The Real Estate Roundtable

October 26, 2006

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

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

Dear Chairman Grassley and Ranking Member Baucus:

By way of this transmittal letter, The Real Estate Roundtable is submitting comments to the Committee regarding H.R. 6264, The Tax Technical Corrections Act of 2006 ("Act") and specifically the provisions providing exceptions to the application of section 470 for certain partnerships.

We appreciate the Committee's recognition that exceptions to the application of section 470 for certain partnerships are necessary. This Code section was intended primarily to shut down abusive sale in, lease out ("SILO") transactions. Due to concern among Committee staff that SILO-like transactions possibly could be replicated in the partnership context, the application of section 470 was extended to partnerships.

We are grateful that the Committee recognizes that section 470's application to partnerships under current law is overly broad and that appropriate exceptions should be added to allow non-abusive partnerships relief. Similar relief is currently provided for leases, but not partnerships. The Committee and the staff have given serious consideration to the issue and to recommendations suggested by affected taxpayers, such as the members of the real estate industry. The Act's section 470 partnership proposed amendment makes some important strides in achieving a workable solution to a partnership section 470 exception.

Nevertheless, we remain highly concerned that the proposed amendment, like current law, inappropriately subjects numerous real estate partnerships that are not engaged in, or being used to replicate, SILO-like loss deferral. We also are concerned that partnerships will be subject to an unacceptable level of uncertainty regarding how and whether certain of the proposed provisions apply. We also have other concerns, including concerns regarding the effective date.

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Accompanying this letter is a section by section analysis of the proposed amendment that includes specific recommendations for modifications the Roundtable believes are necessary for it to be acceptable. Additionally, we support the comments submitted by NAREIT regarding the application of section 470 to REITs. We believe these recommendations improve the provision so as to satisfy the Committee's goal of preventing partnerships from being used to replicate SILOs, while removing real estate (and other) partnerships that have nothing to do with SILOs from the application of section 470.

We strongly urge you to accept these recommended modifications. We look forward to continue working with the Committee to achieve an appropriate and workable partnership exception to section 470.

Thank you.

Respectfully,

Stephen M. Renna
Senior Vice President and Counsel

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The Real Estate Roundtable

COMMENTS REGARDING
H.R. 6264
SECTION 470 PARTNERSHIP EXCEPTION
AMENDMENTS

Section by Section Analysis

1. Section 470(e)(1) and (4)(B) – General Exceptions and All-Or-Nothing Tax-Exempt Use Property Rule.

Bill Language

Section 470(e)(1) --

"(1) IN GENERAL.—In the case of any property which would (but for this subsection) be tax-exempt use property solely by reason of section 168(h)(6), such property shall not be treated as tax-exempt use property for purposes of this section for any taxable year of the partnership if—

(A) such property is not property of a character subject to the allowance for depreciation,

(B) any credit is allowable under section 42 or 47 with respect to such property, or

(C) except as provided in regulations prescribed by the Secretary under subsection (h)(4), the requirements of paragraphs (2) and (3) are met with respect to such property for such taxable year."

Section 470(e)(4)--

"(B) by treating the entire property as tax-exempt use property if any portion of such property is treated as tax-exempt use property by reason of paragraph (6) thereof."

Commentary

We interpret revised section 470(e)(4)(B) to mean that, if a partnership's interests are owned even a *de minimis* amount by a tax-exempt partner, then all partnership section 470 losses would be subject to 470 limits if the partnership cannot satisfy an applicable exception, not just the losses attributable to the tax-exempt partner's share. This fundamentally alters the application of section 168(h)(6), which otherwise limits losses based on the proportional interest of the tax-exempt partner. We believe strongly that this change does not constitute a technical correction. While Congress may not have fully appreciated the breadth of section 168(h)(6) when it incorporated those rules into section 470 in 2004, Congress did understand how section 168(h)(6) operates—and would operate within the context of section 470—particularly with regard to its more visible features such as the proportionate disallowance rule. Therefore, we respectfully submit that the change reflected in revised section 470(e)(4)(B) represents a substantive change to section 470 and that would be wholly inappropriate for inclusion in technical corrections legislation.

