

# TAX MANAGEMENT

## MEMORANDUM

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### Section 470 and Partnerships Left Outside Future Congressional Relief

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#### INTRODUCTION

Much has been written on the broad potential of §470<sup>2</sup> to disallow net losses of partnerships<sup>3</sup> and on how §470 should be narrowed to reduce (or eliminate) this potential. The staffs

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<sup>2</sup> Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code") and to the final, temporary, and proposed regulations promulgated thereunder.

<sup>3</sup> For purposes of this article, "partnerships" mean any type of entity classified as a partnership for federal tax purposes (including limited liability companies), and a person who owns an interest in such an entity (including a member of a limited liability company) is described as a "partner."

of the tax legislation-writing committees of Congress, the Treasury Department, and most tax practitioners seem to agree that §470, in its current form, applies too broadly. Although targeted at particular types of transactions which are described below, §470 applies to partnerships that have no connection with such transactions. Unfortunately, after more than two years of lobbying and negotiation, an appropriate legislative fix has yet to materialize. What happens if §470 is not narrowed for partnerships, or if it is fixed in a manner that leaves the current structure of §470 largely unchanged, with only a narrow exception for certain partnerships? This article explores some of the technical issues that would arise for partnerships forced to apply §470.

#### TARGET OF §470

Section 470 was enacted in 2004<sup>4</sup> primarily to eliminate the tax<sup>5</sup> benefits of entering into a sale-in, lease-out transaction (a "SILO").<sup>6</sup>

A SILO, in its simplest terms, generally involves (i) a sale of a group of depreciable as-

<sup>4</sup> See 2004 American Jobs Creation Act, P.L. 108-357, §848(a); H.R. Rep. No. 548, 108th Cong., 2d Sess. 313 (2004).

<sup>5</sup> For purposes of this article, "tax" means federal income tax.

<sup>6</sup> All references in this article to the term "SILO" are intended to be references to the type of leasing transac-

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sets (such as infrastructure assets) from a tax-indifferent entity (such as a municipality) to a taxable entity (such as a financial services company), (ii) immediately followed by a net lease of such assets from the taxable entity back to the tax-indifferent entity.<sup>7</sup> A management contract is entered into so that the tax-indifferent entity will continue to control (and to bear the burdens of) the operation of the SILO assets. To ensure that the tax-indifferent entity has the ability to reacquire ownership of the SILO assets at the end of the lease term, an option is entered into that permits the tax-indifferent entity to purchase the SILO assets at some future time at a price based on a fixed formula. A SILO generally includes other structural features as well that are not relevant to the purposes of this article.

The taxable entity enjoys depreciation deductions from the SILO assets and interest expense deductions from indebtedness incurred initially to acquire the assets from the tax-indifferent entity. The taxable entity also takes into account rental income from the lease. Such deductions generally outstrip such income until the end of the lease term (i.e., the taxable entity enjoys net tax losses from the SILO until the back end of the lease term, when the taxable entity recognizes net taxable income from the SILO). As a result, the taxable entity enjoys real tax savings due to the deferral of taxable income and the time value of money.

Generally, §470 eliminates the taxable entity's real tax savings by suspending the net tax losses from the SILO until the time the taxable entity realizes net taxable income in the later years of the SILO or until the time the taxable entity terminates the SILO by selling the SILO assets back to the tax-indifferent entity.

## SHOOTING BLINDLY (AND POSSIBLY UNINTENTIONALLY) INTO THE DARK — SECTION 470'S APPLICATION TO PARTNERSHIPS

Unfortunately, §470 was drafted in a manner that causes it also to apply to partnerships that have no economic or tax connection to a SILO. Virtually all partnerships that merely have taxable and tax-exempt partners and some version of a preferred return or spe-

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tion that the Treasury Department considers to be abusive. This article, however, does not address the merits of the Treasury Department's arguments with respect to SILOs, and no inference should be drawn as to the author's views with respect to such arguments or such transaction.

<sup>7</sup> See, for example, Notice 2005-13, 2005-1 I.R.B. 630, and Congressional Research Service, *Tax Implications of SILOs, QTEs, and Other Leasing Transactions with Tax-Exempt Entities*, reprinted in 2005 TNT 40-57 (11/30/04) (hereinafter CRS Report), for more detailed descriptions of SILOs.

cial income allocation could have their net tax losses disallowed by §470.

This problem is best illustrated by walking through the text of §470 and related Code provisions. Section 470 provides that a "tax-exempt use loss" for any taxable year shall not be allowed, and any such loss with respect to any tax-exempt use property shall be treated as a deduction with respect to such property in the next taxable year.<sup>8</sup> A "tax-exempt use loss" means, with respect to any taxable year, the excess of (i) the aggregate deductions (other than interest) directly allocable to a tax-exempt use property and the aggregate deductions for interest properly allocable to such property over (ii) the aggregate income from such property.<sup>9</sup>

The foundation of a "tax-exempt use loss" is the classification of property as "tax-exempt use property." "Tax-exempt use property" of a taxpayer generally means property that constituted (at any point in the past with respect to such taxpayer) or constitutes (in the present with respect to such taxpayer) "tax-exempt use property" as defined in §168(h).<sup>10</sup> Section 168(h)(1) generally defines "tax-exempt use property" as property that is leased to a "tax-exempt entity." A "tax-exempt entity" generally includes a domestic or foreign government (or similar related governmental unit), public charity, pension plan, individual retirement account, other tax-exempt plan of deferred compensation, a foreign person or entity, or an Indian tribal governments.<sup>11</sup> This statutory framework in §168(h), for the most part, does not create any special problems for partnerships.

Unfortunately for partnerships, there is more to §168(h). Section 168(h)(6), in a nutshell, requires partnerships to treat a portion of each of its assets that does not already meet the definition of "tax-exempt use property" in §168(h)(1) as "tax-exempt use property" *without regard to the existence of a lease or any other hallmark of a SILO*. Section 168(h)(6)(A) provides the general rule. It states:

For purposes of this subsection, if — (i) any property which (but for this subparagraph) is

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<sup>8</sup> §470(a), (b).

<sup>9</sup> §470(c)(1).

<sup>10</sup> §470(c)(2), (e)(1).

<sup>11</sup> §168(h)(2); Regs. §1.168(j)-1T Q&A-II. Note, however, that there is an exception for certain foreign persons and foreign entities. Section 168(h)(2)(B) provides that a foreign person or foreign entity shall not be treated as a "tax-exempt entity" for purposes of §168(h) "with respect to any property if more than 50% of the gross income for the taxable year derived by the foreign person or entity from the use of such property is (i) subject to tax under this chapter, or (ii) included under §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 in which such income was derived."

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 . . . be treated as tax-exempt use property.

Section 168(h)(b)(C) provides that a tax-exempt entity's "proportionate share" of any property owned by a partnership is based on "such entity's share of partnership items of income or gain (excluding gain allocated under §704(c)), which results in the largest proportionate share." If such entity's share of partnership items of income or gain "may vary during the period such entity is a partner in the partnership, such share shall be the highest share such entity may receive."<sup>12</sup> So, any special allocation of income other than by reason of §704(c) to a tax-exempt entity partner (even a future, contingent allocation) may cause §470 to apply to most (if not all) of each of a partnership's assets.<sup>13</sup>

However, a careful reader now has realized that the text of §168(h)(6) does seem to offer a partnership a way out of its grasp. All the partnership needs to do is to ensure that all allocations to each tax-exempt entity partner constitute "qualified allocations" (the "qualified allocations safe harbor"). Unfortunately, the "qualified allocations safe harbor" is so narrow that it does not merit the label "safe harbor."

An allocation to a tax-exempt entity is a "qualified allocation" only if (excluding allocations under §704(c)) it: (i) "is consistent with such entity's being allocated the same distributive share of each item of income, gain, loss, deduction, credit, and basis and such share remains the same during the entire period the entity is a partner in the partnership" and (ii) "has substantial economic effect within the meaning of sec-

<sup>12</sup> §168(h)(6)(C)(ii).

<sup>13</sup> For example, assume that a partnership has one taxable partner and one tax-exempt partner and all allocations are shared equally, except that partnership income will be shared 10/90 between the taxable partner and the tax-exempt partner if, but only if, the partnership meets some future profitability threshold. Since the tax-exempt partner's share of partnership income "may vary during the period such entity is a partner" and 90% is "the highest share such entity may receive," the tax-exempt partner's "proportionate share" of any property of the partnership is 90%. See §168(h)(6)(C) (emphasis added). It appears that this determination is not dependent on the partnership actually meeting the contingency that triggers the special 90% income allocation. It seems that the tax-exempt partner's "proportionate share" is 90% from the time the special allocation provision becomes part of the partnership agreement.

tion 704(b)(2)."<sup>14</sup> For a host of reasons not relevant to the purposes of this article and adequately addressed by other commentators, the only type of partnership that can satisfy this rule is a partnership where: (i) each tax-exempt entity partner is allocated the same share of each tax item throughout the life of the partnership (i.e., the partnership provides for "straight-up allocations"), (ii) the partnership allocations meet all the requirements of the primary test for economic effect under the §704(b) regulations, including that each partner have an unlimited obligation to restore a deficit in its capital account upon the liquidation of such partner's interest in the partnership, and (iii) such allocations meet the substantiality rules of the §704(b) regulations.<sup>15</sup> Due primarily to the straight-up allocations requirement and the unlimited deficit restoration obligation requirement, the number of partnerships that do (or could) satisfy this rule could all fit on the head of a pin.

So, virtually all partnerships that have taxable and tax-exempt partners<sup>16</sup> and some version of a preferred return or special income allocation likely will find that a significant portion (if not all) of each of their assets constitutes "tax-exempt use property" for purposes of

<sup>14</sup> §168(h)(6)(B).

<sup>15</sup> See, e.g., *Presant Finds Conflict Problem Between Section 168(j) and Section 704 Regulations*, reprinted in 86 TNT 43-143 (3/3/86) (originally raising this problem with §168(h)(6) almost two decades before Congress enacted §470 and fused §168(h)(6) with it); Regs. §1.704-1(b)(2)(ii)(b) (describing the primary test for economic effect). As previously mentioned, §704(c) allocations are disregarded in determining whether partnership allocations meet the qualified allocations safe harbor. See §168(h)(6)(B). However, it appears that so-called "reverse §704(c) allocations," which arise by reason of a revaluation of partnership property for book purposes, must be taken into account in determining whether partnership allocations meet this safe-harbor, since so-called "reverse §704(c) allocations" are not actually §704(c) allocations — they are §704(b) allocations (although governed by "principles of" §704(c)). See Regs. §§1.704-1(b)(2)(iv)(f)(4), (4)(i), 1.704-3(a)(6)(i). Taking so-called "reverse section 704(c) allocations" into account likely would prevent the partnership from having "straight-up allocations" and, therefore, would prevent it from meeting the qualified allocations safe harbor. This stands as another reason why this safe harbor has almost no practical use for partnerships.

<sup>16</sup> Some might wonder whether a partnership could avoid §470 by eliminating the direct participation of any tax-exempt partners in the relevant partnership by interposing taxable blocker entities between the tax-exempt entity investors and the partnership. Section 168(h)(6)(F) substantially reduces the ability of most tax-exempt entity investors to do this by treating such a blocker entity as a tax-exempt entity for purposes of §168(h)(6) unless it makes a special irrevocable election that causes the tax-exempt entity owner of such blocker entity to treat any disposition gain with respect to any interest in such blocker entity and any interest and dividends from such blocker entity as unrelated business taxable income subject to tax under §511. This onerous rule, however, does not apply to taxable blocker entities of foreign investors. See §168(h)(6)(F)(iii)(I).

§470.<sup>17</sup> As a result, §470 would disallow a significant portion (if not all) of the net tax losses of such partnerships. The existence of a lease or any other hallmark of a SILO is immaterial to this conclusion. Such partnerships are ubiquitous. They are securities partnerships, venture capital funds, real estate partnerships, operating partnerships, domestic-foreign joint ventures, and so on. These partnerships and their economics are driven by legitimate non-tax business purposes. These partnerships have nothing to do with SILOs.

This is the tax and economic problem with §470.

