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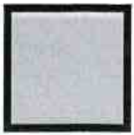

THE IMPACT OF TAX-EXEMPT LEASES ON RESOS

Section 470 will have an adverse affect on every partnership that could incur a loss and that has both taxable and tax-exempt partners.

DANIEL F. CULLEN and MICHAEL T. DONOVAN

Most tax advisors view issuance of Rev. Proc. 2002-22[1] as the catalyst for the emerging tenant in common financial instruments market—the syndication of credit-tenant real estate deals as replacement property for like-kind exchanges. Rev. Proc. 2002-22 provides detailed conditions under which the IRS will consider a request for a ruling that a tenancy-in-common (TIC) interest is not an interest in a business entity but, rather, a direct, undivided interest in real estate for purposes of a Section 1031 like-kind exchange. Subsequently, in Rev. Rul. 2004-86,[2] the IRS ruled that the receipt of an interest in a Delaware Statutory Trust (DST) qualified as an interest in the underlying real estate held by the DST for purposes of Section 1031. A handful of tax practitioners practicing in this area refer to TIC and DST interest deals as "real estate securities offerings" or "RESOs." The classification as real estate, rather than as a partnership or security interest, is critical to taxpayers acquiring TIC interests or DST interests in real estate as replacement property for like-kind exchanges under Section 1031. However, recently enacted Section 470 also has important consequences for both sponsors and investors in RESOs. This article discusses the impact of Section 470 on RESOs and the steps that sponsors and investors should take to minimize the potential impact of Section 470 on RESOs.

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Background

In 2002, the IRS issued guidance concerning whether an undivided fractional interest, or TIC interest, in real estate should be treated as giving rise to a separate business entity for federal income tax purposes. Rev. Proc. 2002-22 provides detailed conditions under which the IRS will consider a request for a ruling that a TIC interest is not an interest in a business entity but, rather, a direct, undivided interest in real estate. As noted above, this classification as real estate, rather than as a partnership or security interest, is critical to taxpayers acquiring TIC interests in real estate as replacement property for like-kind exchanges under Section 1031.[3]

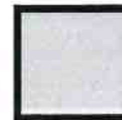
In 2004, the IRS issued Rev. Rul. 2004-86,[4] which addressed whether a DST will be treated as a trust[5] or a business entity[6] for federal income tax purposes. If an entity is classified as a trust, and that trust also satisfies the requirements of a grantor trust under Sec-

tion 671, interests in that trust will be treated as interests in the real property owned by the trust for purposes of applying the like-kind exchange rules under Section 1031. Accordingly, taxpayers disposing of real estate in an otherwise qualifying like-kind exchange can acquire an interest in such DST as qualifying replacement property. In contrast, if the trust is treated as a business entity, interests in the trust will be treated as interests in a partnership or corporation,[7] which will not constitute valid replacement property under Section 1031.[8]

Prior to the emergence of RESOs, a taxpayer who sold real estate (relinquished property) would have to search for other real estate (replacement property) that cost about the same as the proceeds from the prior sale. It often was not possible to find the appropriate replacement property at the right cost in a timely manner (i.e., within the 45 days provided by Section 1031(a)(3) for identifying replacement property), notwithstanding that there were several reputable companies engaged in marketing replacement properties for like-kind exchanges. The purchase of a TIC or DST interest as replacement property makes economic sense in some cases,[9] both because the size of the TIC or DST interest can be tailored to the taxpayer's needs and, in some cases, because the taxpayer may conclude that an investment in a smaller portion of a larger property has the potential to produce superior returns.

Section 470—tax-exempt leases

Congress recently enacted new Section 470, which places a limitation on deductions applicable to property used by tax-exempt entities ("tax-exempt leases") and, perhaps more importantly with respect to RESOs, prohibits a taxpayer from using any portion of a property subject to a tax-exempt lease as replacement property in a like-kind exchange under Section 1031.[10] Although Section 470 was enacted to counter certain sale-in, lease-out transactions (commonly referred to as SILOs), and the legislative history to Section 470 indicates that it is not intended to inhibit legitimate commercial lending transactions,[11] its impact on RESOs can be significant. In light of the limitations imposed on like-kind exchanges by Section 470, a detailed review of all tax-exempt leases has become a critical part of the due diligence process when structuring a RESO intended to qualify as like-kind replacement property.