We also believe that revised section 470(e)(4)(B) is ill-advised. The legislation goes well beyond what is necessary to defeat SILO transactions and any variants involving partnership structures. Given the series of technical–and, in many places, vague—rules that partnerships must satisfy under the legislation in order to maintain loss allowance, a foot fault under these rules does not justify complete loss disallowance, particularly where there might be only *de minimis* tax-exempt participation. We consider this an overreach inconsistent with section 168(h)(6) and the intent of Congress in enacting Section 470.

This provision also may not be in the government's own interest. Section 470 operates by storing up deferred losses which are then released when the tax-exempt partner sells its interest to a taxable partner. The greater the amount of losses that are deferred, the greater the income sheltering potential upon sale.

Also, one hallmark of a SILO transaction is the fact that the taxpayer/lessor is insulated from the economic risk associated with true ownership of the property. A SILO is nothing more than a title flipping arrangement between taxable and tax-exempt entities for purposes of transferring tax benefits. The taxable party's investment, plus a pre-determined rate of return, is virtually guaranteed by the terms of the lease and side agreement terms. The tax-exempt entity is economically compelled to re-purchase the property and sets aside the funds to ensure its ability to do so. The proposed language in section 470(e)(2) and (3) addresses only the set aside part of the SILO arrangement. We believe the economic risk side of the arrangement is equally relevant and should also be used in testing whether a partnership should be subject to section 470. If the taxable partner has economic risk with respect to its interest, the partnership is not being used to replicate a SILO and should not be subject to the application of section 470. An exception based on the taxable partner having economic risk would be consistent with the objectives of section 470(d) (*i.e.*, the exception for "legitimate" leases).

Further, a clear, objective, and easily administrable way to remove a segment of real estate partnerships that are not engaged in, or being used to replicate, SILOs from the inappropriate application of section 470 is to define qualified allocations by reference to the "fractions rule." A partnership that complies with the fractions rule cannot be used to replicate a SILO. Therefore, we strongly believe that using the fractions rule as the touchstone for determining if a partnership's allocations are qualified cannot have any impact on the revenue score associated with the proposal or with the proposal's classification as a technical correction. Further, a reference to the fractions rule could be "updated" to the extent any future legislation modifies that rule. Thus, although the fractions rule is not perfect, we are unaware of any tenable reason why it should not be used in defining qualified allocations, particularly given that the use of such rule would provide thousands of legitimate real estate partnerships with certainty that they are not subject to section 470.

Finally, it is not clear whether the exception for non-depreciable property applies to non-amortizable property. While the bill language only refers to non-depreciable property, the Joint Committee on Taxation ("JCT") description of the bill (JCX-48-06) refers to both non-depreciable and non-amortizable property as being covered by the exception. We see no reason why non-amortizable property should not be excluded as well from the application of section 470.

Recommendation

(i) Apply Section 470 only to losses attributable to the tax-exempt partner(s) interest(s) in the partnership.

(ii) Add an "Economic Risk" test as a fourth (mutually exclusive) exception. For example: "(D) each taxable partner has economic risk with respect to its partnership interest, as evidenced by the investment having a meaningful probability that the after-tax internal rate of return to the taxable partner could vary by at least a pre-defined and reasonable range." We have suggested in the prior meetings a range of 300 basis points of the projected partnership returns as represented by the partnership sponsor. We encourage that this, or a similar approach, be adopted.

(iii) A carve-out is necessary for "pure" preferred interests. Such preferred interests often will not provide for significant economic risk evidenced by a projected variable return. At the same time, such interests will not present the opportunity for producing SILO-like results, since the interests will not provide for loss allocations, except in situations where the partnership has experienced losses at a level that have caused the elimination of the capital of all other partners.

(iv) Clarify that non-amortizable assets are not subject to section 470.

(v) Provide that, for purposes of section 470, section 168(h)(6)(A) shall be applied by disregarding section 168(h)(6)(B) and instead treating an allocation as a "qualified allocation" if it satisfies the rules of section 514(c)(9)(E). All tax-exempt partners would qualify for this allocation treatment. The definition of "qualified organization" in section 514(c)(9)(C) would not apply for purposes of section 470. [See comments above].

2. Section 470(e)(2)(A) and (C) – The "Arrangement and Set Aside" Requirement.

Bill Language

Section 470(e)(2)(A) subjects to section 470 loss limits an arrangement or set aside:

(i) to or for the benefit of any taxable partner of the partnership or any lender, or

(ii) to or for the benefit of any tax-exempt partner to satisfy any obligation of the tax-exempt to the partnership, any taxable partner, or any lender.