## THE PUSH FOR REFORM

### Background

The application of §470 to partnerships came as a surprise to most.<sup>18</sup> This aspect of §470 has driven an extensive lobbying effort from virtually all sectors of the business community over the past two years to eliminate (or substantially narrow) the provision.

The text of §470 does not mention partnerships, nor does the rather extensive legislative history of the statute.<sup>19</sup> The original effective date provision for §470 provided that the provision only applied to “leases entered into” on and after generally March 12, 2004.<sup>20</sup> Nonetheless, informal discussions with staff members of the tax legislation-writing commit-

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<sup>17</sup> In addition to the exception from §470 for certain foreign persons and foreign entities in §168(h)(2)(B), any portion of a partnership asset that is predominantly used by a tax-exempt entity partner in an unrelated trade or business the income of which is subject to tax under §511 is not “tax-exempt use property.” See §168(h)(1)(D), (6)(A). However, the determination of whether a partnership asset is predominantly used by a tax-exempt entity partner in an unrelated trade or business is made “without regard to section 514.” See §168(h)(6)(D). Thus, to the extent that a partnership asset that otherwise meets the definition of tax-exempt use property is treated as predominantly used by a tax-exempt entity partner in an unrelated trade or business the income of which is subject to tax *only by reason of the unrelated-debt-financed rules under §514*, such asset will not qualify for the exception in §168(h)(1)(D) and, therefore, will remain tax-exempt use property.

<sup>18</sup> See, e.g., American Bar Association, Section of Taxation, *Section 470 of the Internal Revenue Code*, reprinted in 2005 TNT 110-35, at 2 n.8 (6/7/05) (hereinafter ABA Comments) (providing detailed comments on §470).

<sup>19</sup> See H. Conf. Rep. No. 755, 108th Cong., 2nd Sess. at 641-50 (10/7/04) [hereinafter *Conference Report*]; H.R. Rep. No. 548, 108th Cong., 2nd Sess. at 312-19 (6/16/04).

<sup>20</sup> See P.L. 108-357, §849(a). The effective date was later amended to remove the ambiguity in the original effective date provision over whether §470 applied to partnerships that did not enter into leases (i.e., by reason of §168(h)(6) applying alone). See 2005 *Gulf Opportunity Zone Act*, P.L. 109-135, §403(f) (“[Effective] in the case of property treated as tax-exempt use

tees of Congress shortly after the enactment of §470 apparently confirmed that the coupling of §168(h)(6) to §470 was by design and not by mistake.<sup>21</sup>

### The First Legislative Proposal

Since then, several industry groups have combined lobbying efforts to eliminate (or narrow) the application of §470 to partnerships by way of §168(h)(6). The first proposed legislative reform was the decoupling of §168(h)(6) from §470 so that partnership assets would have constituted “tax-exempt use property” under §470 only under the same circumstances that assets held by all other types of taxpayers constituted “tax-exempt use property” (i.e., only if such assets were subject to a lease addressed by §168(h)(1)). This proposal would have narrowed §470 so that it served only its true purpose — the elimination of the tax benefits of SILOs. In light of the complete lack of discussion of partnerships in the legislative history and the apparent inability of the staffs of the tax legislation-writing committees of Congress and the Treasury Department to describe the particular circumstances in which a partnership would produce SILO-like tax benefits *that are not otherwise prescribed by other existing partnership rules*, this proposal made (and still does make) sense.<sup>22</sup>

However, there was a problem with this proposal — a \$26.5 billion problem. Section 470 was scored by the staff of the Joint Committee on Taxation as a \$26.5 billion revenue raiser.<sup>23</sup> As a result, §470 became the single largest revenue raiser of the 2004 American Jobs Creation Act (“2004 Act”), which had a seemingly countless number of revenue-losing provisions but was still scored overall as revenue neu-

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property other than by reason of a lease, to property acquired after March 12, 2004.”).

<sup>21</sup> See ABA Comments at 2. The case that the coupling of §168(h)(6) to §470 was intentional is strengthened by the fact that §470(c) includes a “carve-out” from §168(h)(6) for certain property that generates a credit under §42 or §47. The legislative history of §470 does not describe why this was done.

<sup>22</sup> The only attempt at such a description was made by the Section of Taxation of the American Bar Association. See ABA Comments at 17-20. The ABA Comments recognized that the described transaction could be attacked under existing partnership rules and common law doctrines. See ABA Comments at 19 n.59. The ABA Comments also stated that “we are not aware of any passthrough entities that have been structured so as to replicate SILO transactions. The . . . example was created for purposes of these comments and is not based upon any experience with an actual similar transaction.” ABA Comments at 16 n.53.

<sup>23</sup> See Staff of Joint Committee on Taxation, *Estimated Budget Effect of the Conference Agreement for H.R. 4520, The “American Jobs Creation Act of 2004,”* (JCX-69-04) at 8 (10/7/04).

tral.<sup>24</sup> Section 470, according to the staff of the Joint Committee on Taxation, represented approximately one-third of the total revenue to be raised by the 2004 Act. Such a large revenue score for §470 could mean that any subsequent proposal perceived to be a narrowing of §470 will be emblazoned with a scarlet letter “L” for being a “more-than-insignificant revenue loser,” which effectively makes very slim any prospect of the passage of any such proposal as long as the revenue-neutral political climate on Capitol Hill continues.

One might argue that a proposal to amend §470 so that it addresses only the circumstances that Congress had in mind when it enacted the provision (i.e., SILOs) should not be perceived as a narrowing of §470 for revenue-scoring purposes. Further, one might add that it seems unreasonable to score such a proposal as a revenue loser when existing partnership rules already would prevent partnerships from producing SILO-like tax benefits for its partners.<sup>25</sup> So far in the lobbying process, for some unexplained reason, these arguments have not converted the §470 issue on Capitol Hill from a “compelling partnership tax problem with sensitive revenue concerns” to merely a “compelling partnership tax problem.”<sup>26</sup>

This is the political problem with §470.<sup>27</sup>

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<sup>24</sup> *Id.* at 10.

<sup>25</sup> See ABA Comments at 19 n.59; see also §§163, 465, 469, 704(b), 7701(e)(2); Regs. §§1.701-2, 1.704-1(b), 1.704-2, 1.752-2(j); *Comr. v. Culbertson*, 337 U.S. 733, 742 (1949) (stating that a partnership exists for tax purposes if “considering all the facts . . . the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise”); *ASA Investorings Partnership v. Comr.*, 201 F.3d 505 (D.C. Cir. 2000) (finding a sham partnership since the partners had no nontax business purpose for forming the partnership and the only business activities of the partnership were conducted to generate tax savings).

<sup>26</sup> The position that the reason that §470 was estimated to generate such a large amount of revenue was due to the staff of the Joint Committee on Taxation’s becoming satisfied that even the next generation of SILOs (i.e., SILOs conducted through partnerships) would be squelched by §470 (due to its cross-reference to §168(h)(6)) seems specious in light of the complete lack of discussion of partnerships and §168(h)(6) in the legislative history.

<sup>27</sup> Another subsidiary political problem with any attempt to narrow §470 for partnerships is the political fear that some might view any such narrowing as providing a loophole to continue to perpetrate through partnerships the perceived leasing abuses that led to the enactment of §470. In the period leading up to the enactment of §470, the Senate Committee on Finance held a well publicized hearing on leasing tax abuses. At this hearing, a former leasing executive provided the following testimony in a mechanically altered voice: “I am a former leasing executive with between 10 and 25 years of industry experience. I was a leader in the industry, but left in large part because of my unwillingness to do the types of transactions that I will describe today. I appear before you anonymously to protect my wife and children from cer-

## Subsequent Legislative Proposals

This problem has led to a series of legislative proposals that would have limited §470 so that it applies to a partnership only to the extent that the partnership has the structural and tax characteristics of a SILO (i.e., a “virtual SILO”).<sup>28</sup> The first of these legislative proposals would have excluded from §470 all partnership assets that were not otherwise subject to §470 unless the relevant partnership exhibited certain SILO-like characteristics and did not otherwise meet a host of other proposed industry-specific exceptions from §470. In response again to a concern that such a proposal would be a revenue loser, the second of these legislative proposals would have excluded from §470 partnership assets that were not otherwise subject to §470 if, but only if, the relevant partnership could establish that it did not exhibit certain SILO-like characteristics or that it otherwise met a host of other proposed industry-specific exceptions from §470. The third and most recent legislative proposal emanated from the staffs of the tax legislation-writing committees of Congress.<sup>29</sup> The committees continued to couple §470 with §168(h)(6) but offered an exception for all partnerships that focused on only two of several hallmarks of a SILO — defeasance and fixed-price purchase options. Most of the industry-specific exceptions from §470 contained in the earlier proposals were omitted from this proposal. The main components of this proposal generally have been viewed as unacceptable by the tax community for a variety of reasons, one of such reasons being that focusing only on a subset of the characteristics of a SILO still leaves many types of partnerships that have nothing to do

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tain retaliation if my identity were disclosed. . . . [T]he leasing industry is always one step ahead of the IRS. They now have replicated these benefits through service agreement contracts, which are called SILOs – ‘sale in-lease out.’ . . . The numbers involved in these deals are staggering. . . . There is enormous pressure to continue these deals, which is why LILOs were quickly replaced with SILOs.” *Testimony of “Mr. Janet” – A Witness Pseudonym Regarding Abusive Cross-Border Leasing and Leasing with U.S. Municipalities*, reprinted in 2003 TNT 204-38 (10/22/03). In light of this type of public testimony and other publicity leading up to the enactment of §470, the ultimate fix for §470 and partnerships will need to be one that is not *perceived* as permitting the leasing industry to replicate the tax benefits of a SILO through a partnership (separate and apart from the issue of whether such a fix *actually* would permit such replication).

<sup>28</sup> The author’s use of the term “virtual SILO” in no way is meant to suggest that such tax creatures actually do (or could) exist. See ABA Comments at 16 n.53 (“we are not aware of any passthrough entities that have been structured so as to replicate SILO transactions. The . . . example was created for the purposes of these comments and is not based upon any experience with an actual similar transaction.”).

<sup>29</sup> See H.R. 6264, 109th Cong. §6(b) (2006); S. 4026, 109th Cong. §6(b) (2006) (identical bill to H.R. 6264).

with a SILO subject to §470.<sup>30</sup> This has led Treasury Department officials to suggest publicly that the proposal needs to be modified.<sup>31</sup>

This lobbying effort has produced some “stop gap” relief. The IRS has issued three consecutive notices that effectively turn off the reference in §470 to §168(h)(6). The most recent notice, Notice 2007-4,<sup>32</sup> provides that, in the case of partnerships, for taxable years that begin before January 1, 2007, the IRS will not apply §470 to disallow losses associated with property that is treated as tax-exempt use property solely as a result of the application of §168(h)(6).<sup>33</sup> The IRS, however, has indicated that this relief will cease as soon as Congress narrows §470 as it applies to partnerships, if not earlier.<sup>34</sup>

In light of the poor prospects of any legislative proposal perceived to be a more-than-insignificant revenue loser and the continuing struggle over what types of partnership structures should constitute prohibited “virtual SILOs,” the ultimate resolution of this issue might come in the form of a single, much too narrow exception for partnerships in §470 itself (i) without the decoupling of §§470 and 168(h)(6), or (ii) with the decoupling of such provisions and the incorporation of many of the aspects of §168(h)(6) directly into the text of §470. It seems likely that this single exception for partnerships will be broader than the exception in the most recent legislative proposal from

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<sup>30</sup> See American Bar Association, Section of Taxation, *Tax Technical Corrections Act (H.R. 6264 and S. 4026)*, reprinted in 2006 TNT 212-21 (10/31/06). Additional comments critiquing the §470 proposal in H.R. 6264 and S. 4026 were submitted to the House Committee on Ways and Means from Citigroup Inc., the National Association of Real Estate Investment Trusts, and the Real Estate Roundtable.

<sup>31</sup> *Treasury Fielding Complaints About Technical Change to Anti-SILO Rule*, 2006 TNT 194-1 (10/6/06).

<sup>32</sup> 2007-2 I.R.B. 260.

