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July 18, 2005

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Re: Section 470 Legislation

Dear Sirs:

We are writing to recommend that Congress amend Section 470 of the Internal Revenue Code as it relates to partnership transactions. As described below, Section 470 in its current form will apply to a wide variety of ordinary partnership transactions having nothing to do with the type of leasing transaction that Section 470 was intended to prevent. Moreover, Section 470 will inflict a substantial administrative burden on such partnerships and potentially onerous tax consequences on their partners. We understand that, at

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the time of its enactment, some government officials were concerned that if Section 470 were to exempt partnerships, taxpayers might be able to engage in certain types of abusive transactions through partnerships. To address that concern, we recommend a fairly simple legislative solution that will both exempt legitimate partnership transactions from Section 470 and minimize the potential for abusive transactions in partnership form. We urge Congress to enact this solution as quickly as possible.

Background

Section 470[1] was recently enacted as part of the American Jobs Creation Act of 2004 (the "Jobs Act"). As explained by the Congressional committee reports, the purpose of Section 470 is to eliminate the potential tax benefits from a type of leasing transaction known as a "Sale In/Lease Out" or "SILO" transaction.[2] In a typical SILO transaction, a tax-exempt organization, governmental entity or foreign person (referred to herein collectively as "tax-exempt persons") sells property that it uses in its day-to-day activities to a taxable entity and then leases such property back. As described in IRS Notice 2005-13, a typical SILO transaction includes purchase options, nonrecourse financing, defeasance arrangements and other features that cause the purported owner of the property to have relatively few of the benefits and burdens of

[1] All "Section" references herein are to the Internal Revenue Code of 1986, as amended to date.

[2] See, H. Rep. No. 108-548, Pt. 1 (June 16, 2004) at 312-19; S. Rep. No. 108-192 (Nov. 7, 2003) at 197-200; and H.R. Conf. Rep. No. 108-755 (Oct 7, 2004) at 435-445.

ownership of the property. The principal purpose of such transactions is to shift depreciation and other deductions attributable to the subject property to the taxable entity without substantially changing the economic position of either party. The consequence of Section 470 applying to a leasing transaction is that the owner's losses with respect to the property may only be used to offset future income from such property. Any suspended losses may be used to offset unrelated income only after a complete disposition of the property.

In defining the class of transactions that are subject to Section 470, Congress took the approach of referring to the broad definition of "tax-exempt use property" in Section 168(h) of the Internal Revenue Code and then carving out leasing transactions covered by that definition that were viewed as legitimate economic transactions.[3] However, the definition of "tax-exempt use property" includes not only property that is leased to a tax-exempt person, but also any property that is owned by a partnership (or other "pass-thru entity") that includes both tax-exempt and taxable partners (unless the partnership has "qualified allocations" within the meaning of Section 168(h)(6)(B)), regardless of whether such partnership property is subject to a lease.[4] Unlike the approach taken by Section 470 with respect to

[3] See Sections 470(c)(2) and 470(d). This basic definition of "tax-exempt use property" in Section 168(h) is any tangible property that is leased to a tax-exempt organization, governmental entity or foreign person, subject to certain limited exceptions.

[4] Section 168 also provides limited exceptions for (i) situations where the tax-exempt partner is a tax-exempt organization as to which most of the income from the underlying property is taxable under Section 512 (without regard to Section 514) and (ii) situations where the tax-exempt partner is a foreign person as to which most of the income is subject to U.S. income tax.

the leasing prong of the definition of "tax-exempt use property", no carve out was created by Section 470 for legitimate economic partnership transactions.[5]

Problems With Section 470 As Applied to Partnerships

As presently drafted, Section 470 will apply to a wide variety of ordinary partnership transactions having nothing to do with SILO transactions. This follows for two reasons. First, a very large number of private equity, real estate, joint venture and similar partnerships have one or more tax-exempt organizations, governmental entities or foreign persons as partners. Second, it is very common for such partnerships not to have "qualified allocations" within the meaning of Section 168(h)(6)(B), which generally requires that all allocations of income and loss over the life of the partnership be made on a strictly pro rata basis and that such allocations fully comply with the "substantial economic effect" test in the Section 704(b) regulations.[6] This failure to have "qualified allocations" is usually due to the fact that such partnerships embody various commercially reasonable economic terms (such as preferred returns, subordination of capital, carried interests and disproportionate funding of expenses) that necessitate income and loss allocations that do not comply with the rigid mechanical requirements of the

[5] Section 470 also seems to be broader for partnerships in that it literally applies to all partnership property, not just the types of property that are covered by the leasing prong of Section 470 (as described in Section 470(c)(2)). See Section 168(h)(6) (referring to "any property").