Section 470(e)(2)(C) provides that an arrangement includes a loan by a tax-exempt partner or the partnership to any taxable partner, the partnership, or any lender. (Technically, these concepts should be broken apart, as there cannot be a loan by the partnership to the partnership.)

Commentary

While the comprehensive scope of the "benefit of any lender" rule may be appropriate for leasing transactions, we believe that it needs to be narrowed and tailored as applied to partnerships. Implicit in the existing rule for leases is the notion that such an arrangement or set aside is designed to eliminate or significantly mitigate the economic risk of the beneficiary of the arrangement or set aside. Because not all arrangements or set asides in the partnership context are intended to eliminate or reduce the economic risk of taxable partners, we believe that the rule for partnerships and their partners should be limited explicitly to arrangements or set asides that do, in fact, reduce or eliminate the economic risk of the beneficiaries (perhaps in lieu of our recommendation above regarding a fourth general exception from section 470 and/or the economic relationship test in the bill language discussed below).

For example, without such a limitation the rule effectively would prevent partnerships from defeasing loans that may not be prepaid. Many commercial real estate loans are put into conduits, such as REMICs. These loans may not be pre-paid because doing so would frustrate the expected return to conduit investors. A partnership interested in selling the property subject to the conduit loan must defease the collateral with U.S. securities expected to provide a similar cash flow as the property. In this regard, the "benefit of any lender" language would put partnerships at a significant economic disadvantage vis-à-vis other entities.

Also, loans by a tax-exempt partner to the partnership could be very common. If a partnership encounters economic difficulty, it is not at all unusual for partners to begin funding operations through debt rather than equity in order to preserve claims for repayment vis-à-vis other creditors. Letters of credit, etc. are used to support guarantee obligations of tax-exempt partners with respect to partnership debt. Credit support arrangements are used to fund capital calls. Also, partnerships sometimes borrow money relying on the credit of the tax-exempt partner.

More generally, advancing funds to a partnership through a combination of debt and equity is very common. In addition, loans by a partnership to taxable partners are quite common. Also, tax-exempts may loan money to employee/service providers to acquire interests in a partnership. As another example, management companies often lend money to managers to allow the managers to acquire interests as a means of incentive-based compensation.

Partner to partner loans also come into play where there is a default on a capital contribution obligation. Where one partner fails to fund a capital call, another partner can contribute for that partner, with the operative documents considering the advance to be a loan between the partners. As is explained below, the proposed language appears to have "zero tolerance" for such an arrangement, even though the arrangement has nothing to do with a SILO.

Finally, we would note that the application of section 470 would not be limited only to those taxable partners which are the beneficiaries of an arrangement or set aside, so we would be interested in better understanding how the Government anticipates applying section 470 to a particular taxable partner on the basis of a loan among other partners—of which the taxable partner may not even be aware.

Recommendations

(i) Problems created by the proposed language relative to partner loans causing legitimate arrangements to be covered could be alleviated to some extent by limiting the language to arrangements or set asides that reduce or eliminate economic risk of their beneficiaries or, similarly, by adopting the "Economic Risk" exception discussed above (and the other modifications discussed below).

(ii) We understand that that lender arrangements and set asides are included as types of defeasance in section 470(d) primarily to prevent loans to lessors that will be either (1) forgiven or (2) satisfied through payment by the lessee to the lender. If this is correct, then the partnership rule for lender arrangements and set asides should be narrowed so as to only capture situations where the loan arrangement is intended to serve as a device to ensure the return of the taxable partner's investment in the partnership (e.g., repayment of a loan to a taxable partner is contingent upon the return of the partner's investment).

3. Section 470(e)(2)(B) -- Allowable Partnership Amount.

Bill Language

"Allowable partnership amount" is defined to be the greater of:

(i) (a) the sum of 20 percent of the sum of the taxable partners' capital accounts, plus

(b) 20 percent of the sum of the taxable partners' share of recourse liabilities of the partnership, or

(ii) 20 percent of the aggregate debt of the partnership.

Commentary

Given the breadth of arrangements and set asides that would be subject to section 470, the allowable partnership amount clearly should be higher than 20%, although it really is somewhat doubtful that any amount will be sufficient to adequately exempt non-abusive partnerships. The need for a higher allowable amount is particularly acute when a partnership is in the liquidation phase. In the liquidation phase, which can take a year or more depending on market conditions, the last sale or last few sales realistically may put a partnership over the 20% threshold (*e.g.,* last asset is worth $100; sell it and hold proceeds for distribution; the $100 awaiting distribution is above the 20% threshold). This problem is made even more acute by the fact that, when in the liquidation phase, a partnership may not be able to take advantage of the 12-month rule (described below) due to the continuing sales and holding of cash.