<sup>33</sup> See also Notice 2006-2, 2006-2 I.R.B. 278; Notice 2005-29, 2005-1 I.R.B. 796.

<sup>34</sup> Notice 2007-4. This interim relief presents an issue regarding the effective date of any congressional narrowing of §470 for partnerships. Will the effective date of such a congressional fix take this interim relief into account? This interim relief is likely much broader than any future congressional fix for partnerships. So, a partnership that will not qualify for relief under the future congressional fix still could avoid at least three years of potential loss disallowance under §470 if such congressional fix has a prospective effective date. The latest legislative proposal from the staffs of the tax legislation-writing committees of Congress disregarded such interim relief and, therefore, was retroactive to the date of the enactment of §470. See, e.g., H.R. 6264, §6(d). However, the staff of the Joint Committee on Taxation indicated in its description of the legislative proposal that “[i]t is not intended that the provision supercede” such interim relief, which suggests that, despite the retroactive effective date, the IRS would have applied it on a prospective basis only. See Staff of Joint Committee on Taxation, *Description of the Tax Technical Corrections Act of 2006*, (JCX-48-06) at 8 (10/2/06).

the committees, but it seems just as likely that such a broad proposal will not be broad enough to exclude all partnerships that have little (or no) connection to a SILO. With this rather unfortunate premise in mind, it seems that it would be helpful to highlight some of the issues that would arise for a partnership subject to §470 by reason of §168(h)(6) and left outside the likely narrow scope of any future exception for partnerships in §470.

## SELECTED ISSUES IN APPLYING §470 TO PARTNERSHIPS

*Example:* Assume the following —

An entity subject to tax under §11 (“T”) and a tax-exempt entity within the meaning of §168(h)(2) (“E”) formed a limited liability company (“Company”) in 2005 to manufacture laser printers and perfume. Company has been classified as a partnership for federal tax purposes since formation. The Company operating agreement provides that T is entitled to a special allocation of 80% of Company taxable income with respect to the first \$100 million of Company taxable income, and all other taxable income and items thereof are shared 30/70 between T and E.

Company owns two manufacturing plants through wholly-owned subsidiary limited liability companies. The assets and liabilities of the perfume plant (including assets and liabilities related to the direct management of this plant) are held by a subsidiary limited liability company that is treated as not separate from Company for federal tax purposes (“Sub1”). The assets and liabilities of the laser printer plant (including assets and liabilities related to the direct management of this plant) are held by another subsidiary limited liability company that is treated as a corporation for federal tax purposes (“Sub2”).

Company conducts the overall management of Company’s manufacturing plants and the sale of the laser printers and perfume. Company directly owns the building and all related equipment attributable to the overall management of Company.

Company has outstanding a working capital loan from a third party lender the proceeds of which have been used partially to fund operating needs of both of its manufacturing plants. Company also has outstanding several loans from third party lenders related to the acquisition of manufacturing equipment for Sub1.

Although Company does not engage in a SILO or otherwise lease assets to a tax-exempt entity, Company assets nevertheless are subject to §470 by reason of §168(h)(6). Company has at least one taxable partner (T) and at least one tax-exempt partner (E). Company fails the “qualified allocations safe harbor,” since E is not entitled to the same distributive share of Company tax items. With respect to the first \$100 million of taxable income, E is entitled to 14% of such income (i.e., 70% of the 20% of the first \$100 million of taxable income not subject to special allocation to T). E is entitled to 70% of all subsequent income. So, E’s distributive share of tax items will vary from 14% to 70% over the period in which E owns an interest in Company. Note that there is no other provision in §168(h) or §470 that causes Company assets to be subject to §470.

### **Determination of Type of Partnership Assets That Can Be Tax-Exempt Use Property**

Section 168(h)(6)(A) provides that, if the partnership does not have qualified allocations and there is at least one taxable partner and one tax-exempt partner, the tax-exempt partner’s proportionate share of “any property . . . owned by [the] partnership” shall be treated as tax-exempt use property.

In the context of the Example, what does the term “any property” mean? Does it include Company’s interest in Sub2? Does it include other non-depreciable assets of Company (including the assets of Sub1)? The plain language of the statute calls for a broad interpretation — “any” property of a partnership without any exceptions. Under that interpretation, all of the property owned by (and treated as owned by) Company could constitute “tax-exempt use property” of Company, including Company’s interest in Sub2, the inventories of perfume and laser printers manufactured by Sub1 and Sub2,<sup>35</sup> and other non-depreciable assets (such as the parcels of land upon which Company’s headquarters building and the perfume manufacturing plant rest).

Section 168 is a provision of the Code that addresses the determination of the amount of the depreciation deduction provided by §167. So, in light of the legislative purpose of §168, it seems that the term “any property” in §168(h)(6)(A) could be interpreted properly to mean “any depreciable property.” Under that interpretation, only the depreciable property

<sup>35</sup> The inventories of perfume and laser printers are transferred to Company after their manufacture by Sub1 and Sub2, respectively.

owned by (and treated as owned by) Company could constitute “tax-exempt use property” of Company by reason of §168(h)(6). All other property, including the parcels of land underlying Company’s headquarters building and the perfume plant, the inventories of perfume and laser printers manufactured by Sub1 and Sub2,<sup>36</sup> and Company’s interest in Sub2, would be outside the scope of §470.

However, because of the interaction of §168(h)(6) with §168(g), it may be difficult to conclude that the term “any property” in §168(h)(6)(A) should be limited to depreciable property. Prior to the enactment of §470, there appeared to be no need to limit the types of property captured by §168(h)(6) to, for example, depreciable property. The primary function of §168(h)(6) prior to the enactment of §470 was to force taxpayers to apply the alternative depreciation system in §168(g) to their depreciable property, which forced taxpayers to depreciate property over longer recovery periods and on the straight-line method. For example, land (i.e., non-depreciable property) could be classified as tax-exempt use property under §168(h)(6), and such classification would have no tax effect under §168(g), because §168(g) only applies to depreciable property. Thus, the statutory interaction of §168(h)(6) with §168(g) *effectively* limited the types of property captured by §168(h)(6)(A)’s term “any property” to “any depreciable property.” However, §470 only references §168(h) — not §168(g). So, the limiting effect of this statutory interaction between §168(h)(6) and §168(g) appears to be unavailable to taxpayers in the §470 context.

Nonetheless, §470 was enacted to eliminate the tax benefits of a SILO. A SILO generates tax benefits from the sale and lease-back of depreciable property — not land, inventory, or investment assets.<sup>37</sup> Thus, applying §168(h)(6) in the §470 context so that it causes non-depreciable assets of a partnership to be tax-exempt use property would appear to exceed the legislative scope of §470.

This is one aspect of the §470 problem for partnerships that the tax legislation-writing committees of Congress seem to agree needs clarification. Recent legislative proposals have limited partnership property subject to §470 to only depreciable and amortizable property.<sup>38</sup> Thus, it appears likely that any future congressional narrowing of §470 for partnerships will ex-

<sup>36</sup> See Regs. §1.167(a)-2 (“[The depreciation] allowance does not apply to inventories or stock in trade . . .”).

<sup>37</sup> See Notice 2005-13, 2005-1 I.R.B. 630; CRS Report.

<sup>38</sup> See H.R. 6264, §6(b) (introduced Sept. 29, 2006); S. 4026, §6(b) (introduced Sept. 29, 2006 as an identical bill to H.R. 6264); §197(f)(7) (“For purposes of this chapter [(which includes §§168 and 470)], any amortizable §197 intangible shall be treated as property, which is of a character subject to the allowance for de-

clude from the definition of “tax-exempt use property” assets of a partnership that are not subject to the allowance for depreciation provided in §167.

## Determination of “Proportionate Share” of Partnership Assets That Constitutes Tax-Exempt Use Property

For purposes of continuing the analysis of the Example, let us assume that only depreciable property is included in the phrase “any property.” Thus, only the depreciable property owned by Company (and treated as owned by Company through Sub1) would be eligible to be treated as “tax-exempt use property” of Company. All other property, including the parcels of land underlying Company’s headquarters building and the perfume plant, the inventories of perfume and laser printers manufactured by Sub1 and Sub2,<sup>39</sup> and Company’s interest in Sub2, would fall outside the scope of §470.

So, what is the tax-exempt partner’s “proportionate share” of each of these assets? Pursuant to Company’s operating agreement, E’s highest share of partnership items of income or gain is 70%. Thus, §168(h)(6)(C) requires that E’s “proportionate share” of each of these depreciable assets is 70%.

What if there were more than one tax-exempt partner of Company? In that case, there appears to be some uncertainty regarding the determination of what share of each Company asset would be tax-exempt use property. Assume that, in the Example, Company has another tax-exempt partner (“E2”) and Company allocates taxable income in the same fashion, except that the original allocations to E are split 60/40 between E and E2. So, E and E2 are entitled to 42% and 28%, respectively, of all tax items not otherwise allocated to T. Under §168(h)(6), what portion of each Company asset is tax-exempt use property — 28%, 42%, or an aggregate of both tax-exempt partners’ highest distributive shares (i.e., 70%)? It appears that the text of §168(h)(6)(A) supports the aggregation approach (i.e., 70% of each Company asset would be tax-exempt use property), since nothing in §168(h)(6) seems to prevent the re-application of §168(h)(6) with respect to different tax-exempt partners of the same partnership in the same taxable year. However, this approach creates more ambiguity if both of the tax-exempt partners’ distributive shares of income vary over time so that each tax-exempt partner’s distributive share of income at some point exceeds 50%. In that case, under the aggregation approach, the share of

preciation provided in §167.”).

<sup>39</sup> See Regs. §1.167(a)-2 (“[The depreciation] allowance does not apply to inventories or stock in trade . . .”).

each Company asset treated as tax-exempt use property would be greater than 100%, which cannot be the right answer.

Now, let us go back to the original set of facts in the Example. Although the legislative history of §168(h)(6) and the related regulations are not entirely clear, it seems that §168(h)(6) contemplates that Company would split each of its depreciable assets (owned directly or through Sub1) into a “tax-exempt use property” portion equal to 70% (the “tax-exempt use portion”) and a remaining portion equal to 30% (the “remaining portion”). While there may be some uncertainty in the determination of the magnitude of these portions under §168(h)(6)(C) where there are multiple tax-exempt partners, the actual identification of these portions is also unclear. Should the tax-exempt use portion and the remaining portion of each of the relevant assets represent undivided interests in those assets? Alternatively, should these portions represent distinct segments of these assets?

For example, assume that one of the depreciable assets that Company owns has a fair market value of \$100 and an adjusted basis of \$30. On one hand, the “70%” tax-exempt use portion of this asset could be treated as the portion that represents 70% of the fair market value and adjusted basis of the asset. On the other hand, it seems that §168(h)(6), the related legislative history, and the related regulations do not expressly prevent the tax-exempt use portion of this asset from being treated as the portion of the asset in excess of the \$30 adjusted tax basis (i.e., the “70%” tax-exempt use portion would be treated as a separate asset with a \$70 fair market value and a \$0 adjusted basis and the “30%” remaining portion would be treated as a separate asset with a \$30 fair market value and a \$30 adjusted basis).<sup>40</sup> This interpretation presumably would prevent the remaining depreciation deductions arising from the asset from being treated as allocable to tax-exempt use property and, therefore, would free such deductions from §470.

However, this interpretation seems to be at odds with the rest of §168. Section 168 focuses on the determination of depreciation, which is tied to basis — not fair market value. Also, this interpretation would frustrate one of the primary purposes of §168(h), which is to limit the depreciation deductions of certain taxpayers pursuant to §168(g). Nonetheless, this ambiguity seems to exist in §168(h)(6).

<sup>40</sup> Regs. §1.168(j)-1T Q&A-4 addresses a similar issue outside the partnership context. However, the regulation merely provides that “the amount of [the asset’s] unadjusted basis that is properly allocable to the portion of the [asset] that is tax-exempt use property” should be treated as the basis of such portion of such asset for purposes of §168(g). The regulation does not define the words “properly allocable.”

For purposes of continuing the analysis of the Example, let us assume that the “70%” tax-exempt use portion of each depreciable asset of Company (owned directly or through Sub1) represents 70% of the fair market value and adjusted basis of each such asset. Accordingly, each such portion of these assets constitutes a “tax-exempt use property” under §168(h)(6) for purposes of §470.