[6] Temporary regulations under Section 168 provide an exception for certain guaranteed payments, but the scope of that exception is very limited. See Treas. Reg. § 1.168(j)-1T (Q&A 25).

definition of "qualified allocations". In addition, some partnerships may not have "qualified allocations" for more technical reasons, such as a failure to comply with all the specific requirements of the Section 704(b) regulations. While we do not know for certain how many partnerships with tax-exempt persons as partners do not have "qualified allocations", we would think that it is a large majority of them.

Not only does Section 470 cover a very large number of ordinary partnership transactions, but it will inflict a substantial administrative burden on such partnerships and potentially onerous tax consequences on their partners. As noted above, Section 470 applies on a property-by-property basis, suspending any tax losses from a particular property until future periods when there is net income from such property. Accordingly, Section 470 requires that a partnership identify and separately compute all items of income, gain, loss and deduction attributable to each of its properties, even those properties (such as desks and chairs) that are not leased and have no income stream directly attributable to them. The administrative burden to properly track and compute this tax accounting information for a typical partnership with many items of property could be overwhelming. Even with the temporary moratorium created by IRS Notice 2005-29,[7] we doubt that many partnerships will be able to provide all the necessary tax accounting information needed to fully comply with Section 470, at least in the absence of additional guidance from the

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[7] Notice 2005-29 deferred the effective date of the partnership aspect of Section 470 to taxable years beginning on or after January 1, 2005.

Treasury or the IRS addressing various technical issues and authorizing the use of aggregation rules and other simplifying conventions.[8]

Moreover, the actual tax consequences to the partners could be very onerous given the property-by-property application of Section 470. As a simple illustration, consider an operating partnership that has two items of property, one of which generates a net loss of $100 and one of which generates net income of $100. Assume further that half of the partnership interests are owned by tax-exempt persons. Since the partnership is operating on a break-even basis, the result normally would be that the partners report no income or loss. However, if the partnership does not have qualified allocations for any reason, the result under Section 470 is that the partners must report $50 of net income and carry forward $50 of net loss.[9] In other words, "phantom" income of $50 is produced, which is a truly punitive result in the context of an ordinary partnership that has not engaged in any kind of abusive transaction.

We doubt that Congress fully appreciated the potential impact of Section 470 in the context of partnership transactions. In fact, the partnership aspect of Section 470 is not mentioned in any of the Congressional

[8] Note that this administrability concern does not arise with respect to the partnership aspect of Section 168(h), since that provision only requires that the partnership adjust the depreciation schedules that it uses for its depreciable properties.

[9] The $50 of net income results because half the $100 of net loss from the second property is suspended under Section 470, so only $50 of such net loss may be netted against the $100 of net income from the first property. Note that even the passive activity loss limitation in Section 469 would not produce that result, as Section 469 generally would allow the netting of all the loss against all the income (either on the theory that the two properties represent a single activity or because each property constitutes a passive activity).

committee reports on the Jobs Act, despite the far-reaching tax consequences that it may have. Also, the transition rules for Section 470 refer only to "leases" and thus are not clear as to when the partnership aspect of Section 470 was intended to be effective.[10]

At first blush, it might seem appropriate in principle for Section 470 to apply to the same class of partnership transactions that are subject to Section 168(h). However, we do not believe that is the case. As background, Section 168(h), in its original form, was enacted in 1984 to stretch out the depreciation lives of any property that was leased to a tax-exempt person. As applied to partnership transactions, it had the effect of stretching out the depreciable lives of partnership property to the extent a partnership had tax-exempt persons as partners (unless the partnership had "qualified allocations"). The origin of the partnership aspect of Section 168(h) is obscure, because the legislative history focuses almost exclusively on leasing transactions and only refers to the partnership aspect in passing as an "anti-abuse rule" without any further explanation.[11] Assuming that the purpose of the partnership aspect of Section 168(h) is to prevent an improper shifting of partnership tax benefits from tax-exempt partners to taxable partners, it is

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[10] We acknowledge that the flush language at the end of Section 470(c)(2) contains a limited exception from the partnership aspect of Section 470, which suggests that some consideration was given to the partnership aspect of Section 470 before it was enacted. However, we understand that that exception was the result of a lobbying effort by a private group and it hardly is convincing proof that Congress really appreciated what it was doing in the partnership area.