Furthermore, the 20% threshold by reference to taxable partners' capital accounts and recourse debt share may not give much help where a partnership has *de minimis* taxable partners participating, especially in light of the fact that revised section 470(e)(4)(B) (discussed above) would eliminate the section 168(h)(6) proportionate disallowance rule. A partnership with minimal participation by taxable partners is not an unusual arrangement. In numerous investment partnerships, the tax-exempt partner(s) provide(s) the overwhelming amount of the capital. They are the "finance" partners. The taxable partner is often the real estate company sponsor that is putting in some capital along side the tax-exempt but its primary contribution is its real estate management, development, and investment expertise.

The alternative allowable amount of 20% of aggregate partnership debt also will not give much help where partnership is not highly leveraged. This is a particularly likely scenario in liquidation phase when debt is being paid off.

Recommendations

(i) The allowable amount should be increased to *at least* 50 percent. Most SILO arrangements had defeasance levels for taxable partners of nearly 100 percent. The 50 percent threshold further makes sense since section 470(d) already permits the Treasury Secretary to increase the threshold to 50% for leases under certain circumstances.

(ii) Section 470 should not apply when a partnership is in the liquidation phase, perhaps pursuant to a plan of liquidation. There is little, if any, opportunity to transfer tax benefits and defease a taxable partner's risk in this relatively short period. Moreover, any deferred losses likely will be released in any case during liquidation upon disposition of the tax-exempt use property (see present-law section 470(e)(2)).

(iii) Similarly, Section 470 should not apply to funds in escrow or otherwise held due to litigation.

(iv) Another allowable amount standard should be the aggregate at risk amounts of the partners as determined under Section 465 since this represents the amount of economic risk the partners have invested. At-risk amounts under Section 465 are cash, basis of property contributed, recourse debt and qualified non-recourse financing.

4. Section 470(e)(2)(B)(iii) - No Allowable Partnership Amount for Arrangements Outside the Partnership.

Bill Language

This section provides that the allowable partnership amount shall be zero with respect to any set aside or arrangement under which any of the funds referred to in subparagraph (A) are not partnership property.

Commentary

Given the broad definition of arrangement, the absolute prohibition on arrangements and set asides outside the partnership will sweep many partnerships, not just the involved partners, into Section 470 with absolutely no means of relief. A common example of outside defeasance would be a situation in which an employer loans an employee money to buy a partnership interest in a fund sponsored by the employer and the employee puts up a letter of credit as part of the repayment terms.

As another example, if a partner guarantees partnership debt, the lender often may require that partner to post collateral to secure the loan in a manner that constitutes an impermissible arrangement; given the absolute prohibition on defeasance outside the partnership, this legitimate arrangement would cause the partnership to fall outside the scope of the exception and to be subject to section 470 with respect to depreciable property. Further, as was mentioned above, legitimate loans among partners and between partners and partnerships also could cause partnerships to fall outside the scope of the exception.

Again, since the application of section 470 would not be limited only to those taxable partners which are the beneficiaries of an arrangement or set aside, we would be interested in better understanding how the Government anticipates applying section 470 to a taxable partner on the basis of transactions among other partners—of which the taxable partner may not even be aware—particularly in light of the absolute prohibition against arrangements outside the partnership.

Recommendation

Outside partnership defeasance should be allowed the same relief allowed inside partnership defeasance. We are not aware of any reason why outside partnership defeasance is more pernicious than inside partnership defeasance such that no allowable amount of defeasance should be permitted, particularly with the heightened potential that section 470 could apply to taxable partners who simply are unaware of arrangements that might exist among other partners and that are unrelated to the partnership.

5. Section 470(e)(2)(D)(i) – Exception for Short Term Funds

Bill Language

This provision provides that funds which are set aside, or subject to any arrangement, for a period of less than 12 months shall not be taken into account under subparagraph (A). Except as provided by the Secretary, all related set asides and arrangements shall be treated as 1 arrangement. The JCT description of the bill states that a series of multiple set asides or arrangements which combine to exceed the 12-month threshold will not be eligible for the exception. It goes on to say that the exception should not be interpreted to permit taxpayers to effectively extend the 12-month threshold by use of separate and fungible set asides or arrangements.