## Calculation of the Amount of a Tax-Exempt Use Loss

### Partnership-Level or Partner-Level Approach?

Many of the issues in applying §470 to partnerships stem from whether a tax-exempt use loss should be determined (and the related deductions comprising such loss should be disallowed and carried forward) at the partnership level or the partner level. It seems that §470 requires partnership-level determinations.<sup>41</sup>

A tax-exempt use loss can exist only if tax-exempt use property exists.<sup>42</sup> Section 470(c)(2) provides that tax-exempt use property is determined under §168(h). Section 168(h)(6) causes an amount equal to a tax-exempt partner’s proportionate share of “any property . . . owned by a partnership” to be tax-exempt use property.<sup>43</sup> Further, prior to the enactment of §470, the primary function of §168(h) was to reduce the amount of depreciation deductions a taxpayer could take into account under §167.<sup>44</sup> Depreciation with respect to property owned by a partnership is determined at the partnership level.<sup>45</sup> Thus, it appears that §168(h)(6) requires a partnership to determine at the partnership level whether its property is tax-exempt use property.

A tax-exempt use loss exists only if the deductions allocable to a tax-exempt use property exceed the income from such property.<sup>46</sup> If tax-exempt use property exists by reason of §168(h)(6), there appears to be no reason to determine any resulting tax-exempt use loss at the partner level, since all the factors needed to make such a determination exist at the partnership level (i.e., deductions allocable to the relevant partnership property and the income from such partnership property). Further, §470(b) provides that any tax-exempt use loss with respect to any tax-exempt

use property for any taxable year shall be treated as a deduction with respect to such property in the next taxable year. If a tax-exempt use loss attributable to partnership property were to be determined at the partner level, §470(b) would not make much sense, since that provision requires that a disallowed tax-exempt use loss be treated in the next taxable year as a deduction with respect to such partnership property (rather than with respect to property of the partner).

The fact that §470(a) disallows a tax-exempt use loss for any taxable year without regard to any particular type of person<sup>47</sup> generating such loss also suggests that determinations under §470 should be made at the partnership level. Section 465(a) provides that the at-risk rules apply only to individuals and certain C corporations. Section 469(a) provides that the passive activity loss rules apply only to individuals, estates, trusts, certain C corporations, and personal service corporations. Partnerships are not included in the types of persons subject to either of these rules. As a result, in the partnership context, these rules are applied at the partner level and only to the extent that a partner is one of the included types of persons described in the preceding sentences. Unlike §§465 and 469, §470 does not provide that it applies only to certain types of persons. Section 470 does not disallow a tax-exempt use loss “of a” certain type of person.<sup>48</sup> It simply disallows a tax-exempt use loss. The fact that §470 does not limit the types of persons subject to its rules suggests that §470 applies to all types of persons, including partnerships. Thus, the underlying statutory structure that causes §§465 and 469 to be applied at the partner level (rather than at the partnership level) is not present in §470, which further suggests that determinations under §470 should be made at the partnership level.

Applying a loss disallowance provision at the partnership level is not without precedent in the partnership context. Sections 267(a)(1) and 707(b)(1) both are applied at the partnership level to disallow disposition losses of a partnership.<sup>49</sup> However, the key difference between these loss disallowance provisions

<sup>41</sup> The Section of Taxation of the American Bar Association has stated that “the conclusion that the loss disallowance [by reason of §470] occurs at the partnership level seems inescapable under the statute.” ABA Comments at 26.

<sup>42</sup> See §470(c)(1).

<sup>43</sup> §168(h)(6) (emphasis added).

<sup>44</sup> See §168(g).

<sup>45</sup> See §§702(a)(8), 703(a).

<sup>46</sup> See §470(c)(1).

<sup>47</sup> For this purpose, the term “person” is defined as the Code defines it (i.e., “person” is defined as including an individual, a trust, an estate, a partnership, an association, a company, and a corporation). See §7701(a)(1).

<sup>48</sup> See §470(a).

<sup>49</sup> See §267; Regs. §1.267(b)-1(b); Rev. Rul. 96-10, 1996-1 C.B. 138 (regarding §707(b)(1)). Section 704(d) does not appear to disallow partnership losses at the partnership level. Rather, §704(d) prohibits a partner from taking into account its “distributive share of partnership loss” to the extent such share exceeds the partner’s basis in its interest in the partnership. Section 704(d) then causes such loss to be carried forward and to be eligible to be taken into account *by that partner* in succeeding taxable years. See Regs. §1.704-1(d)(1), (2).

and §470 is that these provisions *permanently* disallow partnership loss to the relevant partnership<sup>50</sup> while §470 only *temporarily* disallows partnership loss to the relevant partnership by reason of (i) §470(b) requiring the carry forward of a tax-exempt use loss, and (ii) the disposition rule of §470(e)(2) (discussed in detail below). Since §§267(a)(1) and 707(b)(1) permanently disallow partnership loss, the IRS takes the position that such disallowed losses should not create a disparity between the aggregate basis of the relevant partnership in its assets and the aggregate bases of the partners in their interests in the partnership.<sup>51</sup> However, as discussed below, the fact that §470 only temporarily disallows partnership loss at the partnership level seems to create the potential for such disparity. It is this aspect of §470 that does not seem to have any precedent in the partnership context. This aspect of §470 is explored in more detail below.

For purposes of continuing the analysis of the Example, let us assume that a tax-exempt use loss is determined (and the related deductions comprising such loss are disallowed and carried forward) at the partnership level.

#### **Asset-by-Asset or Aggregation?**

Recall that §470 provides that a “tax-exempt use loss” for any taxable year shall not be allowed, and any such loss with respect to any “tax-exempt use property” shall be treated as a deduction with respect to such property in the next taxable year.<sup>52</sup> A “tax-exempt use loss” means, with respect to any taxable year, the excess of (i) the aggregate deductions (other than interest) directly allocable to “a tax-exempt use property” and the aggregate deductions for interest properly allocable to “such property,” over (ii) the aggregate income from “such property.”<sup>53</sup> Thus, a tax-exempt use loss arises only if (and to the extent that) certain deductions related to tax-exempt use property exceed income from such property. What if the relevant taxpayer has multiple assets that meet the definition of “tax-exempt use property”? Are tax-exempt use losses calculated on an asset-by-asset basis or on some form of aggregate basis?

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<sup>50</sup> Although §§267(a)(1) and 707(b)(1) permanently disallow the loss of the relevant partnership arising from the disposition of loss property, both of these provisions permit the transferee of such property to reduce any gain recognized upon a subsequent disposition of such property. See §§267(d), 707(b)(1). This potential future gain reduction, however, benefits only the transferee — not the transferor partnership that had its loss disallowed by either §267(a)(1) or §707(b)(1).

<sup>51</sup> See, e.g., Rev. Rul. 96-10, 1996-1 C.B. 138 (ruling that a partnership loss disallowed by §707(b)(1) reduces the bases of the partners in their interests in the relevant partnership).

<sup>52</sup> §470(a), (b).

<sup>53</sup> §470(c)(1).

The statutory language of §470 appears to leave no room for an approach other than an asset-by-asset approach. The term “tax-exempt use loss” is defined with respect to “a” tax-exempt use property.<sup>54</sup> Further, §470(g) provides that the IRS may issue regulations allowing “the aggregation of property subject to the same lease.” This statement implies that, without such regulations, aggregation of property is not permitted. Thus, despite the enormous administrative burden created by an asset-by-asset approach in the partnership context, the statutory language seems to require such an approach. The legislative history of §470 does nothing to dispel this notion.

However, recall that a “tax-exempt use property” for purposes of §470 is defined by §168(h), particularly §168(h)(6) for partnerships.<sup>55</sup> This provision could be interpreted in a manner so that all partnership property (or portions thereof) not meeting the requirements of §168(h)(6)(A) would constitute one mass “tax-exempt use property” of a partnership. This mass “tax-exempt use property” could serve as “a” tax-exempt use property in §470.

Section 168(h)(6)(A) provides that, if “any property” that does not already constitute tax-exempt use property is owned by a partnership with at least one taxable partner and at least one tax-exempt partner and the partnership allocations do not meet the “qualified allocations safe harbor,” then an amount equal to such tax-exempt partner’s proportionate share of “such property” shall be treated as tax-exempt use property. The definition of the word “any” includes “one, some, or all indiscriminately of whatever quantity.”<sup>56</sup> Using this definition of “any,” the phrase “any property” in §168(h)(6)(A) could be interpreted as referring to *all* property of a partnership that does not already constitute tax-exempt use property. Thus, the subsequent phrase “such property shall . . . be treated as tax-exempt use property” in §168(h)(6)(A) could be interpreted as referring to a single mass asset consisting of a proportionate share of all such partnership property. Under this interpretation of §168(h)(6)(A), partnerships could apply §470 by reason of §168(h)(6) effectively on an aggregate basis, thereby lessening their administrative burden.

Unfortunately, there are obstacles to this interpretation. First, the term “any” also is defined as “one . . . of whatever quantity.”<sup>57</sup> Second, the context in which Congress used the word “any” in §168(h)(6)(A) suggests that it meant “one . . . of whatever quantity” rather than “all . . . of whatever quantity.” As de-

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<sup>54</sup> See §470(c)(1).

<sup>55</sup> See §470(c)(2).

<sup>56</sup> MERRIAM-WEBSTER’S COLLEGIATE DICTIONARY (10th ed. 1998) (emphasis added).

<sup>57</sup> *Id.*

scribed above, one of the primary purposes of §168(h)(6) is to force certain taxpayers to depreciate assets under the alternative depreciation system of §168(g).<sup>58</sup> Section 168(g) generally forces taxpayers to depreciate certain property under the straight-line method and over a recovery period longer than what would otherwise apply. The applicable longer recovery period varies depending on the type of property involved (e.g., personal property of a certain class life, nonresidential real and residential rental property, etc.).<sup>59</sup> If §168(h)(6)(A) were interpreted so that a partnership initially could aggregate its property into one mass “tax-exempt use property,” that partnership would have to separate that mass “tax-exempt use property” into its component types of property in order to apply §168(g), which would appear to render the initial aggregation of such property meaningless in the context of §168. Third, the regulations related to §168(h)(6) suggest through examples that §168(h)(6)(A) should not produce one mass “tax-exempt use property” in the partnership context.<sup>60</sup>

This authority against a mass “tax-exempt use property” approach to §168(h)(6)(A) seems formidable for purposes of applying §168(g) but not for purposes of applying §470. There is no reference to §168(g) in §470 or its legislative history. Section 470 only refers to §168(h). Further, the regulations (and the examples therein) related to §168(h)(6)(A) were issued well before §470 was part of the Code. Thus, they were written to address only the interaction of §168(h)(6) with §168(g) — not the interaction of §168(h)(6) with §470.

If taxpayers like Company were required to determine tax-exempt use losses on an asset-by-asset basis, the administrative burden would be crippling.<sup>61</sup> The aggregate cost to taxpayers like Company of applying

<sup>58</sup> See §168(g)(1)(B).

<sup>59</sup> See §168(g)(2), (3).

<sup>60</sup> See Temp. Regs. §1.168(j)-1T Q&A-21 Ex., Q&A-22 Ex. 2.

<sup>61</sup> See ABA Comments at 26 (“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 §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 §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 in-

ventory 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.”).

§470 on an asset-by-asset basis could substantially offset the public revenue that the staff of the Joint Committee on Taxation estimated §470 would generate. Absent the position for a mass “tax-exempt use property” approach described above for purposes of applying §470 by reason of §168(h)(6), a statutory change or regulatory guidance will be needed to reduce this burden significantly. For example, the Section of Taxation of the American Bar Association has suggested that taxpayers be permitted to elect to aggregate assets in the partnership context on a “business-unit basis or any other reasonable method . . . provided the method is employed consistently.”<sup>62</sup>

No matter what type of aggregation (if any) is (or will be) permitted, it appears that other aspects of calculating a partnership’s tax-exempt use loss will create great administrative burdens as well. For purposes of continuing with the Example, let us assume that, for §470 purposes, Company is permitted to (and does) aggregate all of its directly owned tax-exempt use property (i.e., its depreciable property) into one basket (“Admin Property”) and all of its tax-exempt use property (i.e., its depreciable property) owned through Sub1 into another basket (“Perfume Property”).

ventory 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.”).

