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## INTERNAL REVENUE CODE SECTION 470: IMPLICATIONS FOR SECTION 1031 EXCHANGES

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In 2004 tax legislation, Congress addressed what it considered to be abusive sale and leaseback transactions involving tax-exempt entities known as “sale-in, sale-out,” or SILO transactions. In general, SILO transactions shifted certain tax benefits attributable to depreciable property from tax exempt entities which could not use them to taxpayers who were able to use the tax benefits. The legislative remedy was new Section 470 which includes provisions that can have a substantial and adverse impact on certain like-kind exchanges of real property.

In general, Section 470, which was enacted on October 22, 2004 as part of the American Jobs Creation Act of 2004, creates new limitations on the deductibility of losses relating to tax-exempt use property. With limited exceptions, Section 470(a) provides that a “tax-exempt use loss” for any taxable year is not allowed. A tax-exempt use loss means, with respect to any taxable year, the amount (if any) by which the sum of the aggregate deductions (other than interest) directly allocable to tax-exempt use property, plus the aggregate deductions for interest properly allocated to the property, exceeds the aggregate income from the property. Any disallowed loss is treated as a deduction with respect to the property in the next taxable year, and ultimately is allowed upon the taxable disposition of the property.

Property is “tax-exempt use property” if it is leased to a “tax-exempt entity.” Tax-exempt entities include organizations exempt from tax, such as charitable organizations and qualified employee benefit plans, certain foreign persons and entities that are not subject to income tax with respect to the property and most governmental bodies.

If any property that is not otherwise “tax-exempt use property” is owned by a partnership that has both a tax-exempt entity and a person who is not a tax-exempt entity as partners, and any allocation to the tax-exempt entity of partnership items is not a qualified allocation, an amount equal to the tax-exempt entity’s proportionate share of the property generally is treated as tax-exempt use property. Therefore, Section 470 will be applicable to many real estate investments that include tax-exempt partners.

In the case of nonresidential real property, tax-exempt use property means the portion of the property that is leased to a tax-exempt entity in a “disqualified lease.” A disqualified lease is any lease of property to a tax-exempt entity if any of the following four conditions is satisfied:

1. Tax-exempt debt was used directly or indirectly to finance all or a portion of the property.
2. The lease includes either a purchase or sale option at a fixed or determinable price.
3. The term of the lease is in excess of 20 years.
4. There is a sale-leaseback with respect to the property.

As a general exception, nonresidential real property will not be treated as tax-exempt use property unless more than 35% of the property is leased to tax-exempt entities. In such a circumstance, the existence of leases to tax-exempt entities will not override the application of Section 1031 to an exchange in which either the relinquished or the replacement properties include tax-exempt leases.

The principal impact of Section 470 on like-kind exchanges is found in the special rules of Section 470(e). Section 470(e) provides that (i) Section 1031(a) (and Section 1033(a)) will not be applicable to provide nonrecognition of gain (or loss) if the exchanged or relinquished property is tax-exempt use property subject to a lease that was entered into between March 13, 2004, and which would not have met the requirements for an exempt lease under Section 470(d) (as described below) had such requirements then been effect; and (ii) Section 1031(a) (and Section 1033(a)) will not be applicable to an exchange if the replacement property is tax-exempt use property subject to a lease that is not an exempt lease under Section 470(d). Accordingly, every person who acquires leased replacement property in a Section 1031 exchange will have to determine whether there is any tax-exempt user of the property and if there is, determine that the lease satisfies the requirements of Section 470(d).

As indicated above, Section 470(d) provides that leases that satisfy all of the following criteria are “exempt leases”:

1. **Availability of Funds.** The tax-exempt lessee may not have more than an “allowable amount” of funds subject to either (a) any arrangement described below, or (b) any arrangement by which a reasonable person would conclude that funds were set aside or were expected to be set aside. The term “arrangement” includes a defeasance arrangement, a loan by the lessee to the lessor or any lender, a deposit arrangement, a letter of credit collateralized with cash or cash equivalents, a payment undertaking agreement, prepaid rent, a sinking fund arrangement, a guaranteed investment contract, financial guaranty insurance, or any similar arrangement by which the tax-exempt lessee monetizes its lease obligations. An allowable amount of funds is generally equal to 20% of the lessor’s adjusted basis in the property on the date the lease is entered into.
2. **Substantial Equity Investment by Lessor.** The taxpayer must make and maintain a substantial equity investment in the property. Under Section 470(d)(2), a taxpayer does not make or maintain the requisite investment unless (a) on the date the lease is entered into the taxpayer makes an unconditional at-risk equity investment in the property of at least 20% of the taxpayer’s adjusted basis in the leased property, and (b) the taxpayer maintains that equity investment throughout the lease term. Further, at all times during the lease term, the fair market value of the property at the end of the lease term is reasonably expected to equal at least 20% of its initial value.
3. **Lessee May Not Bear More than a Minimal Risk of Loss.** There is no arrangement under which the lessee bears (a) any portion of the loss that would occur if the fair market value of the leased property were 25% less than its reasonably expected fair market value at lease termination, or (b) more than 50% of the loss that would occur if the fair market value of the leased property at the time the lease is terminated were zero.
4. **Option to Purchase.** If the property has a class life of more than seven-years, and if the lessee has an option to purchase the property, the purchase price must equal the fair market value of the property at the time of exercise of the option to purchase.

If the four requirements described above are satisfied, the lease is an exempt lease for purposes of Section 470 and it will not preclude nonrecognition under Section 1031.

Section 470 creates yet another tax trap for the unwary. Although it was designed to correct what is considered by most to be abusive transactions, “SILO” transactions, as enacted, Section 470 has a much broader impact. Taxpayers wishing to engage in a like-kind exchange should be careful to consider Section 470 and its affect on the exchange properties, and should prepare purchase contracts that allow withdrawal under the contract if the property is not suitable for an exchange.