Commentary

While we welcome any safe harbor relief from the application of section 470, the exception for short-term funds raises several interpretive and operational questions that create doubts as to its usefulness to non-abusive partnerships. For instance, what does the term "related" mean in this context? Cash and certain types of securities are completely fungible. Would the following example be considered a related multiple set aside which combines to exceed the 12 month threshold?

Partnership sells a non-leveraged asset for $100 and holds the proceeds in the partnership's bank account for 90 days before distributing them. On day 60, the partnership sells another non-leveraged asset for $200 and holds the proceeds in the same account until they are distributed 11 months later. It's clear that the sale proceeds from each of the two sales, if viewed completely separately, are distributed within the allotted 12 months. But, is the intention of this language such that the $100 of proceeds from the first sale actually is considered set aside for 13 months since there is at least $100 in the partnership bank account for that period?

If this interpretation is correct, partnerships that are frequently selling property and distributing proceeds will be left to rely solely on the allowable amount for relief. When a partnership hits liquidation phase, the problem is exacerbated as properties will be sold on a continuous basis.

Recommendations

(i) The term "related" needs to be clarified beyond the discussion in the JCT description of the bill.

(ii) At a minimum, funds held by the partnership should be deemed not to be set aside once the partnership has adopted a plan of liquidation, with some reasonable period of time, such as two years, allowed for the partnership to carry out its liquidation.

6. Section 470(e)(2)(D)(ii) -- Economic Relationship Test

Bill Language

The provision provides an exception for funds subject to an arrangement, or set aside or expected to be set aside, that bear no connection to the economic relationships between and among the partners and that bear no connection to the economic relationships between the partners and the partnership. Any funds that bear a connection either to the economic relationship between two or more partners or to the economic relationship between the partnership and any partner do not meet the exception and must be taken into account.

Commentary

Again, while we welcome any efforts to narrow the application of section 470 with regard to non-abusive partnerships, it is unclear what this provision means. We understand that this provision may have been included given that the bill does not designate who can (or cannot) set aside funds or be subject to an arrangement to or for the benefit of a partner, the partnership, or any lender. Nonetheless, the "no connection" language could be interpreted in a very restrictive manner such that it would not apply in certain common situations in which parties may have some relationships, but not of a nature that could give rise to SILO concerns.

For example, a taxable and tax-exempt party may be partners in one partnership, with the tax-exempt partner lending funds to the taxable partner in a wholly different context. Although the loan has nothing to do with the joint investment of the parties in the partnership, the loan does bear a clear connection to the economic relationship of the taxable partner and tax-exempt partner.

Recommendation

This provision is in need of elaboration, which we hope would clarify that it exempts from the application of section 470 arrangements and set asides that do not, in a real and substantial way, affect the relationships of the relevant parties in a capacity that relates to the partnership being analyzed under section 470. Also, the provision needs to explain how lenders are taken into account – for example, by clarifying that arrangements or set asides with respect to lenders are only taken into account where such arrangements affect the economic relationships among the partners or among the partners and the partnership.

We believe that the recommendation provided above (with regard to section 470(e)(2)(A) and (C) – the "arrangement and set aside" requirement) to limit the definition of defeasance to arrangements or set asides that reduce or eliminate the risk of loss for the beneficiaries of such arrangements or set asides would largely remove the need for the "no economic connection" exception. The recommendation also would provide a much clearer and more useful expression of the underlying principle of section 470 as it applies to partnerships.

7. Section 470(e)(2)(D)(iii) – Reasonable Person Standard

Proposed Language

For purposes of subparagraph (A)(ii), funds shall be treated as set aside or expected to be set aside only if a reasonable person would conclude, based on the facts and circumstances, that such funds are set aside or expected to be set aside.

Commentary

In a SILO transaction, any amount set aside would seem to be for the purpose of defeasing the taxable lessor. There are not many reasons in a lease arrangement to set aside cash other than to protect the economic interest of the lessor. In reality, the reasonable person test most likely was not envisioned by lawmakers to be applied in the lease context since Section 470 was designed as a deterrent to SILO transactions. In the partnership context, however, Section 470 is an operational statute. Further, given the nature of a partnership, all funds are held for the benefit of those with an economic stake in the venture, including lenders and partners. Presumably, the "reasonable person" standard was intended to identify only a subset of partnership funds that are segregated and are not available for general use in connection with the business of the partnership.