<sup>62</sup> *Id.* In certain partnership contexts, aggregation may cause more problems than it solves. For example, assume an equity fund classified as a partnership for tax purposes has one taxable partner and one tax-exempt partner and provides a preferred return to the tax-exempt partner. Also assume that the fund has two equity investments (“Investment C” and “Investment D”). The tax-exempt partner’s proportionate share of Investment C and Investment D is tax-exempt use property of the fund by reason of §168(h)(6). Section 470(e)(2) generally provides that, if a taxpayer disposes of its *entire interest* in tax-exempt use property, any tax-exempt use loss attributable to such property will break free from §470. Under an asset-by-asset approach, if the fund sells Investment C for a loss, such loss will break free from §470 pursuant to §470(e)(2) since the fund disposed of its entire interest in the relevant tax-exempt use property (Investment C). However, if Investment C and Investment D are treated as one mass tax-exempt use asset, the loss from the disposition of Investment C will not break free from §470 pursuant to §470(e)(2), since the fund will be treated as disposing of only a portion of its mass tax-exempt use property (the fund has retained Investment D). If non-depreciable property were excluded from the scope of §470 for partnerships, it seems that this issue would no longer arise in the equity fund context or the inventory context, but this issue would continue to exist for partnerships with assets subject to depreciation (e.g., partnerships that own manufacturing equipment or residential rental properties).

## Identifying Partnership Income and Deductions Allocable to Tax-Exempt Use Property

### *What Partnership Deductions Are “Directly Allocable” or “Properly Allocable” to a Tax-Exempt Use Property?*

Company’s next step is to determine at the Company level the tax-exempt use loss attributable to Admin Property and the tax-exempt use loss attributable to Perfume Property. Recall that a “tax-exempt use loss” means, with respect to any taxable year, the excess of (i) the aggregate deductions (other than interest) “directly allocable” to a tax-exempt use property and the aggregate deductions for interest “properly allocable” to such property, over (ii) the aggregate income from such property.<sup>63</sup> How are the words “directly allocable” and “properly allocable” supposed to be interpreted in this context?

The conference report accompanying the AJCA 2004 describes §470 as prohibiting a taxpayer from claiming “deductions for a taxable year from [a] lease transaction in excess of the taxpayer’s gross income from the lease for that taxable year.”<sup>64</sup> The Conference Report further states that §470 “applies to deductions or losses *related to* a lease to a tax-exempt entity and the leased property.”<sup>65</sup> In an accompanying footnote, the Conference Report expanded on this statement:

Deductions *related to* a lease of tax-exempt use property *include* any depreciation or amortization expense, maintenance expense, taxes or the cost of acquiring an interest in, or lease of, property. In addition, this provision applies to *interest* that is *properly allocable* to tax-exempt use property, including interest on any borrowing by a related person, the proceeds of which were used to acquire an interest in the property, whether or not the borrowing is secured by the leased property or any other property.<sup>66</sup>

Does the Conference Report’s use of the words “related to” in place of the statutory language of “directly allocable” clarify the issue? It seems that, in this respect, this legislative history increases rather than decreases the potential for ambiguity.

### *The Passive Activity Loss Rules of §469 Could Provide Guidance*

The passive activity loss rules of §469 seem to shed some light on these issues. Section 469 is similar to

§470 as far as that it is a provision that defers deductions to combat perceived taxpayer abuse. In fact, Congress already has signaled that §469 is an appropriate model to use in addressing other aspects of §470. Section 470(e)(2) provides that, “[i]f during the taxable year a taxpayer disposes of the taxpayer’s entire interest in tax-exempt use property . . . , rules similar to the rules of §469(g) shall apply for purposes of” §470.

Section 469 employs statutory language similar to the relevant language used in §470(c). Section 469(e)(1)(A) provides that certain portfolio income and related expenses are not taken into account in determining the income or loss from a passive activity. The provision reads:

There shall not be taken into account—(i) any—(I) gross income from interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business, (II) expenses (other than interest) which are *clearly and directly allocable* to such gross income, and (III) interest expense *properly allocable* to such gross income . . . . [emphasis added].

### *“Directly Allocable” Deductions*

The regulations related to §469(e) provide that an expense (other than interest) is “clearly and directly allocable” to portfolio income “if and only if such expense is incurred as a result of, or incident to, an activity in which such gross income is derived or in connection with property from which such gross income is derived.”<sup>67</sup> The regulations contain an example that provides that “general and administrative expenses and compensation paid to officers attributable to the performance of services that do not directly benefit or are not incurred by reason of a particular activity or particular property are not clearly and directly allocable to portfolio income.”<sup>68</sup> Overall, this interpretation of “directly allocable” seems to cast a rather broad net.

Weaving these rules and the legislative history of §470 together might produce a rule such as the following: “A deduction of a taxpayer (other than a deduction for interest) is directly allocable to a tax-exempt use property if and only if such deduction is incurred in connection with such property. Such deductions include deductions for depreciation or amortization expense, maintenance expense, taxes, and the cost of acquiring an interest in, or lease of, such property. General and administrative expenses and compensation paid to officers attributable to the performance of services that do not directly benefit, or are

<sup>63</sup> §470(c)(1).

<sup>64</sup> See Conference Report at 643-644.

<sup>65</sup> See Conference Report at 644 (emphasis added).

<sup>66</sup> See Conference Report at 644 n.608 (emphasis added).

<sup>67</sup> Regs. §1.469-2T(d)(4).

<sup>68</sup> *Id.*

not incurred by reason of, tax-exempt use property are not directly allocable to such property.”

Under these rules, the deductions (other than interest) directly allocable to the Company’s Admin Property would seem to include all deductions for depreciation and amortization expense from the property included in Admin Property, all maintenance expenses incurred in connection with such property, and all property taxes and similar taxes imposed on such property. Further, it seems that all general and administrative expenses (including employee compensation) of Company incurred by reason of, or that directly benefit, the property in Admin Property would be taken into account. All general and administrative expenses (including employee compensation) incurred by reason of property in Perfume Property or Company’s management of Sub2 would be excluded. An analogous result would apply to Perfume Property, except that some of the overall management activities conducted directly by Company would be allocated to Perfume Property to the extent that such activities are incurred by reason of, or directly benefit, the property in Perfume Property.

Note that such allocations would have to take into account the fact that Company’s two mass tax-exempt use properties (Admin Property and Perfume Property) consist of 70% portions of the depreciable assets of Company — not 100% portions of such assets. For example, if \$100 of depreciation deductions were “directly allocable” to a depreciable asset owned directly by Company, Company would have to determine how much of such depreciation was “directly allocable” to the 70% “tax-exempt use property” portion of such asset. As discussed above, that determination would require Company to determine whether such depreciation should be treated as “directly allocable” to all portions of such asset or to only a distinct segment of such asset.

Further, it seems that, even with these rules, difficulties would remain in allocating Company deductions for employee compensation and overhead expenses among Admin Property, Perfume Property, and all other non-tax-exempt use property of Company. For example, should Company deductions for compensation for employees who work at managerial headquarters on behalf of the entire Company be allocated based on time spent addressing the perfume manufacturing plant, the laser printer manufacturing plant, and all other activities of Company? Such an approach could be too broad, since not all assets of those plants constitute tax-exempt use property (e.g., all the assets owned by Sub2 and the parcels of land underlying the perfume plant and management headquarters).

Would Company deductions for compensation for services performed by employees that benefit the

Company as a whole (such as work to qualify Company for a favorable state regulatory treatment) constitute “directly allocable” deductions? If so, it seems that one reasonable way to allocate these deductions to Admin Property, Perfume Property, and all other non-tax-exempt use property would be based on the relative fair market value of such classes of property.<sup>69</sup> However, such an approach would require an annual appraisal of such property, which would further increase the administrative burden of applying §470.

#### *“Properly Allocable” Interest Deductions*

The regulations related to §469(e) also generally provide that interest expense is “properly allocable” to portfolio income “if and only if such interest expense . . . is allocated” under the interest tracing rules of §163 to such portfolio income.<sup>70</sup> The interest tracing rules generally provide that interest accruing on a debt is allocable in the same manner as the proceeds of the debt are used.<sup>71</sup> This approach seems already to be echoed in the legislative history of §470. The Conference Report states: “In addition, this provision applies to interest that is properly allocable to tax-exempt use property, including interest on any borrowing by a related person, *the proceeds of which were used to acquire an interest in the property*, whether or not the borrowing is secured by the leased property or any other property.”<sup>72</sup>

Again, weaving the legislative history of §470 with the §469(e) rules might produce a rule such as the following: “Deductions for interest are properly allocable to a tax-exempt use property to the extent that such interest is allocated to such property under Regs. §1.163-8T. For example, deductions for interest are properly allocable to tax-exempt use property to the extent that (i) such interest accrues on debt of the taxpayer or any person related to the taxpayer under §707(b), and (ii) only to the extent that the proceeds of such debt are used (or treated as used under Regs. §1.163-8T) to acquire an interest in such property or to pay for any expenses that constitute deductions of the taxpayer directly allocable to such property under §470(c)(1)(A)(i).”

Under this rule, the deductions for interest properly allocable to Company’s Perfume Property would seem to include interest accruing on the third party

<sup>69</sup> Cf. Regs. §1.263A-1(f)(4) (permitting a taxpayer that produces more than one parcel of property for resale to allocate its total production costs to each parcel based on any reasonable method), -1(g)(4)(iv)(A) (identifying relative fair market value of assets as one reasonable approach to allocating mixed service costs).

<sup>70</sup> See Regs. §§1.469-2T(d)(3), 1.163-8T.

<sup>71</sup> See Regs. §1.163-8T(c)(1).

<sup>72</sup> See Conference Report at 644 n.608 (emphasis added).

debt used to acquire manufacturing equipment owned by Sub1, which are some of the assets that comprise Perfume Property. If the proceeds of the third party debt were used to acquire manufacturing equipment owned by Sub2 or administrative equipment owned by Company directly, the interest accruing on that portion of the debt would need to be excluded for purposes of this determination.

The interest accruing on the working capital loan would be allocable to Company's Perfume Property and Admin Property to the extent that such loan proceeds were used for expenditures that created deductions directly allocable to such mass tax-exempt use properties. For example, interest accruing on working capital loan proceeds used to incur maintenance expenses for property comprising Perfume Property would be "properly allocable" to Perfume Property.

Note again that the determination of the interest deductions properly allocable to Admin Property and Perfume Property also would have to take into account the fact that these two mass tax-exempt use properties consist of 70% portions of only the depreciable assets of Company — not 100% portions of such assets nor any of the non-depreciable assets held by Company or Sub1.

#### *What Partnership Income Is "from" a Tax-Exempt Use Property?*

The allocation of income to Company's two mass tax-exempt use properties presents its own difficulties. Since Perfume Property is only a subset of all the property used by Sub1 in manufacturing perfume, presumably Company cannot simply assign all the income from selling such perfume to Perfume Property for §470 purposes. Sub1's manufacturing plant is situated on land owned by Sub1, which (at least for purposes of this Example) is not tax-exempt use property. This land presumably is used by Sub1 just as much as the manufacturing building and equipment are used by Sub1 to manufacture the perfume. But, how does one differentiate between perfume sales income "from" the building and equipment and perfume sales income "from" the underlying land upon which the building and equipment rest? It seems that Company could differentiate based on the relative fair market values of the building and equipment, on one hand, and the land, on the other hand. However, such an approach would require an annual appraisal of such assets, which would further increase the administrative burden of applying §470.

#### *A Great Administrative Burden Could Await Partnerships*

As evident from this exercise, it seems that a great administrative burden could await Company in determining the amount of the separate tax-exempt use

losses attributable to Admin Property and Perfume Property, even under the assumption that Company can aggregate its assets into these two mass tax-exempt use properties. Company's cost accounting systems would need to be adjusted so that they addressed these allocation issues. Company might need to hire additional accounting and tax compliance employees. If aggregation of partnership property were not permitted, this great administrative burden would only grow worse.

