(h)(1)). As was explained above, section 7701(e)(2) already

88 By focusing on whether there is a lease of property to a tax-exempt entity under section 168(h)(1), both approaches resolve the current disconnect between the scope of property covered under section 168(h)(1) and the scope of property potentially covered under section 168(h)(6). See discussion at Part II.A of our Detailed Comments in text supra.
89 The definition of tax-exempt use property, for purposes of section 470, also includes certain property described in section 470(c)(2)(B).
90 This change would make the flush language at the end of section 470(c) referring to certain “credit” partnerships unnecessary. We note that the reference to sections 168(h)(1)(C) and (3) in section 470(c)(2)(A) expands the section 168(h) definition of tax-exempt use property for purposes of section 470. See supra note 32. The addition of a reference to section 168(h)(6) to section 470(c)(2)(A), however, would narrow the section 168(h) definition of tax-exempt use property for purposes of section 470.
contains a mechanism pursuant to which a pass-thru entity (or other arrangement) can be recast as a lease where a tax-exempt entity uses partnership property. Although section 7701(e)(2) may be best suited to combat synthetic SILO transactions in which a tax-exempt entity contributes cash to a partnership that, in turn, purchases partnership property that will be used and controlled by the tax-exempt entity, there appears to be no reason why the factors set forth in section 7701(e)(2) (and its legislative history) could not also be used to identify those synthetic SILO transactions in which a tax-exempt entity contributes property to a partnership.

Nonetheless, a significant downside of this approach is that neither the Government nor taxpayers may be aware of precisely how to apply the section 7701(e)(2) rules for purposes of section 470. As was indicated above, section 7701(e)(1) sets forth certain factors that can be taken into account in determining if a service contract is a lease, while section 7701(e)(2) indicates that an arrangement not described in section 7701(e)(1) also can be recast as a lease, taking into account all relevant factors, including factors similar to those in section 7701(e)(1). The factors set forth in section 7701(e)(1), however, may be difficult to apply in identifying a SILO transaction, given that they are focused more generally on identifying lease arrangements (as opposed to a sale followed by a lease). Further, although section 7701(e)(2) provides the Government with flexibility to take into account “similar” factors, there is likely to be considerable uncertainty, on the part of both the Government and taxpayers, as to exactly what situations should be recast as leases for purposes of applying sections 168(h)(1) and 470.

Thus, if this approach is pursued, it would be imperative for the legislative history of the statutory amendment to section 470 to make clear that Congress intended to apply the rules of section 7701(e)(2) so as to deter the use of pass-thru entities in replicating SILO transactions, but not to inhibit other arrangements. Examples of transactions to which section 470 should and should not apply by virtue of section 7701(e)(2) (similar to those set forth in these comments) would be important in this regard. Under this approach, administrative guidance also would be needed to provide certainty as to how section 7701(e)(2) applies for purposes of section 470.

If this approach is pursued, we believe that the “repeal” of the reference to section 168(h)(6) should be effective retroactively either to the effective date of the Act or to taxable years beginning on or after January 1, 2005. Given that the Notice precludes section 470 from applying to pass-thru entities solely as a result of the application of section 168(h)(6) for taxable years beginning before January 1, 2005, either such effective date would prevent section 168(h)(6) from inappropriately being used as a touchstone for identifying SILO-like arrangements for any period. Nonetheless, the Government’s interests in policing abusive SILO-like arrangements would be protected. In fact, the legislative history of the amendment could make clear that, in a situation in which a partnership was being used to replicate a SILO transaction, the IRS could apply sections 7701(e)(2) and 168(h)(1) to treat the partnership as a lease to a tax-exempt entity and could look to the general “leases entered into after March 12, 2004” effective date of section 470.

B. Preferred Approach -- New Rule for Partnerships

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91 See supra note 40 (discussing an example where property purchased by a partnership is treated as leased to a tax-exempt entity). The type of SILO transaction with which Congress was concerned typically involved a sale of property by a tax-exempt entity to a taxable entity followed by a lease back of such property to the tax-exempt entity in a situation where the Government viewed the taxable entity’s interest in the property as having limited economic substance. Where the tax-exempt entity contributes property to a partnership, and the taxable entity’s partnership interest has limited economic substance, it may be difficult to find the initial “sale” that would have to precede the “lease” under section 7701(e)(2).

92 See supra note 90. Similarly, once an arrangement is classified as a lease under section 7701(e)(2), it would be difficult to overlay the factors of section 470(d) to determine if the arrangement appropriately should be classified as a SILO subject to section 470. Further difficulties could arise in applying section 7701(e)(2) in a tiered-partnership context.

93 If such an approach were adopted, we also suggest that section 470 further be amended to allow partnerships to establish that they are not being used in a manner that circumvents the purpose of the anti-SILO rules of section 470. Such an exception would alleviate, to some extent, the problems associated with the lack of a partnership counterpart to the exception of section 470(d).
Given the subjectivity and concomitant uncertainty associated with using section 7701(e)(2) as a touchstone for identifying situations in which partnerships are being used to replicate SILO transactions, we believe that a better approach would be as follows.