Therefore, the reasonable person test needs definition so it can be applied with greater certainty. Further, consideration needs to be given as to how partnerships could establish with certainty the purposes for which funds are set aside in a manner that is not overwhelmingly administratively burdensome, given fungible money and tracing concerns.

Recommendation

We recommend limiting the application of defeasance to "set asides that a reasonable person would conclude, based on facts and circumstances, are made to provide distributions to the taxable partner, (or payment to a lender who has advanced funds in an arrangement designed to support return of the taxable partner's investment), so as to reduce the partner's economic risk of loss." This would tie in with the Economic Risk test discussed above. Further, given the subjectivity that always will be inherent in a "no set aside" requirement, using the fractions rule to measure whether allocations are qualified at least would provide an objective means by which real estate partnerships could be certain that section 470 is not applicable.

8. Section 470(e)(3)(A) – Option to Purchase.

Bill Language

(A). In General. The requirement of this paragraph is met for any taxable year with respect to any property owned by the partnership if (at all times during such taxable year) –

i. Each tax-exempt partner does not have an option to purchase (or compel distribution of) such property at other than fair market value.

ii. Each tax-exempt does not have an option to purchase any direct or indirect interest in the partnership at other than fair market value.

iii. Each taxable partner does not have an option to sell (or compel distribution of) such property to a tax-exempt partner at other than fair market value.

iv. Each taxable partner does not have an option to sell a direct or indirect interest in the partnership to a tax-exempt partner at other than fair market value.

v. The partnership does not have an option to sell (or compel distribution of) such property to a tax-exempt partner at other than fair market value.

vi. The partnership does not have an option to sell a direct or indirect interest in the partnership to a tax-exempt partner at other than fair market value.

Commentary

The bill language above is dissected into the transactions between the parties and properties described in this portion of the bill: We find the transaction described in (iii) to be confusing.

With respect to (iii), the taxable partner does not own the property held by the partnership and thus seemingly could not be under any obligation to transfer such property to a tax-exempt partner. If there is a concern about a tax-exempt partner taking a distribution of property and then selling such property, that series of transactions should be specifically described.

Regarding the tax-exempt partner's option to purchase property at fair market value, the statute only addresses fair market value with respect to the partnership property. Presumably, the Government also is concerned that the credit given to the tax-exempt partner for the interest that is redeemed reflects the fair market value of that interest. This raises the difficult issue of how one determines the fair market value of a partnership interest. Taxpayers and the Government have wrestled with this issue in the past. In the proposed regulations regarding "partnership interests for services," the IRS decided to allow taxpayers to choose between liquidation value and a "willing buyer- willing seller" approach.

Also, would there be a difference in the measurement of fair market value with respect to the partnership interest where a partner is receiving a distribution of property from the partnership (*i.e.,* the regulations under section 704(b) generally look for such distributions to be in accordance with positive capital accounts) as compared to when one partner is selling its interest to another partner (*i.e.*, such transactions generally take into account factors such as control in management, liquidity of the investment, etc., and rarely focus on positive capital accounts in determining the purchase price)? Such a disparity in analysis seems difficult to justify, although something would have to be done to bridge the gap between these two situations.

Non-fair market value options in the context of employee/service provider interests present another issue. Partnership agreements often allow the partnership to reacquire a partnership interest when a service provider partner leaves for the amount paid for the interest, book value, or some other amount that does not reflect fair market value. This is meant to establish a penalty element for leaving the employ of the sponsor. This is not addressed in the proposed language. An exception should be provided for these re-acquisitions.

In general, note that it may not be economically feasible for partnerships to renegotiate existing option agreements with employees and option holders in order to "satisfy" the bill's exception, particularly given the leverage of the option holder and changes in economic circumstances since the option was put in place. This raises effective date concerns, discussed below.

9. Section 470(e)(3)(B) – Option For Determination of Fair Market Value

Bill Language

Under regulations prescribed by the Secretary, a value of property determined on the basis of a formula shall be treated for purposes of subparagraph (A) as the fair market value of such property if such value is determined on the basis of objective criteria that are reasonably designed to approximate the fair market value of such property at the time of the purchase, sale, or distribution, as the case may be.