### **Determination of Which Allocable Deductions (and Portions Thereof) Comprise a Tax-Exempt Use Loss**

For purposes of continuing with the Example, let us assume that, after allocating Company deductions and income among Admin Property, Perfume Property, and all other non-tax-exempt use property, Company does not have a tax-exempt use loss with respect to Admin Property but does have a \$10 million tax-exempt use loss with respect to Perfume Property. The tax-exempt use loss attributable to Perfume Property arises from \$20 million of income from such property and \$30 million of deductions allocable to such property. The \$30 million of deductions consist of \$14 million of depreciation deductions, \$15 million of §162 deductions for maintenance expenses, and \$1 million of deductible interest expense.

Of the \$30 million of deductions directly allocable (or properly allocable) to Perfume Property, which \$10 million portion is disallowed under §470(a)? Is it some portion of each such allocable deduction or should a particular ordering rule apply? Section 470 and the related legislative history do not answer these questions.

However, the regulations under §469 contain guidance in a similar context. Section 469 generally provides that a taxpayer's passive activity loss for a taxable year is disallowed and carried forward to the next taxable year.<sup>73</sup> The §469 regulations address which (and to what extent) deductions from a passive activity are treated as part of a passive activity loss and, therefore, are disallowed and carried forward.<sup>74</sup> These regulations provide that "a ratable portion of each passive activity deduction . . . of the taxpayer from such activity is disallowed."<sup>75</sup> The "ratable portion" of a passive activity deduction that is disallowed is determined by multiplying the amount of the overall passive activity loss with respect to the relevant passive activity by the fraction obtained by dividing the

<sup>73</sup> See §469(a), (b).

<sup>74</sup> See Regs. §1.469-1T(f).

<sup>75</sup> Regs. §1.469-1T(f)(2)(ii).

amount of such passive activity deduction by the sum of all passive activity deductions of the taxpayer for such activity for the taxable year.<sup>76</sup> Applying this rule in the §470 context to Company would produce the following results.

- \$4.67 million of depreciation deductions would be disallowed (i.e., the \$10 million tax-exempt use loss multiplied by the fraction of \$14 million of depreciation deductions directly allocable to Perfume Property over \$30 million of total deductions allocable to Perfume Property).
- \$5 million of §162 deductions for maintenance expenses would be disallowed (i.e., the \$10 million tax-exempt use loss multiplied by the fraction of \$15 million of §162 deductions for maintenance expenses directly allocable to Perfume Property over \$30 million of total deductions allocable to Perfume Property).
- \$330,000 of interest deductions would be disallowed as well (i.e., the \$10 million tax-exempt use loss multiplied by the fraction of \$1 million of interest deductions properly allocable to Perfume Property over \$30 million of total deductions allocable to Perfume Property).

These results seem reasonable.

Nonetheless, is there a better case for some sort of ordering rule? The primary source of the overall tax benefit generated from a SILO appears to be depreciation.<sup>77</sup> The primary legal argument of the IRS in attacking SILOs is that the tax-exempt lessee (rather than the taxable lessor) continues to own the leased property.<sup>78</sup> Such an argument, if successful, would cause the taxable lessor's depreciation deductions taken with respect to such leased property to be disallowed but would not necessarily cause the disallowance of other deductions not inextricably linked to tax ownership of property, such as the taxable lessor's interest expense deductions. This rationale might serve as the basis for a §470 rule that all depreciation deductions should be disallowed before any other types of deductions (possibly with all other deductions dis-

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<sup>76</sup> *Id.* A similar rule applies when determining which partnership losses are disallowed and carried forward at the partner level pursuant to the basis limitation rule of §704(d). See Regs. §1.704-1(d)(2).

<sup>77</sup> See CRS Report at 7; ABA Comments at 2.

<sup>78</sup> See *IRS Coordinated Issue Paper on Losses Claimed and Income to be Reported from Sale In/Lease Out (SILO) Transactions*, reprinted in 2005 TNT 126-14 (6/29/05).

allowed on the "ratable portion" basis, described above).<sup>79</sup>

Under this rule, the \$10 million tax-exempt use loss with respect to Perfume Property would consist of \$10 million of depreciation deductions only. The remaining directly allocable depreciation deductions, all the directly allocable §162 deductions for maintenance expenses, and all the properly allocable interest expense deductions would not be disallowed by §470.

## Inside Basis Effects

The disallowance of the depreciation deductions under either a pure "ratable portion" basis or a modified "ordering and ratable portion" basis raises another issue. Does such depreciation reduce the adjusted basis of Company's assets (i.e., Company's "inside basis" of depreciable property) at the time such depreciation initially arises and is disallowed by §470, or only if and when §470 no longer applies to such depreciation deductions?

Section 1016(a)(2) provides that the adjusted basis of depreciable property is reduced by depreciation deductions allowed or allowable under §167. The application of §465 or §469 to otherwise allowed depreciation deductions generated by property owned by a taxpayer subject to either of these provisions (or generated by property owned by a partnership in which such a taxpayer is a partner) does not appear to override the basis reduction provided by §1016(a)(2).<sup>80</sup> Sections 465 and 469 merely prevent the relevant taxpayer from immediately using such otherwise allowed deductions to reduce taxable income.<sup>81</sup> Section 470 seems to serve the same purpose. The legislative history states, "[T]he taxpayer may not *claim* deductions for a taxable year from the lease transaction in excess of the taxpayer's gross income from the lease for that taxable year."<sup>82</sup> Thus, it seems reasonably clear that depreciation deductions arising in a particular taxable year that are disallowed at the partnership level under §470 should nevertheless reduce the adjusted basis of partnership property under §1016(a)(2) for such taxable year.

For purposes of continuing with the Example, let us assume that the deductions disallowed by §470 are

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<sup>79</sup> *Cf.* Regs. §1.704-2(j)(1)(ii) (applying deductions of a partnership in a similar manner for purposes of determining a partnership's nonrecourse deductions).

<sup>80</sup> See Prop. Regs. §1.465-1(e); TAM 9628002 (addressing §469); S. Rep. No. 313, 99th Cong., 2nd Sess. at 723 n.9 (1986) ("amounts at risk are reduced even if deductions which would be allowed under the at-risk rules are suspended under the passive loss rules. Similarly, basis is reduced as under present law, even in the case where deductions are suspended under the passive loss rules.").

<sup>81</sup> See, e.g., Regs. §1.469-1T(d)(3).

<sup>82</sup> Conference Report at 643-44 (emphasis added).

determined on the pure “ratable portion” basis, described above. Thus, \$4.67 million of depreciation deductions directly allocable to Perfume Property are disallowed by §470 at the Company level. Pursuant to §1016(a)(2), those deductions and the remaining \$9.33 million of such depreciation deductions reduce Company’s adjusted bases in the depreciable assets comprising Perfume Property. Also recall that \$5 million of the \$15 million of §162 deductions for maintenance expenses directly allocable to Perfume Property and \$330,000 of the \$1 million of interest deductions properly allocable to Perfume Property are disallowed by §470 at the Company level.

## Outside Basis Effects

### Introduction

Recall that the Company operating agreement provides that T is entitled to a special allocation of 80% of Company taxable income with respect to the first \$100 million of Company taxable income, and all other taxable income and items thereof are shared 30/70 between T and E. Let us assume that Company already has crossed the \$100 million taxable income threshold and is applying the general 30/70 ratio to all tax items. Thus, T and E would have allocated to them (at least tentatively allocated to them with respect to the deductions disallowed by §470) 30% and 70%, respectively, of, among other items:

- the \$4.67 million of disallowed depreciation deductions directly allocable to Perfume Property,
- the remaining \$9.33 million of such depreciation deductions not disallowed by §470,
- the \$5 million of disallowed §162 deductions for maintenance expenses directly allocable to Perfume Property,
- the remaining \$10 million of such §162 deductions for maintenance expenses not disallowed by §470,
- the \$330,000 of disallowed interest deductions properly allocable to Perfume Property, and
- the remaining \$670,000 of such interest deductions not disallowed by §470.

How do the allocations of the tax items disallowed by §470 affect T and E’s bases in their interests in Company? Do they reduce basis immediately or only if and when such items no longer are subject to §470 in a later taxable year? Section 705 controls the determination and adjustment of a partner’s basis in its partnership interest (i.e., such partner’s “outside ba-

sis”). Section 705(a)(2) provides that the adjusted basis of a partner’s interest in a partnership is reduced by “losses of the partnership” (§705(a)(2)(A) items) and “expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account” (§705(a)(2)(B) items).<sup>83</sup>

### Do Disallowed Deductions Constitute §705(a)(2)(A) Items?

The phrase “losses of the partnership” in §705(a)(2)(A) refers to (i) certain losses of a partnership, such as capital losses, that are separately stated and passed through to the partners (i.e., separately stated losses), and (ii) other losses and deductions that are incorporated into bottom line loss of the partnership and passed through to the partners (i.e., bottom line loss).<sup>84</sup>

Deductions disallowed by §470 at the partnership level do not appear to fall within any of the specifically enumerated types of separately stated losses.<sup>85</sup> The only specifically enumerated type of loss that seems to present any question is a loss or deduction “which, if separately taken into account by any partner, would result in an income tax liability for that partner, or for any other person, different from that which would result if that partner did not take the item into account separately.”<sup>86</sup> Since (i) deductions of a partnership seem to be disallowed by §470 at the partnership level, and (ii) §702(b) would appear to preserve the character of such deductions as disallowed under §470 if taken into account as a separately stated loss by the partners of such partnership, it seems that such deductions would constitute disallowed deductions whether (a) they are taken into account by a partner separate from the remaining items of the partnership, or (b) they are taken into account by a partner through such partner’s distributive share of bottom line taxable income or loss of the partnership. Thus, it does not appear that such deductions fall within any of the specifically enumerated types of loss.

Moreover, it does not appear that deductions disallowed by §470 at the partnership level would fall into bottom line loss of a partnership either. Bottom line loss is the excess of “the total of all other allowable deductions (not separately stated) over the total of all

<sup>83</sup> Section 705(a) also reduces outside basis for partnership distributions and for a partner’s depletion deductions. The reduction in outside basis for partnership distributions seems irrelevant to the issue of whether and when deductions disallowed by §470 reduce outside basis. The issue of how to treat depletion deductions in the §470 context is beyond the scope of this article.

<sup>84</sup> Regs. §§1.702-1(a), 1.703-1(a), 1.705-1(a)(3).

<sup>85</sup> See §702(a); Regs. §1.702-1(a).

<sup>86</sup> Regs. §1.702-1(a)(8)(ii).

other items of gross income (not separately stated).<sup>87</sup> It seems rather clear that deductions disallowed by §470 at the partnership level would not meet the plain meaning of “allowable deductions” for purposes of calculating bottom line loss of a partnership.<sup>88</sup>

So, it appears that deductions disallowed by §470 at the partnership level do not constitute separately stated losses or bottom line loss of a partnership. Thus, such deductions apparently do not meet the definition of “losses of the partnership” in §705(a)(2)(A).<sup>89</sup> However, such disallowed deductions still could reduce outside basis in the taxable year that they initially arise if they constitute “expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account” (i.e., §705(a)(2)(B) items).

### **Do Disallowed Deductions Constitute §705(a)(2)(B) Items?**

Neither §705 nor the related regulations contain a definition of a §705(a)(2)(B) item. Based solely on the language of the statute, it appears that a deduction disallowed by §470 at the partnership level would constitute a §705(a)(2)(B) item. Such deduction represents “an expenditure of the partnership” that §470 makes “not deductible in computing its taxable income,” and no Code provision appears to permit such disallowed deductions to be capitalized to the basis of any asset.

However, the IRS takes the position that an expenditure constitutes a §705(a)(2)(B) item only if it arises from a transaction that has a permanent effect on the partnership’s basis in its assets, without a corresponding current or future effect on its taxable income.<sup>90</sup> The IRS’s rationale for this position is that a partner’s share of nondeductible expenditures must be deducted from the partner’s outside basis in order to prevent that amount from giving rise to a loss to the partner on a sale or a redemption of the partner’s interest in the partnership.<sup>91</sup>

It appears that a deduction disallowed by §470 at the partnership level would not satisfy this definition.