EVERY ACQUIRER OF LEASED REPLACEMENT PROPERTY WILL NEED TO DETERMINE WHETHER THERE IS A TAX-EXEMPT USER OF THE PROPERTY.

Generally speaking, under new Section 470, Section 1031(a) (the like-kind exchange rules) and Section 1033(a) (the involuntary conversion rules) will not apply if the exchanged or converted property is "tax-exempt use property" subject to a lease that was entered into before 3/13/04, and that would not have met the requirements for an "exempt lease" under Section 470(d) had such requirements been in effect.[12] Furthermore, Section 1031(a) and Section 1033(a) will not apply 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).[13] Thus, every acquirer of leased replacement property will need to determine (1) whether there is a tax-exempt user of the property; (2) if there is, verify whether the lease is tax-exempt use property; and (3) if it is, determine whether the

[1] 2002-1 CB 733. Like any revenue procedure, Rev. Proc. 2002-22 is not a statement of law; rather, it provides only guidance for taxpayers wishing to obtain a private letter ruling that certain co-owned real estate should not be treated as giving rise to a separate business entity for federal income tax purposes.

[2] 2004-31 IRB 118.

[3] Prior to Rev. Proc. 2002-22, the IRS issued Rev. Proc. 2000-46, 2000-2 CB 438, in response to several requests for private rulings filed on behalf of "promoters" that were selling TIC interests in real estate as replacement property for like-kind exchanges. The Service announced at that time that it would not issue advance rulings or determination letters on (1) whether a TIC interest in real property is an interest in an entity (i.e., a partnership interest) that is not eligible for a tax-free exchange under Section 1031(a)(2)(D), or (2) whether arrangements in which taxpayers acquire a TIC interest in real property constitute separate entities for federal tax purposes.

[4] 2004-33 IRB 191. For a detailed discussion of this ruling, see Lipton, Golub, and Cullen, "Delaware Statutory Trusts and 1031: A Marriage Made In Heaven or Just a Pipe Dream," 101 J. Tax'n 140 (September 2004).

[5] Reg. 1.7701-4.

[6] Reg. 1.7701-3.

[7] *Id.*

[8] See Sections 1031(a)(2)(D) and (E).

[9] As always, taxpayers should evaluate the tax deferral benefit derived under Section 1031 in contrast to the tax depreciation benefit provided from a step-up in tax basis in an after-tax deal.

[10] See Section 470(e)(4)(A)(ii).

[11] Staff of the Joint Committee on Taxation, *General Explanation of Legislation Enacted in the 108th Congress* (JCS-5-05), page 421.

[12] Section 420(e)(4)(A)(i).

[13] Section 470(e)(4)(A)(ii).

lease satisfies the requirements of Section 470(d).[14]

With this new limitation in mind, two of the most important aspects of Section 470 are the definitions of "tax-exempt entity" and "tax-exempt use property."

Tax-exempt entity. A "tax-exempt entity" is generally defined under Section 168(h)(2)(A) and includes the following:

- *U.S. government agencies.* A tax-exempt entity includes the U.S., any state or political subdivision thereof, a US possession, or any agency or instrumentality of any of the foregoing.[15] However, a corporation is not treated as an instrumentality of the U.S. or of any state or political subdivision thereof if all of the activities of the corporation are subject to U.S. federal income tax and a majority of the board of directors is not selected by the U.S. or any state or political subdivision thereof.[16]
- *Exempt entities.* A tax-exempt entity includes an entity (other than a cooperative described in Section 521) that is exempt from taxes imposed by Chapter 1 of the Code (e.g., qualified plans and Section 501(a) exempt organizations).[17] In addition, an organization that was previously treated as tax exempt is deemed to be a tax-exempt entity with respect to property if it was tax exempt at any time during the five-year period during which the property was first used by such organization.[18] For this purpose, the term "tax-exempt use period" means the period beginning in the tax year in which the property is first used by the organization and ending with the close of the 25th tax year following the last tax year of the applicable recovery period of such property.[19]
- *Foreign persons and entities.* A tax-exempt entity includes any foreign person or entity. Foreign persons or entities include any foreign government, any international organization, or any agency or instrumentality thereof as well as any person that is not a U.S. person, but does not include a foreign partnership or other foreign pass-through entity.[20] Foreign persons or entities are excluded from the definition of tax-exempt entities with respect to a particular property if more than 50% of the gross income from the tax year derived by the foreign person or entity from the use of such property is (1) subject to U.S. federal income tax or (2) is included under Section 951 in the gross income of a U.S. shareholder for the tax year of the U.S. shareholder with or within which ends the tax year of the controlled foreign corporation during which such income was derived.[21] While not strictly excluded from Section 470, foreign individuals and corporations leasing nonresidential real property generally will be engaged in a U.S. trade or business and therefore will be excluded from the definition of foreign persons and entities because more than 50% of their gross income derived from the property will be subject to U.S. tax.
- *Indian tribal governments.* A tax-exempt entity includes any Indian tribal government described in Section 7701(a)(40).[22]

THERE IS AN IMPORTANT EXCEPTION IN SECTION 470(d) FOR EXEMPT LEASES THAT MEET CERTAIN STRINGENT REQUIREMENTS.

Tax-exempt use property. Tax-exempt use property general generally is defined for purposes of Section 470 by reference to Section 168(h),[23] which provides (in Section 168(h)(1)(A)) that tax-exempt use property means that portion of any tangible property (other than nonresidential real property) leased to a tax-exempt entity. Because any real property acquired in a RESO that is leased to a tax-exempt entity will qualify as nonresidential real property in vir-

[14] With respect to relinquished property to which Section 1031 does not apply under Section 470(e)(4)(A)(i), investors and their advisors generally are responsible for verifying that their relinquished property qualifies for like-kind exchange treatment or not. Nevertheless, while this is not a risk arising from an investment in the sponsor's offering, sponsors may wish to consider disclosing this risk to investors as an added precaution.

[15] Section 168(h)(2)(A)(i).

[16] Section 168(h)(2)(D).

[17] Section 168(h)(2)(A)(ii).

[18] Section 168(h)(2)(E). Section 470 provides for an exception to this rule for the Federal Home Mortgage Corporation. In addition, certain organizations described in Section 501(c)(12) can make an irrevocable election to avoid the application of Section 168(h)(2)(E) by agreement not to be exempt from tax during the tax-exempt use period with respect to the property.

[19] Section 168(h)(2)(E)(ii)(II).

[20] Section 168(h)(2)(C).

[21] For this purpose, exclusions or exemptions are not applied in determining the amount of the gross income so derived, but are applied for purposes of determining the portion of such gross income subject to tax. Section 168(h)(2)(B).

[22] Section 168(h)(2)(A).

[23] Section 470(c)(2).

tually all cases, the discussion below will consider only the rules applicable to nonresidential real property. In the case of nonresidential real property, Section 168(h)(1)(B)(i) provides that tax-exempt use property means the portion of the property leased to a tax-exempt entity in a "disqualified lease." A disqualified lease is defined in Section 168(h)(1)(B)(ii) as any lease of the property to a tax-exempt entity, but only under one of the following conditions:

1. Part or all of the property was financed (directly or indirectly) by tax-exempt debt.
2. There is a fixed or determinable purchase or sale option under such lease.
3. The lease has a term in excess of 20 years.
4. There is a sale-leaseback with respect to the property.