Commentary

The statute appears to only grant regulatory authority. There are numerous purchase and sale options in partnerships based on formulas designed to approximate fair market value. These partnerships are operational now and cannot wait for regulations to be issued.

Additionally, there are numerous types of arrangements designed to approximate fair market value that are not based on an objective criteria formula. An example of one such arrangement is where one partner can name a price to buy another partner's interest. The offeree can accept or has a right to buy the offering party out at the offered price. This method of determining sales price seemingly would approximate fair market value, but the interest is not being offered to the broader public, so one cannot be sure. The price determination is not made pursuant to a "formula", and it may not even meet the "objective criteria" requirement since, it is a proffer, not a criterion. There clearly is substance though, given that the offering partner presumably is not going to offer to buy out the other partner for an amount that they are not willing to accept themselves.

Finally, a right of first refusal arrangement at a named price is not really formula based, although it seemingly should achieve a fair market value price. No appraisal would be undertaken but you would have a willing buyer-seller situation.

Recommendations:

(i) Statutory guidance should be provided, not merely regulatory authority.

(ii) Statutory language and regulatory authority should provide for a formula *or arrangement* that is designed to approximate current fair market value at the time of option exercise. The language "determined on the basis of objective criteria that are" should be deleted since not every arrangement is, or must be, based on objective criteria in order to achieve fair market value

(iii) Where the price for the interest or partnership property is determined by reference to a bona fide offer from an unrelated third party bargaining at arms' length or on the basis of adverse interests, such price should be conclusively presumed to represent fair market value.

10. Section 470(g)(5) – Tax-Exempt Partner Definition

Proposed Language

The term 'tax-exempt partner' means, with respect to any partnership, any partner of such partnership which is a tax-exempt entity within the meaning of section 168(h)(6).

Commentary

The definition of tax-exempt entity under section 168(h)(6) provides in (F)(1) that a tax-exempt controlled entity shall be treated as a tax-exempt entity. As a result, a tax-exempt partner cannot relieve a partnership from section 470 by owning its interest through a taxable "blocker" corporation and thereby agreeing to fully subject itself to tax. A blocker corporation is often used to ensure that the tax-exempt does not incur UBTI.

We believe that this is a substantive change to section 168(h)(6) and not a technical correction. Congress did not address, or express an intention to address, the operation of section 168(h)(6) when it enacted section 470.

Recommendation

An exception should be included in the proposed definition of tax-exempt entity to exclude tax-exempt controlled entities.

11. Section 470(h)(C)(3) - Tiered and Other Partnership Regulatory Authority –

Proposed Language

The language grants regulatory authority to "provide for the application of this section to tiered and other related partnerships."

Commentary

A large number of partnerships are part of tiered structures. Clear and comprehensive tiered partnership rules are necessary given the broad reach of the proposed statute before section 470 is applied to defer losses of any partnership by reason of section 168(h)(6). Otherwise, it will be extremely difficult, if not impossible, to apply section 470 in the context of tiered partnerships or even to figure out whether or not section 470 applies to an entity in a tiered structure. Is it correct to presume that arrangements and set asides anywhere in the tiered structure will give rise to application of section 470? If not, will section 470 apply only to the partnership(s) in the tiered structure that have taxable and tax-exempt partners?

How is the 20% allowable amount rule applied in a tiered arrangement? Is an arrangement or set aside in existence at any level other than the level at which property subject to section 470 is held treated as "inside" defeasance (with the 20% allowable amount rule available) or "outside" defeasance" (with no allowable amount rule available)?

Also, as discussed earlier, options moving property or partnership interests up one or more tiers may not be considered fair market value and thus could give rise to application of section 470. It seems like it would only be a problem if the property is moving in a way that tax-exempt participation is increasing. But, how is this determination made if the ultimate make-up of the most upper-tier partners is unknown? How do lower-tier partnerships report out on K-1s when they do not know what is going on above them? Does this create the same situation that existed with respect to section 199 where every partnership arguably had to report relevant information for section 199 on the off-chance that a partner might want to take advantage of section 199?

Recommendation

There are no easy answers to questions dealing with how to apply Section 470 in the context of tiered partnerships. Nonetheless, taxpayers are entitled to arrange their business affairs in a manner such that tax results accompanying such affairs are reasonably determinable. The tiered partnership rules would be of much less concern if an exception to section 470 were adopted which could be readily applied at the partnership level where the property that is subject to section 470 is held.