[11] See, e.g., Joint Committee on Taxation, General Explanation of the Rev1enue Provisions of the Deficit Reduction Act of 1984 (Dec. 31, 1984) at 68-9.

clearly overbroad given that most ordinary partnerships lack qualified allocations for reasons having nothing to do with any such shifting of tax benefits (as noted earlier). Taxpayers seem to have been able to live with the consequences of Section 168(h) in the partnership context, because the practical effect was often only a modest slow down in depreciation deductions, especially after Congress revised the depreciation rules in 1986 to reduce depreciation benefits for regular property. However, the potential effects of Section 470 are much more draconian and, like the effects of Section 168(h), bear no relation to whether any abuse is occurring through the partnership (or, if so, the magnitude of that abuse). Moreover, as noted above, the application of Section 470 to partnerships would involve a complex process of keeping track of tax items attributable to each property owned by the partnership, an undertaking that a partnership would not normally have any reason to engage in otherwise. Section 168, in contrast, imposes no such burdens on partnerships. Consequently, we believe Section 470 should be applied in the partnership context only to the extent truly justified to prevent potentially abusive transactions.

It has been suggested that Section 470 should apply to partnerships in its current form in order to prevent taxpayers from engaging in "synthetic SILO" transactions through partnerships. For the following reasons, we question that assertion. In any case, as further discussed below, we believe that our proposed solution would deal adequately with any such concern.

As a threshold matter, we have difficulty seeing how a transaction truly comparable to a SILO transaction could be effectuated in a commercially reasonable manner using a partnership. More importantly, any such transaction may be vulnerable to attack by the IRS on any number of grounds, including (1) the Section 704(b) regulations, (2) the partnership anti-abuse rule in Treasury Regulation § 1.701-2, (3) traditional tax principles regarding ownership of property, (4) the substance over form doctrine, (5) the economic profit doctrine and (6) the transaction recharacterization rules in Section 7701(e) (which may recharacterize the transaction as a lease subject to Section 470). We believe that it would be difficult for a taxpayer to withstand an IRS challenge of a "synthetic SILO" transaction in the face of these doctrines.

We note that a comment letter from the Section of Taxation of the American Bar Association described one possible way that a taxpayer might attempt to engage in a "synthetic SILO" transaction through a partnership.[12] In the transaction, a partnership is created between a foreign municipality and a taxable person to acquire a subway system previously owned and operated by the municipality. The municipality continues to operate the subway system under a management contract with the partnership, and all the depreciation from the subway system is allocated to the taxable person. However, we question whether this transaction would be commercially

[12] See the letter of the Section of Taxation of the American Bar Association dated June 7, 2005 captioned "Section 470 of the Internal Revenue Code" (the "ABA Letter").

viable in view of the business operating risks borne by the partnership, the taxable partner's personal liability for a large amount of partnership debt and other features. Furthermore, we believe that such transaction would be vulnerable to challenge by the IRS on most of the legal grounds noted earlier (as the ABA Letter itself seems to acknowledge).

Notwithstanding the foregoing, we agree with those in government who believe that some safeguard should be included in Section 470 to prevent taxpayers from attempting to engage in "synthetic SILO" transactions through partnerships. However, we believe that Section 470 in its current form is overbroad for that purpose and that what is needed is a more tailored provision aimed specifically at partnerships embodying the features of a SILO transaction.

Recommendations

In view of the foregoing, we believe that Congress should scale back the partnership aspect of Section 470 to a provision that is more targeted to potential SILO-like transactions. Set forth in Exhibit A hereto is our proposed legislative solution. Our proposal would eliminate the partnership aspect of Section 470 in its current form by removing the cross-reference to the partnership aspect of Section 168(h). In its place, our proposal would add a provision applying Section 470 only to partnership transactions that embody the two key features of a SILO transaction. Those features would be (1) the use of partnership property by a tax-exempt partner and (2) a

disproportionately large share of the tax benefits from the property being allocated to taxable partners. This provision uses objective criteria should enable the participants in typical partnership transactions to quickly and easily conclude that such transactions are not subject to Section 470, while at the same time preventing abusive transactions.[13] It would be possible to list additional features in defining the class of partnership transactions subject to Section 470, but we do not believe that is necessary for the provision to have a reasonably limited scope.[14] However, in recognition of the possibility that some legitimate partnership transactions might be covered by the provision, our proposal allows the IRS to waive the application of the provision if it determines that to be appropriate in any particular case. Our proposal also includes a grant of regulatory authority to the Treasury to interpret the provision and expand its reach if that becomes necessary to prevent abuses (including through the issuance of notices rather than regulations).