First, amend section 470, as under the first approach, by amending section 470(c)(2)(A) in the manner described above in Part I.A of our Alternative Approaches, such that the definition of tax-exempt use property would not take into account the application of section 168(h)(6).

Second, amend section 470 to provide a special rule for partnerships. As a conceptual matter, this rule would eliminate the uncertainty associated with applying section 7701(e)(2) in conjunction with section 168(h)(1). Instead, the special rule would import certain of the principles of both sections 7701(e)(2) and 168(h)(6) and craft a more precise definition of when (and to what extent) a partnership is being used to replicate a SILO transaction.

Specifically, section 470 could be amended to provide that, solely for purposes of section 470, (1) section 7701(e)(2) would not apply, but that (2) a partnership would be considered to have leased property to a tax-exempt person for purposes of the definition of tax-exempt use property in section 470(c)(2), to the extent (A) the partnership has both a taxable and a tax-exempt entity as partners, (B) any allocation to the tax-exempt entity is not a qualified allocation, and (C) the tax-exempt entity has significant operational control over the property or uses the property to a significant extent. This rule focuses on those factors that must be present in the kind of leasing arrangement with which the Congress was concerned that are easiest to define objectively in the context of a partnership arrangement -- that is, use of the property and shifting of tax benefits. Under this approach, most partnerships that are not being used to circumvent the Congressional intent underlying the enactment of the “anti-SILO” rules should have certainty that they fall outside the scope of section 470.

As stated above, the factors that indicate a SILO transaction involve more than just use of the property and shifting of tax benefits. Other factors that indicate a lack of economic substance on the part of the taxable entity’s investment also are hallmarks of a SILO transaction. These factors, however, are more difficult to define objectively in the context of partnership arrangements that may take different forms. Thus, there may be some partnership arrangements that meet the objective standards but that are not being used to replicate the economics of SILO transactions. In order to prevent section 470 from being applied inappropriately to these partnerships, an exception could be provided indicating that a partnership will not be considered to have leased property to a tax-exempt entity to the extent the partnership can establish that it is not being used in such a manner so as to circumvent the purposes of section 470, with the burden of so establishing being upon the taxpayer.

For purposes of applying this exception, we respectfully suggest that the drafters of the legislation provide (either in the statute or legislative history) that factors similar to those in section 470(d) should be used to determine whether a partnership is being used to replicate a SILO transaction. The factors in section 470(d) focus on the economic substance of the taxable entity’s investment, looking to attributes such as risk of loss on the part of the taxable entity and defeasement of the tax-exempt entity’s obligations to the taxable entity. The use of factors “similar” to those set forth in section 470(d), with the burden being on the taxpayer to show that it is not replicating a SILO arrangement, should adequately balance protecting the interests of the Government with not impeding legitimate business arrangements.

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94 Cf. § 124.100 of the Small Business Administration (“SBA”) regulations, 54 Fed. Reg. 34692 (Aug. 21, 1989) (regulations relating to the SBA Minority and Small Business and Capital Ownership Development Program define “operational control” as “actual or constructive authority to establish long and short term goals for the concern, and to manage the concern’s day-to-day operations”).

95 See supra text accompanying note 16.
For purposes of the proposed rule, the definition of tax-exempt entity could be defined in a similar manner as in section 168(h)(2), but with exceptions such that taxable blocker corporations and foreign persons that are taxed adequately in foreign jurisdictions would be excluded. Further, the definition of “qualified allocation” could be made by reference to the “fractions rule” of section 514(c)(9)(E)(i), rather than the qualified allocation rule of section 168(h)(6); as was discussed in Part II. C.4 of our Detailed Comments above, the fractions rule reflects more recent Congressional thinking regarding allocations and, while far from perfect, is better suited to defining the kinds of allocations that could give rise to SILO concerns in a partnership context. In addition, the concepts of “control” and “use” could be defined by reference to section 7701(e)(2); however, regulatory guidance would be needed to further define such terms and to address when control and use are “significant.”

As with the first approach, the legislative history accompanying the amendment would need to explain the intricacies of the special rule (including such issues as the meaning of “control”) and the kinds of partnerships to which the rule is, and is not, intended to apply. Further, as with the first approach, examples would be helpful so that both the Government and taxpayers could understand what kinds of transactions would be covered.