Under Section 168(h)(1)(B)(iii), however, nonresidential real property is not treated as tax-exempt use property unless more than 35% of the property is leased to tax-exempt entities. There are a number of exceptions in Section 168(h)(1), including an exception under which the property is used in an unrelated trade or business of the tax-exempt entity.[24]

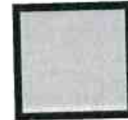
Although Section 470 generally defines "tax-exempt use property" by reference to Section 168(h), it makes several important exceptions as well. First, the exceptions in Section 168(h) for short-term leases and leases of high technology equipment are wholly inapplicable for purposes of Section 470.[25] Second, for purposes of applying Section 470, any Section 197 intangible, or any property described in Section 167(f)(1)(B) (computer software) or Section 167(f)(2) (intangible assets that are separately acquired), is treated as if it were tangible property, so that the utilization of such property by a tax-exempt entity could give rise to a lease.[26] However, Section 470 does not apply to property that would be subject to a low-income housing or rehabilitation credit if such property is treated as tax-exempt use property solely because it is owned by a partnership with tax-exempt partners.[27]

There is an important exception in Section 470(d) for certain leases (exempt leases) that meet certain stringent requirements:

- *Limited 'defeasance arrangements' or 'set aside' amounts.* The tax-exempt lessee may not have more than an "allowable amount" of funds subject to either (1) any arrangement described in Section 470(d)(1)(B) or (2) any arrangement under which a reasonable person would conclude, based on the facts and circumstances, that funds were set aside or expected to be set aside. Section 470(d)(1)(B) refers to 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, and any similar arrangement. Business interruption insurance and similar types of insurance purchased by the lessor should not be treated as described in Section 470(d)(1)(B).

  An "allowable amount" of funds is generally equal to 20% of the lessor's adjusted basis in the property at the time the lease is entered into, although a higher percentage could be allowed by regulation.[28] If the lessee has the option to purchase property for a fixed price or for other than its fair market value (determined at the time of exercise), the allowable amount at the time such option may be exercised may not exceed 50% of the price at which such option may be exercised.[29] The allowable amount is zero with respect to any arrangement that involves (1) a loan from the lessee to the lessor or a lender; (2) any deposit received, letter of credit issued, or payment undertaking agreement entered into by a lender otherwise involved in the transaction; or (3) in the case of a transaction that involves a lender, any credit support made available to the lessor in which any such lender does not have a claim that is senior to the lessor.[30]

- *Substantial equity investment.* The taxpayer must make and maintain a substantial equity investment in the leased property. For this purpose, the taxpayer generally does not make or maintain a substantial equity investment unless (1) at the time the lease is entered into, the taxpayer initially makes an unconditional at-risk



TAX COUNSEL REVIEWING A PROPOSED RESO MUST CONDUCT CAREFUL DUE DILIGENCE WITH RESPECT TO ANY TAX-EXEMPT LEASE.

[24] Section 168(h)(1)(D).
[25] Section 470(c)(2)(A).
[26] Section 470(c)(2)(B).
[27] Section 470(c)(2).
[28] Section 470(d)(1)(C)(i).
[29] Section 470(d)(1)(C)(iii).
[30] Section 470(d)(1)(C)(iv).

equity investment in the property equal to at least 20% of the taxpayer's adjusted basis in the leased property at that time, and (2) the taxpayer maintains such equity investment throughout the lease term.[31]

- *Fair market value at end of lease term.* At all times during the lease term, the fair market value of the property at the end of the lease term must reasonably be expected to equal at least 20% of its initial value.[32]
- *Lessee's risk of loss.* There must be no arrangement under which the lessee bears (1) 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 the time the lease is terminated, or (2) 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.[33]
- *Fair market value purchase option.* If the property has a class life of more than seven years (other than fixed-wing aircraft) and if the lessee has the option to purchase the property, the purchase price must be equal to the fair market value of the property at the time of exercise of the purchase option.

Complying with the due diligence requirements under Section 470 in a RESO

In light of the new limitations provided under Section 470, tax counsel reviewing a proposed RESO must conduct careful due diligence with respect to any tax-exempt lease. The following issues list may prove helpful in complying with the due diligence requirements under Section 470:

1. Tax-exempt status. As a first step in the due diligence process, one must determine if the lessee is a tax-exempt entity. This may sometimes be more difficult than it sounds, because much of the traditional due diligence the sponsor receives will not indicate whether a lessee is tax exempt or not, but in most cases should not pose a significant problem. U.S. and state government agencies should be fairly easy to identify from the rent roll, as should Indian tribal governments. As noted above, identification of foreign individuals and entities generally should not be a problem since these persons will generally be engaged in a U.S. trade or business. Because more than 50% of their income from the property will be subject to U.S. tax, foreign individuals and entities generally will not constitute tax-exempt entities. More difficult to identify may be charitable organizations and similar exempt entities, though in many cases they will have words indicating their status in their names, such as foundation, trust, pension, and so forth. It occasionally may be difficult to determine whether an entity is owned by a foreign government.