We note that some commentators have suggested retaining the partnership aspect of Section 470 but adding exceptions for partnership transactions that are not abusive. We would counsel against that approach. First, as previously mentioned, the need for any sort of rule to prevent

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[13] Note that the provision should apply to the transaction described in the ABA Letter, since (i) the subject property is operated by the municipality pursuant to a management contract and (ii) a disproportionately large share of the tax benefits from the property is allocated to the taxable person.

[14] The additional features that might be added include (i) features that reduce the benefits and burdens of ownership as to the taxable partners (e.g., fixed price put options, defeasance arrangements and nonrecourse financing), (ii) an implicit "fee" to the tax-exempt partner and (iii) a lack of meaningful economic profit motive on the part of the taxable partners.

"synthetic SILO" partnerships appears to be fairly limited, so only a very targeted rule would seem to be warranted. Second, the approach of covering most partnerships but then providing specific exceptions for legitimate transactions would force taxpayers and the government to apply what would inevitably be complex law defining the exceptions. In particular, creating an exception based upon the "fractions rule" in Section 514(c)(9)(E), as some have suggested, would involve enormous complexity and create very significant commercial problems.[15] As the Tax Section has stated in three separate reports, the fractions rule is deeply flawed even as applied in its original context of leveraged real estate partnerships with tax-exempt organization partners.[16] Extending the fractions rule more broadly for Section 470 purposes would only compound the problems associated with the fractions rule. Furthermore, a fractions rule exception would not be nearly broad enough to carve out the many types of ordinary partnership transactions that do not involve SILO-like abuses.

[15] A proposal along these lines can be found in the letter of the Real Estate Roundtable dated March 4, 2005 captioned "Section 470 and Real Estate Partnerships".

[16] Our most recent comments, including recommended reforms, were provided in "Report on Section 514(c)(9)(E) Concerning Investments in Leveraged Real Estate Partnerships" dated Feb. 14, 1997 (reproduced at 97 TNT 34-39).

We appreciate your consideration of our recommendations regarding Section 470. We urge that legislative action be taken as quickly as possible. We would be happy to meet with your staff members to discuss this topic further if that would be helpful to you.

Respectfully submitted,

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Chair

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Proposed Section 470 Amendment

Section ____. Modification of Section 470.

(a) Paragraph (2)(A) of Section 470(c) (relating to the definition of 'tax-exempt use property' for purposes of Section 470) is amended to read as follows:

"(A) without regard to paragraphs (1)(C), (3) and (6) thereof, and"

(b) Section 470 (relating to certain limitations on losses from tax-exempt use property) is amended by redesignating subsection (g) as subsection (h) and by inserting after subsection (f) the following new subsection:

"(g) Certain Partnership Transactions

(1) Unless the Secretary determines otherwise, the loss disallowance principles of Section 470 shall apply to any property owned by a partnership with respect to which the following conditions apply -

(A) such property is substantially used by, or operated by or for the benefit of, one or more tax-exempt entities (as defined in Section 168(h)(2)) that are partners in such partnership (or related parties within the meaning of paragraph (f)(1) with respect to a partner), whether pursuant to a lease, service contract, management agreement or other arrangement; and

(B) a disproportionately large share of the losses or deductions attributable to such property is allocated by such partnership to partners therein that are not tax-exempt entities.

If this subsection (g) applies to any item of partnership property, then the tax-exempt use loss with respect to such property shall be determined by reference to the proportionate share of such property attributable to tax-exempt entity partners (as determined under the principles of Sections 168(h)(1)(D), 168(h)(6)(C) and 168(h)(6)(D))."

(c) Subsection (h) (relating to the Secretary's regulatory authority) is amended to delete the word "and" at the end of paragraph (1), replace the period at the end of paragraph (2) with ", and" and add the following new provisions at the end thereof:

"(3) clarifying the application of subsection (g) and expanding its scope as appropriate to prevent partnership transactions contrary to the intent of this Section 470.

The authority set forth in paragraph (g)(3) above may be exercised by the issuance of written notices or other administrative guidance without the promulgation of regulations."

(d) The amendments made by this section shall apply to partnerships and pass-thru entities described in Section 168(h)(6)(E) with respect to taxable years beginning on or after January 1, 2005.