We, along with numerous other groups representing a variety of industries, have previously endorsed a regime that would except property from section 470 so long as a tax-exempt partner does not use or have operational control with respect to property held by the partnership. We continue to believe that, in the vast majority of cases, this rule provides a sound indicator of partnerships that might engage in a SILO-like transaction. This rule also has the benefit of applying by reference to information that would be available at the level of the partnership that holds property subject to section 470. We respectfully urge reconsideration of this approach, even if the approach is utilized in the context of less than all property classes that might be held by a partnership.

12. Section 470(h)(C)(4) –Regulatory Catch All Authority

Proposed Language

The proposed language grants regulatory authority to provide for the treatment of partnership property (other than property described in subsection (e)(1)(A)) as tax-exempt use property if such property is used in an arrangement which is inconsistent with the purposes of this section determined by taking into account one or more of the following factors:

(A) A tax-exempt partner maintains physical possession or control or holds the benefits and burdens of ownership with respect to such property.

(B) There is insignificant equity investment in such property by any taxable partner.

(C) The transfer of such property to the partnership does not result in a change in use of such property.

(D) Such property is necessary for the provision of government services.

(E) The deductions for depreciation with respect to such property are allocated disproportionately to one or more taxable partners relative to such partner's risk of loss with respect to such property or to such partner's allocation of other partnership items.

(F) Such other factors as the Secretary may determine.

Commentary

This grant of regulatory is unacceptably broad and vague. Further, only "one or more" of the factors may be all that is required. Items (B), the insignificant equity for taxable partners factor and (E), the disproportionate allocations of depreciation to taxable partners relative to risk of loss factor, are extremely troubling. Item (E), in particular, seems to be an indirect attempt to permit the Treasury Department to alter the operation of the section 465 at-risk rules with respect to a limited category of partnerships.

Item (F) is also troubling given the lack of clear guidance as to what kinds of partnership arrangements Congress did, and did not, intend to be covered by section 470. This item resembles the broad grant of regulatory authority that was contained in the Administration's proposed SILO legislation but was soundly rejected by Congress on the grounds that it would have been an inappropriate delegation of legislative authority to the Treasury Department.

Given the lack of clear definition as to what the purpose of the section is, this appears to grant very broad authority to the Government to address by regulation issues not within the statutory construction or Congressional intent of Section 470. This would be even more troubling if the regulations could be retroactive.

Recommendation

This regulatory authority should be eliminated. At a very minimum, it should be clarified, narrowed significantly and made more neutral (e.g., include regulatory authority to exclude transactions from section 470 that do not exhibit one or more of these factors). Indeed, as we previously suggested, partnerships that do not qualify for any of the bill's exceptions should be provided a mechanism by which they can establish that they are not engaged in the kind of SILO-replication abuse that Congress intended to prevent in enacting section 470. These factors would seem to do the opposite.

13. Effective date

Proposed Language

The amendments made by this section shall take effect as if included in the provisions of the American Jobs Creation Act of 2004 to which they relate.

Commentary

This language would sweep in losses for property acquired after March 12, 2004, with respect to taxable years beginning after 12/31/05. Given the moratoria provided in Notices 2005-29 and 2006-2, taxpayers and advisors have justifiably anticipated that section 470 would be narrowed in the partnership context so as to more effectively target SILO-like transactions. Partnerships never saw the particular requirements of the bill's exceptions (or the expansion of the amount disallowed) coming and should not be bound by the particular requirements and rules. It will not be possible to unwind many arrangements that will throw into section 470 partnerships that do not meet the "set aside" and "option" exception (*i.e.*, defeasance with respect to loans that could not be prepaid; options that are an integral part of the partners' economic deal, etc.). Thus, partners often will not be able to use self-help to get out of section 470.

Recommendation

Section 470 (in its current form and as amended) should not be applied to defer losses of any partnership with respect to property acquired before the date the Technical Corrections bill was introduced (or is re-introduced). Further, grandfather relief should be provided for options, set asides, and other arrangements put into place (or subject to a binding commitment) before such date. Providing such an effective date should not cause the bill to lose revenue or open the door to SILO abuses given that the enactment of section 470 in 2004 should have deterred the promotion of partnerships as vehicles to circumvent the application of section 470. It also would be consistent with effective date relief provided in certain other sections of the bill.