The analysis becomes more complicated if the property is held by or leased to a partnership or other pass-through entity subject to the rules of Section 168(h)(5) or (6). If Section 168(h)(5) or (6) applies, additional due diligence relating to the ownership and allocations of the entity may be required. Under Section 168(h)(5), in the case of a partnership or other pass-through entity, a proportionate share of the property leased to the partnership is deemed to be leased to its tax-exempt partners.[34] Partners in a foreign partnership (and the beneficiaries of other foreign pass-through entities) are rebuttably presumed to be persons who are not U.S. persons. Under Section 168(h)(6), if property that otherwise would not be tax-exempt use property is owned by a partnership that has both tax-exempt and non-tax-exempt partners, and that makes allocations other than qualified allocations to its partners, such property is treated as tax-exempt use property to the extent of the tax-exempt partner's proportionate share of the property. Such property is also treated as tax-exempt use property for purposes of Section 470 unless a credit is allowable under Section 42 or 47 with respect to the property.[35] For purposes of Sections 168(h)(5) and (6), corporations controlled by tax-exempt entities generally are

[31] This requirement does not apply to leases with a term of five years or less.

[32] Section 470(d)(2)(A)(ii).

[33] Section 470(d)(3). The IRS is granted authority to issue regulations under which this requirement is not met if the lessee bears more than a minimal risk of loss.

[34] The tax-exempt entity's proportionate share is determined under Section 168(h)(6).

[35] Thus, sponsors who sell both partnership interests to non-Section 1031 investors and TIC interests in Section 1031 investors (commonly referred to as "A-B structures") may wish to exclude tax-exempt entities from the partnership or, as an alternative, make sure that all partnership allocations are qualified allocations.

deemed to be tax exempt, unless an election is filed and the tax-exempt owners agree to recognize gain on the disposition of the interest in the corporation. For these reasons, it may be difficult and time-consuming for sponsors to identify leases to tax-exempt entities. These rules make can make the identification of tax-exempt use property a complex undertaking.

2. Determine whether tax-exempt entities account for more than 35% of the leased property. In virtually every circumstance, property leased to a tax-exempt entity in a RESO transaction will be nonresidential real property (which term includes, for this purpose, residential rental property). Section 470 applies only to disqualified leases. As noted above, nonresidential real property constitutes tax-exempt use property only if more than 35% of the property is leased to tax-exempt entities in disqualified leases. Accordingly, if 35% or less of the property is leased to tax-exempt entities, it will be unnecessary to analyze particular leases under Section 168(h) or Section 470. In this case, more than 35% of the property refers to more than 35% of the net rentable floor space of the property, excluding common areas.[36] If the property includes more than one building, however, each building is treated as a separate property unless the buildings are part of a single project. Generally, two or more buildings are treated as part of a single project if they are constructed, under a common plan, within a reasonable time of each other, on the same site, and will be used in an integrated manner.[37]

3. Is the lease a disqualified lease? Section 470 applies only to leases that are disqualified leases under Section 168(h). In addition, it generally is easier to determine whether a lease is a disqualified lease under Section 168(h) than to determine whether exception under Section 470(d) applies. Accordingly, if more than 35% of the property is leased to tax-exempt entities, the next step will be to determine whether one or more of the leases with tax-exempt entities is a disqualified lease. In the case of nonresidential real property, if 35% or less of the property is leased to tax-exempt entities pursuant to disqualified leases, Section 470 cannot apply. The important due diligence items for identifying disqualified leases are the following:

- *Tax-exempt financing.* Sponsors should identify property that was financed, directly or indirectly, by tax-exempt bonds.[38]
- *Sale-leasebacks.* Sponsors should identify leases which are part of a sale-leaseback.[39]
- *Lease term.* Sponsors should determine the lease term. A critical part of due diligence will be determining the lease term as (1) leases with terms of 20 years or less are not disqualified leases under Section 168(h) and (2) for purposes of 470(d), leases with terms of five years or less are exempt from the substantial equity requirement of Section 470(d)(2) and the requirement that the lessee may bear no more than minimal risk of loss under Section 470(d)(3).[40] If the lease includes renewal options, other than options to renew at fair market value determined at the time of renewal, the period covered by the renewal options must be included. In addition, if there is a service contract or similar arrangement that (1) is part of the same transaction (or series of related transactions) that includes the lease and (2) is with respect to the property subject to the lease or substantially similar property, the term of the lease includes the term of the service contract. It is also important to note that two or more successive leases that are part of the same transaction (or series of related transactions) with respect to the same or substantially similar property are treated as one lease for purposes of determining the lease term.[41]
- *Options.* The due diligence process should determine if the lessee has an option to purchase the property at a fixed price or a price other than fair market value at the time of exercise. This is critical for determining whether the lease is a disqualified lease under Section 168(h) and the applicability of the exception provided under Section 470(d).

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[36] Temp. Reg. 1.168(j)-1T, Q&A 6.

[37] *Id.*

[38] The Sponsor is the person who organizes and is responsible for the offering (without retaining an interest in the property in which interests are offered).

[39] For this purpose, property that is leased within three months after the date the property is first used by the tax-exempt entity is not a sale-leaseback that is treated as a disqualified lease. Section 168(h)(1)(B)(v).

[40] Sections 168(h)(1)(B)(ii)(III), 470(d)(2)(C), 470(d)(3)(C).

[41] Sections 168((i)(3), 470(f)(2).

4. Defeasance funds. In enacting Section 470, Congress was concerned about lessees "monetizing" their leases (creating funding mechanisms to ensure a lessor or lender would be paid). Thus, one must identify arrangements that insulate the lessor or lender from a risk of default by the lessee and a risk of loss with respect to the property. Such arrangements may exist outside of the terms of the lease itself. The due diligence process should determine whether some sort of reserve of funds has been established or is guaranteed to be available (e.g., an irrevocable letter of credit) assuring the lessor or lender will be paid. However, a guaranty of a lessee's obligations by an affiliate alone should not create an issue.

In most cases, one will need to determine if there are funds subject to certain arrangements to or for the benefit of the lessor or any lender, or to or for the benefit of the lessee to satisfy the lessee's obligations or options under the lease. The arrangements are a defeasance arrangement, a loan by lessee to lessor or lender, a deposit arrangement, a letter of credit collateralized with cash or cash equivalents, a payment undertaking agreement, any prepaid rent, a sinking fund arrangement, a guaranteed investment contract, a financial guaranty insurance, and any similar arrangement (whether or not the arrangement provides credit support).

If any such amounts are identified, the Sponsor must then determine whether the sum of such amounts exceeds the allowable amount.

5. Substantial equity investment requirement. The due diligence review also must focus on the amount of the lessor's investment in the property and whether the lessor will maintain that investment in the property throughout the lease term. As discussed above, leases with terms of less than five years do not raise this concern. In short, the lessor must have, at the time the lease is entered into, an unconditional at-risk equity investment in the property equal to at least 20% of the lessor's adjusted basis in the property.

Even if the lessor has a substantial equity investment in the property, arrangements with the lessee can effectively protect the lessor from ever losing that investment. Examples include residual value guarantees and put options under which the lessor may be able to force the lessee to purchase the property if its value declines, and lessee call options at other than fair market value (with an implicit understanding that the lessee will exercise). In short, the due diligence review must determine whether an arrangement effectively is intended to allow the lessor to shift the loss associated with a decline in the value of the property to the lessee.

Conclusion

Section 470 has been criticized because of its unanticipated impact on innocent transactions. Although the exception in Section 470(d) is helpful, it will not apply to many routine transactions otherwise caught in Section 470's broad reach. Perhaps Congress will recognize that the reach of Section 470 is too broad, and the scope of the legislation will be scaled back. However, for many tax practitioners, as well as sponsors of RESOs, Section 470 has the potential of being a hidden pitfall that could make taxable an exchange of like-kind property. ■