Also as with the first approach, we suggest that this approach be effective retroactively either to the effective date of the Act or to taxable years beginning on or after January 1, 2005 (i.e., to taxable years not covered by the “moratorium” set forth in the Notice). It is critical that section 168(h)(6) not be used as a touchstone for identifying an abusive partnership arrangement for any period; otherwise, as was described in depth above, a host of partnerships that are not in any way involved in SILO transactions could be inappropriately subject to the burdensome new loss deferral regime. Although we understand that Congress in many cases may be reluctant to apply legislation retroactively, we believe that the use of such a date in this situation protects those taxpayers that were not the intended targets of the initial “anti-SILO” legislation, while allowing the Government to pursue those situations in which the hallmarks of a SILO transaction are present.

Finally, note that this approach, like the first approach, would mitigate the problems associated with like-kind exchange and involuntary conversion rules contained in section 470(e)(4) by narrowing the universe of partnership property that would be considered tax-exempt use property for purposes of that section. Nonetheless, even with this legislative change, the application of section 470(e)(4) in a partnership setting still may be unclear. Thus, regardless of which approach is taken, we believe that consideration should be given to revisiting the rules of section 470(e)(4) to ensure that the application of those rules in a partnership situation produces rational results.

II. Administrative Guidance

As has been discussed above, administrative guidance will be critical to the extent legislation amending section 470 is not enacted. If legislation is not enacted, we strongly recommend that, in providing the needed guidance, the IRS and Treasury exercise the broad regulatory authority granted in section 470(g) in such a manner so as to limit the application of section 470, to the maximum extent possible, to those pass-thru entities that are being used to engage in, or to replicate, SILO transactions. We believe such an interpretation would be consistent with the manifest Congressional intent not to apply section 470 so as to inhibit legitimate commercial arrangements.

96 See supra note 86.
97 See supra note 50.
If section 470 is not narrowed legislatively or interpreted through regulations so as to apply only to those pass-thru entities that are engaged in the kinds of arrangements that gave rise to Congressional concerns about SILO transactions, then guidance will be needed on a variety of issues regarding the application of section 470 to pass-thru entities. Please see our discussion in Part II.C of our Detailed Comments above for a more in-depth discussion of these issues. These issues include:

- **Clarification of the effective date.** Possible options include looking to whether a pass-thru entity acquired property after either March 12, 2004, or October 22, 2004. Depending upon how the effective date is clarified, guidance may be needed on such matters as improvements, intangible property, and technical terminations. Guidance also may be needed on applying the effective date if property can be aggregated for purposes of determining the amount of the tax-exempt use loss.

- **Other pass-thru entities.** We recommend that S corporations, RICs, and REITs not be treated as pass-thru entities for purpose of the anti-SILO rules of section 470, given that they are not suitable vehicles for replicating SILO transactions.

- **Aggregating Property.** Given the administrative burdens and practical issues that can be presented in certain situations with a property-by-property approach, we support the notion of allowing a pass-thru entity to elect to aggregate property for purposes of determining tax-exempt use losses on either a business-unit basis or any other reasonable method (based on the particular facts and circumstances), provided such method is employed consistently.

- **Types of Property.** We recommend that the IRS and Treasury make clear that partnership property is tax-exempt use property only to the extent such property is of a kind that could be tax-exempt use property if it were leased to tax-exempt entity in a transaction described in section 168(h)(1).

- **Like-Kind Exchanges and Involuntary Conversions.** We recommend that IRS and Treasury interpret the rules of section 470(e)(4) in such a manner so as not to change how and whether the like-kind exchange and involuntary conversion rules apply in situations in which pass-thru entities lease property to taxable persons.

- **Tiered Partnerships.** Given the administrative and practical difficulties involved in determining whether and to what extent a lower-tier partnership may indirectly make allocations that are not qualified to tax-exempt entities, we recommend that a lower-tier partnership not be subject to the current version of section 470 if all of its allocations are qualified allocations (even if there are direct or indirect allocations to tax-exempt entities that were not qualified higher up the chain).

- **Other.** Guidance is needed on other issues, including what allocations are qualified allocations, how to allocate interest expense and other deductions, whether the status of tax-exempt use property is determined on a yearly basis, the impact of taxable “blocker” entities, and the treatment of inventory.

    

    Thank you for considering these comments. We would be happy to answer any questions you may have or to provide further information.

    Sincerely,

    Kenneth W. Gideon
    Chair, Section of Taxation
cc: Hon. John Snow, Secretary of the Treasury
    Mark W. Everson, Commissioner, Internal Revenue Service
    Eric Solomon, Acting Deputy Assistant Secretary of the Treasury (Tax Policy)
    Donald L. Korb, Chief Counsel, Internal Revenue Service
    Helen M. Hubbard, Tax Legislative Counsel, Treasury Department
    Russ Sullivan, Democratic Staff Director, Senate Finance Committee
    Kolan Davis, Republican Staff Director and Chief Counsel, Senate Finance Committee
    Robert Winters, Republican Chief Tax Counsel, House Ways and Means Committee
    John Buckley, Democratic Chief Tax Counsel, House Ways and Means Committee
    George K. Yin, Chief of Staff, Joint Committee on Taxation