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<sup>87</sup> See Regs. §1.703-1(a)(1)(ii).

<sup>88</sup> See also §703(a).

<sup>89</sup> Cf. §§267(a)(1), 707(b)(1); Rev. Rul. 96-10, 1996-1 C.B. 138 (implying that a partnership loss disallowed at the partnership level under §707(b)(1) does not constitute a §705(a)(2)(A) item).

<sup>90</sup> See Rev. Rul. 96-10 (concluding that loss from the sale of partnership property disallowed under §707(b)(1) decreases outside basis under §705(a)(2)(B)); Rev. Rul. 96-11, 1996-1 C.B. 140 (concluding that the inside basis of partnership property contributed to charity (rather than the property’s fair market value) reduces outside basis under §705(a)(2)(B)); Notice 99-57, 1999-2 I.R.B. 692.

<sup>91</sup> See *id.*; see also H.R. Rep. No. 1337, 83rd Cong., 2nd Sess. at 225 (1954); S. Rep. No. 1622, 83rd Cong., 2nd Sess at 384 (1954).

As stated above, it appears that depreciation deductions disallowed by §470 at the partnership level nevertheless would reduce the partnership’s bases in its depreciable assets. So, it seems that depreciation deductions disallowed by §470 at the partnership level at least would meet the first part of the IRS’s definition — permanent effect on the partnership’s basis in its assets. However, it appears uncertain whether other types of deductions disallowed by §470 at the partnership level would have a permanent effect on the partnership’s basis in its assets, such as Company’s interest expense deductions and §162 deductions for maintenance expenses. Such deductions themselves do not reduce Company’s basis in its assets. However, one could view the underlying expenditures of cash that generate such deductions as having a permanent effect on Company’s basis in its assets (i.e., Company’s cash is reduced).<sup>92</sup>

Regardless of this uncertainty, these deductions (and the depreciation deductions) apparently would not meet the second part of the IRS’s definition of a §705(a)(2)(B) item — no current or future effect on the taxable income of the partnership — due to the carryover provision of §470. Section 470(b) provides that any tax-exempt use loss with respect to any tax-exempt use property that is disallowed for any taxable year is treated as a deduction with respect to such property in the next taxable year. Thus, pursuant to §470(b), the deductions that comprise the tax-exempt use loss of Perfume Property will be carried forward to Company’s next taxable year and will be treated as deductions with respect to Perfume Property. If such mass tax-exempt use property produces enough income in the next taxable year, the deductions carried forward to such taxable year will no longer be subject to §470 and, therefore, will reduce bottom line income (or create bottom line loss) of Company under §703(a). Alternatively, even if Perfume Property does not produce enough income in the next taxable year, the deductions carried forward to such taxable year will no longer be subject to §470 if, generally, Company disposes of its entire interest in Perfume Property in a taxable transaction with an unrelated party.<sup>93</sup> This exercise illustrates that a deduction disallowed by §470 at the partnership level, although it does not have a *current* effect on the taxable income of the partnership under §703(a), can have a *future* effect on such taxable income under §703(a). Thus, depreciation deductions (and all other types of deductions)

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<sup>92</sup> See Rev. Rul. 96-10, 1996-1 C.B. 138 (sale of loss property had permanent effect on the partnership’s basis in its assets, since the sale actually removed the basis of such property from the partnership); Rev. Rul. 96-11, 1996-1 C.B. 140 (same regarding property donated by partnership).

<sup>93</sup> See §§469(g), 470(e)(2).

disallowed by §470 at the partnership level would appear not to meet the second part of the IRS's definition of a §705(a)(2)(B) item — no current or future effect on the taxable income of the partnership. In effect, these disallowed deductions constitute deferred deductions rather than permanently disallowed deductions.<sup>94</sup>

### No Outside Basis Effect

Since it appears that deductions disallowed by §470 at the partnership level do not constitute §705(a)(2)(A) items or §705(a)(2)(B) items, such deductions presumably cannot reduce outside basis for any partner in the taxable year in which such deductions are disallowed. As described above, such deductions are carried forward and tested anew under §470.<sup>95</sup> When such deductions no longer are subject to §470, such deductions generally should fall within the definition of bottom line income or loss under §703(a) since they would constitute “allowable deductions” at that point.<sup>96</sup> This treatment would cause such deductions to constitute §705(a)(2)(A) items, which would reduce the partners' outside bases at that time.<sup>97</sup>

Note that this outside basis treatment for deductions disallowed by §470 differs from how passive activity deductions from a partnership and partnership deductions subject to the at-risk rules affect partners' outside bases. In the §§465 and 469 contexts, deductions of a partnership reduce the outside bases of the partners (assuming adequate outside basis under §704(d)) prior to being tested at the partner level under §§465 and 469.<sup>98</sup> It seems that what drives this difference in outside basis treatment is the fact that §§465 and 469 disallow losses only at the partner level, and §470 appears to disallow losses at the partnership level.

## Inside-Outside Basis Disparity

### Introduction

So from this discussion, it appears that an inside-outside basis disparity would arise between the time

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<sup>94</sup> Cf. Regs. §1.1367-1(c)(2) (stating that noncapital, nondeductible expenses of an S corporation for purposes of stock basis adjustments “are only those items for which no loss or deduction is allowed and do not include items the deduction for which is *deferred* to a later taxable year”) (emphasis added); Regs. §1.1502-32(b)(3)(iii)(A) (defining noncapital, nondeductible expenses of a member of a consolidated group for purposes of the consolidated return stock basis adjustment rules as expenses that are “*permanently* disallowed or eliminated”) (emphasis added).

<sup>95</sup> See §470(b).

<sup>96</sup> Regs. §1.703-1(a).

<sup>97</sup> Some of such deductions might also fall into one of the definitions of separately stated losses under Regs. §1.702-1(a) at that point. The resulting effect on outside basis would be the same.

<sup>98</sup> See Prop. Regs. §1.465-1(e); S. Rep. No. 313, at 723 n.9.

that partnership deductions are disallowed by §470 and the time that such deductions no longer are subject to §470. It appears that a partnership's basis in depreciable property is reduced immediately by depreciation deductions disallowed by §470. It also appears that partnership cash is reduced immediately by expenditures that qualify as other types of deductions, such as interest deductions and §162 deductions for maintenance expenses. At the same time, it appears that the outside bases of the partners remain unaffected by such disallowed deductions.

Let us apply this approach to the Example. For efficiency purposes, let us also disregard the §162 deductions for maintenance expenses and the interest deductions. \$4.67 million of depreciation deductions directly allocable to Perfume Property is disallowed by §470 at the Company level. Pursuant to §1016(a)(2), those deductions and the remaining \$9.33 million of such depreciation deductions reduce Company's adjusted bases in the depreciable assets comprising Perfume Property. Pursuant to the operating agreement of Company, T and E would have allocated to them 30% and 70%, respectively, of such deductions. Based on the analysis above, it does not appear that the disallowed depreciation deductions would constitute §705(a)(2)(A) items or §705(a)(2)(B) items. Thus, although Company's bases of the depreciable assets that comprise Perfume Property would be reduced by the \$4.67 million of disallowed depreciation deductions, such disallowed deductions would not reduce T's and E's outside bases in Company. Accordingly, this would cause the aggregate outside bases of T and E to be \$4.67 million higher than the aggregate adjusted basis of Company's depreciable assets that comprise Perfume Property (i.e., T and E would have a \$1.4 million and a \$3.27 million difference, respectively, between inside and outside basis attributable to their interests in Perfume Property).

Is this an appropriate result? For efficiency purposes, let us further assume that Company only consists of Perfume Property. Also, assume that T sells its interest in Company to a third party for cash equal to the fair market value of T's interest (and assume tax depreciation is an accurate measure of the decline in value of depreciable property and, accordingly, in the value of T's interest in Company). One might think that, all other things being equal, such a sale would cause T to recognize a loss under §§741 and 1001 equal to \$1.4 million, which represents the difference between T's outside basis and its share of the adjusted basis of Company's depreciable assets that comprise Perfume Property. One might further think that this result also would permit the transferee of T's interest in Company to take into account the related disallowed depreciation deductions in a later year when

Company generated sufficient income attributable to Perfume Property or Company disposed of its entire interest in Perfume Property in a transaction described in §469(g).<sup>99</sup> This result would cause the same \$1.4 million loss to be recognized twice.

### **The Case for §469(g) Rules Applying at Both the Partner and Partnership Levels**

However, there appears to be another way to view the tax consequences of T's sale. Section 470 provides that, if during the taxable year a "taxpayer disposes of the taxpayer's entire interest in tax-exempt use property . . . , rules similar to the rules of §469(g) shall apply for purposes of" §470.<sup>100</sup> Section 469(g) generally provides that, if a taxpayer disposes of its entire interest in a passive activity in a taxable transaction with an unrelated party, the taxpayer's passive activity losses associated with that activity no longer remain subject to the passive activity loss rules (i.e., such losses are treated as not from a passive activity). The legislative history of §469(g) indicates that, if a taxpayer's interest in a passive activity is held entirely through a partnership interest (i.e., the passive activity is conducted at the partnership level), §469(g) applies to the taxpayer's passive activity loss attributable to that activity when the taxpayer disposes of its entire interest in the partnership (i.e., the partnership itself need not dispose of the activity to trigger the application of §469(g) to the taxpayer).<sup>101</sup> Since "rules similar to the rules of section 469(g)" apply in the §470 context by reason of §470(e)(2), there seems to be a fair position that the disposition of T's interest in Company to the third party for cash should constitute an event where rules similar to §469(g) should apply to the losses disallowed by §470 at the Company level.

The §469(g) rules, however, operate in an overall framework of passive activity loss rules that focus on the partner rather than on the partnership. For example, a taxpayer that holds its entire interest in a passive activity through the ownership of an interest in a partnership still reduces its outside basis by its distributive share of passive activity deductions, subject to the outside basis limit of §704(d).<sup>102</sup> Section 469 simply prevents the taxpayer from properly claiming such deductions on the taxpayer's personal return. Those deductions are not disallowed and carried forward at the partnership level.<sup>103</sup> Rather, they are dis-

allowed and carried forward at the partner level.<sup>104</sup> Further, depreciation deductions of a partnership that also constitute passive activity deductions nevertheless reduce the partnership's adjusted basis of depreciable property under §1016(a)(2).<sup>105</sup> Accordingly, unlike §470, there appears to be no inside-outside basis disparity created by the §469 rules with respect to depreciation deductions of a partnership.

In light of how §469 operates in the partnership context, it is not surprising that §469(g), its legislative history, and the related regulations do not contain any guidance on what should occur (if anything) upon a taxpayer's disposition of its entire interest in a partnership (i) when there is an inside-outside basis disparity with respect to such interest that was created by disallowed deductions, or (ii) when deductions are disallowed at the partnership level rather than at the partner level. So, even though §470(e)(2) clearly indicates that §469(g) rules apply in the §470 context and the legislative history of §469(g) indicates that §469(g) should apply upon the disposition of a taxpayer's entire interest in a partnership, there appears to be no rules under §469(g) that are readily applicable to the disposition of a taxpayer's entire interest in a partnership in the §470 context.

It seems that the following rules could be viewed as consistent with §469(g) in the context of §470 and the complete disposition of partnership interests. At the time that a taxpayer disposes of its entire interest in a partnership in a transaction described in §469(g), that taxpayer's distributive share of the deductions that comprise a partnership's tax-exempt use loss are no longer treated as part of such tax-exempt use loss. Such distributive share of such deductions no longer constitutes losses disallowed by §470. Therefore, at that point, such deductions become §705(a)(2)(A) items that decrease the outside basis of the taxpayer immediately before the disposition of its interest in the partnership.<sup>106</sup>

Applying these rules to the disposition of T's interest in Company would free from §470 the \$1.4 million of previously disallowed deductions with respect to T's interest in Perfume Property. Such deductions would decrease T's outside basis immediately before the sale of T's interest to the third party.<sup>107</sup> Such basis reduction would eliminate the potential \$1.4 million disposition loss under §§741 and 1001. However, T would be able to take into account, through its distributive share of Company tax items, a similar amount of loss (assuming adequate outside basis un-

<sup>99</sup> See §470(c), (e)(2).

<sup>100</sup> §470(e)(2).

<sup>101</sup> See S. Rep. 313, at 725-26; H.R. Conf. Rep. 841, at II-145.

<sup>102</sup> See §705(a)(2)(A); Regs. §1.702-1(a)(8); Regs. §1.469-2T(d)(6)(v); S. Rep. No. 99-313, at 723 n.9 (1986).

<sup>103</sup> See §469(a)(2); Regs. §1.469-2T(e)(1).

<sup>104</sup> See Regs. §1.469-2T(e)(1); Regs. §1.469-1(f)(4)(iii) Ex. 4.

<sup>105</sup> See S. Rep. No. 313, at 723 n.9.

<sup>106</sup> See §§705(a), 706(c)(2).

<sup>107</sup> See §§705(a), 706(c)(2).

der §704(d)) due to §470 no longer applying to the \$1.4 million of previously disallowed deductions.<sup>108</sup> The real difference now is that such deductions would be unavailable to the transferee of T's interest in Company, since such deductions would no longer be eligible to be carried forward to subsequent taxable years of Company under §470(b). This approach would prevent the same \$1.4 million loss from being recognized twice. Accordingly, the case that the inside-outside basis disparity created by §470 is appropriate would be strengthened if this approach were used to apply the rules of §469(g) to partnerships in the §470 context.

However, it seems that an additional rule would be needed to prevent E's share (or a portion thereof) of the disallowed depreciation deductions (i.e., the remaining \$3.27 million of disallowed depreciation deductions) from being taken into account by the transferee of T's interest in Company upon Company's complete disposition of Perfume Property (or upon the transferee's subsequent disposition of its interest in Company). Continuing with the Example, since the \$1.4 million of depreciation deductions has been freed from §470, only the remaining \$3.27 million of depreciation deductions is eligible to be carried forward to the subsequent taxable year of Company and treated as deductions with respect to Perfume Property. At the end of such subsequent taxable year (assuming Company generates an equal amount of deductions and income allocable to Perfume Property for such year), a \$3.27 million tax-exempt use loss should arise with respect to Perfume Property. This loss effectively is attributable to the \$3.27 million disallowed depreciation deductions carried forward at the Company level from the previous year that had been tentatively allocated to E.

If Company disposes of its entire interest in Perfume Property at the end of that year in a transaction described in §469(g), this \$3.27 million tax-exempt use loss presumably would be freed from §470 at the Company level. If the deductions that comprise such tax-exempt use loss were allocated under the operating agreement of Company, 30% of those deductions would be allocated to the transferee of T's interest in Company. In effect, this later disposition of Perfume Property would shift from E to the transferee of T's interest in Company 30% of the \$3.27 million of depreciation deductions that remained a tax-exempt use loss immediately after T's sale of its interest in Company. It seems that additional rules would be needed to prevent this shift from occurring.

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<sup>108</sup> Although a similar *amount* of loss may be taken into account by T through its distributive share of Company tax items, the *character* of such loss (or tax items comprising such loss) may differ from the character of any loss from the disposition of T's interest in Company.

## The Case for §469(g) Rules Applying Only at the Partnership Level

Alternatively, there appears to be a reasonable position for the original approach described above to applying §469(g) to partnerships in the §470 context. Recall that such approach was that, upon the disposition of a taxpayer's entire interest in a partnership in a transaction that is described in §469(g), §470 should continue to apply to partnership deductions (including the taxpayer's distributive share of such deductions) that comprise a tax-exempt use loss of the partnership. Section 470(e)(2) only provides that rules *similar to* — not exactly like — the rules of §469(g) should apply in the §470 context. What differences between §469 and §470 could serve as the basis for the position that, even though a taxpayer disposes of its entire interest in a partnership in a transaction that is described in §469(g), §470 should continue to apply to all partnership deductions that comprise a tax-exempt use loss?

As described above, on one hand, passive activity losses attributable to activities conducted by a partnership are disallowed at the partner level under §469. Section 470, on the other hand, seems to require that tax-exempt use losses attributable to property owned by a partnership be disallowed at the partnership level. Further, in the passive activity loss context, a partner generally is treated as participating in an activity conducted by a partnership merely through the ownership of its interest in that partnership.<sup>109</sup> A partner, however, is not treated as owning tax-exempt use property of a partnership for purposes of §470 merely by reason of its ownership of an interest in that partnership (only the partnership is treated as owning such property).<sup>110</sup> Thus, in the partnership context, §469 primarily focuses on the partners, and §470 appears to focus on the partnership.

This difference between §469 and §470 suggests that, unlike in the §469 context, the rules of §469(g) should apply only at the partnership level in the §470 context. Under this approach, only *Company's disposition* of its entire interest in Perfume Property should free the related disallowed deductions from §470. *T's disposition* of its entire interest in Company should have no effect for purposes of continuing to apply §470 to Company's deductions.

Let us assume that these rules apply to the Example. T's disposition of its interest in Company in a transaction described in §469(g) should not cause any share of Company's tax-exempt use loss attributable to Perfume Property to reduce T's outside basis imme-

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<sup>109</sup> See §469(h)(2); Regs. §1.469-4(a); Regs. §1.469-2T(c)(2), (d)(5), (e).

<sup>110</sup> See §§470(c), 168(h)(6). See also ABA Comments at 26.

diately before the disposition or to be taken into account on T's personal return. However, T's disposition should permit T to recognize a \$1.4 million loss under §§741 and 1001. Further, the deductions that comprised such tax-exempt use loss should remain at the Company level and be taken into account by E and the transferee of T's interest in Company when Company generates sufficient income from Perfume Property or disposes of its entire interest in Perfume Property itself in a transaction described in §469(g). Thus, this approach causes the same \$1.4 million loss to be recognized twice. Accordingly, it appears that this approach weakens the case that the inside-outside basis disparity created by §470 is appropriate, unless some other provision would prevent such loss duplication.

## Application of §743 to a Tax-Exempt Use Loss

Under this partnership-level approach to applying §469(g) in the §470 context, could §743 eliminate the potential for loss duplication? Section 743(b) generally permits (and, in some cases, requires) partnerships to reduce (and, in some cases, eliminate) inside-outside basis disparities upon, among other transactions, a sale of a partnership interest. If applicable, §743(b) presumably could reduce (or eliminate) the potential for loss duplication by reducing (or eliminating) at the Company level the deductions that had been disallowed by §470.

Section 743(b) reduces (or eliminates) inside-outside basis disparities by adjusting the basis of "partnership property." Are deductions disallowed at the partnership level by reason of constituting tax-exempt use losses "partnership property" for purposes of §743(b)?

Neither §743 nor the related regulations seem to answer the question. However, the Tax Court, in *Bartolme v. Comr.*,<sup>111</sup> concluded that interest that had been prepaid and deducted by a partnership in a previous year was partnership property subject to adjustment under §743(b), since the parties believed there was actual value in such prepaid interest and the parties took that value into account in determining the price the buyer paid for the relevant interest in the partnership.<sup>112</sup> The IRS later acquiesced in the result of *Bartolme*.<sup>113</sup> The IRS agreed with the Tax Court's decision, because the prepaid interest constituted an asset under "generally accepted accounting" prin-

ciples and "from a commercial and business view."<sup>114</sup>

It seems that deductions disallowed by §470 at the partnership level could constitute deferred tax assets under generally accepted accounting principles. Although such deductions do not reduce tax for partners in the year in which they arise, they can reduce tax for partners in future years when the partnership generates sufficient income or disposes of its entire interest in the relevant tax-exempt use property. Further, it seems that a seller and a purchaser of an interest in a partnership that had deductions disallowed by §470 could properly view those "suspended deductions" as valuable and, accordingly, incorporate such value into the purchase price for the interest.<sup>115</sup> For example, if Company disposed of its entire interest in Perfume Property in a subsequent year, such deductions would break free from §470, which could permit all partners, including the transferee of T's interest in Company, to use such deductions to reduce taxable income.<sup>116</sup> Thus, it seems that, under the principles of *Bartolme*, partnership deductions disallowed by §470 could be treated as "partnership property" for purposes of §743(b).

If deductions disallowed by §470 at the Company level were treated as "partnership property" subject to §743(b), additional issues would arise. Section 743(b), in conjunction with §755, adjusts the *basis* of partnership property with respect to the transferee partner. For purposes of serving as the base from which §743(b) adjustments are made, what bases would Company initially take in such disallowed deductions? Would such bases simply equal the amount of such disallowed deductions? How would the overall §743(b) basis adjustment be allocated among the differing types of disallowed deductions that comprise a tax-exempt use loss? Recall that partnership deductions that constitute a tax-exempt use loss for a particular taxable year are carried forward to the next year and tested anew under §470.<sup>117</sup> What happens to the §743(b) adjustment to the basis of each deduction disallowed by §470 when such deductions are carried forward to the next year under §470(b)? Do these adjustments to basis reduce pre-existing deductions (or convert into additional deductions) of Company at that time?

<sup>114</sup> *Id.*

<sup>115</sup> See ABA Comments at 27 ("[P]artners 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.").

<sup>116</sup> See §§470(e)(2), 469(g).

<sup>117</sup> See §470(b).

<sup>111</sup> 62 T.C. 821 (1974).

<sup>112</sup> See 62 T.C. at 830.

<sup>113</sup> IRS AOD, 1975 WL 38181 (12/1/75).

Finally, §743(b) is elective generally.<sup>118</sup> However, §743(b) automatically applies to a partnership when the partnership has a “substantial built-in loss.”<sup>119</sup> A partnership has a “substantial built-in loss” if the partnership’s adjusted basis in partnership property exceeds the fair market value of such property by more than \$250,000.<sup>120</sup> Even assuming that there was guidance on what basis deductions disallowed by §470 should take, how is a partnership to determine the fair market value of such disallowed deductions? What if the seller and buyer of the relevant partnership interest do not enter into a written sales agreement that specifically describes how much consideration is allocated to such deductions?

## A Significant Regulatory Project Could Loom

These questions are just a subset of the seemingly large number of questions related to the application of §470 to partnerships that do not have readily apparent answers under existing guidance. The Example above admittedly only addresses a small slice of the universe of potential issues created by §470’s application to partnerships.<sup>121</sup> Overall, it seems that, even after Congress narrows the class of partnerships subject to

§470, a significant regulatory project awaits the Treasury Department. Of course, if Congress simply eliminated this problem for all partnerships by deleting the cross-reference to §168(h)(6) in §470(c), many (if not all) of these issues would disappear, which should be food for thought for the staffs of the tax legislation-writing committees of Congress.

## CONCLUSION

Much attention has fallen on how Congress should narrow the circumstances in which §470 applies to partnerships. Unfortunately, it appears that such congressional narrowing might come only in the form of a single, much-too-narrow exception for partnerships, with §470 continuing to cross reference §168(h) (including §168(h)(6)) for the definition of “tax-exempt use property.” Thus, it seems that some partnerships that have no tax or economic connection to a SILO will find themselves still within §470’s grasp. Not much attention has been paid to how §470 actually would apply to these partnerships. This article at the very least demonstrates that there could be a considerable amount of administrative burden, uncertainty, and complexity awaiting any partnership and its tax advisors that are forced to apply §470.

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<sup>118</sup> See §§743(a), 754.

<sup>119</sup> See §743(a), (d).

<sup>120</sup> See §743(d)(1).

<sup>121</sup> For example, there are a host of issues regarding tiered partnerships. See, e.g., ABA Comments at 22. Further, it is unclear how §168(h)(6) should apply in the §470 context (if at all) to S corporations, real estate investment trusts, and other entities that

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might be treated as “passthrough entities” in §168(h)(6). See §168(h)(6)(E). It also appears unclear how a partner is to apply §108 with respect to debt of a partnership where partnership deductions are disallowed by §470. Are such deductions subject to the partner-level attribute reduction rules of §108(b)? See §108(d)(6). Finally, it appears unclear whether the classification of partnership property as tax-exempt use property must be done on an annual basis or some other basis. See §470(e)(1).