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WRITTEN COMMENTS

ON

H.R. 6264, THE "TAX TECHNICAL CORRECTIONS ACT OF 2006"

OCTOBER 31, 2006

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ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
September 29, 2006
FC–26

CONTACT: (202) 225–1721

Thomas Announces Request for Written Comments on H.R. 6264, the "Tax Technical Corrections Act of 2006"

Congressman Bill Thomas (R–CA), Chairman of the Committee on Ways and Means, today announced that the Committee is requesting written public comments for the record from all parties interested in H.R. 6264, the "Tax Technical Corrections Act of 2006."

BACKGROUND:

On Friday, September 29, 2006, Chairman Thomas introduced H.R. 6264, the "Tax Technical Corrections Act of 2006." The legislation contains technical corrections needed with respect to recently enacted tax legislation.

"H.R. 6264 includes important corrections intended to make Congressional intent clear regarding crucial components of recent tax legislation," said Chairman Thomas. "We are asking the public to review the proposed text and provide comments during the coming weeks so that Congress can send appropriate legislation to the President as soon as possible. Although the *Tax Technical Corrections Act of 2006* does not include any technical corrections to the *Pension Protection Act of 2006*, we are interested in receiving any proposals for technical corrections to this important legislation."

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit for the record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, *http://waysandmeans.house.gov*, select "*109th Congress*" from the menu entitled, "*Hearing Archives*" (*http://waysandmeans.house.gov/Hearings.asp?congress=17*). Select the request for written comments for which you would like to submit, and click on the link entitled, "*Click here to provide a submission for the record*." Once you have followed the online instructions, completing all informational forms and clicking "submit" on the final page, an email will be sent to the address which you supply confirming your interest in providing a submission for the record. You ***MUST REPLY*** to the email and ***ATTACH*** your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by close of business Tuesday, October 31, 2006. **Finally**, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–1721.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word or WordPerfect format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons, and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at *http://waysandmeans.house.gov*.

Statement of American Council of Life Insurers

1. Investment Advice

Need for change

The provision requires that an eligible investment advice program either be based on a computer model or that the fees of the fiduciary adviser, including commissions, not be affected by the advice (i.e., fee leveling). The provision was intended to apply the fee leveling requirement solely to the individual actually providing such advice; however, the term used in the section is "fiduciary adviser" which is defined to include the entity employing the individual providing the advice, rather than simply the individual. In addition, the provision was intended to require an eligible investment advice arrangement to take into account all designated investment vehicles under the plan (excluding brokerage windows). Finally, a typographical error in section 601(b)(3) of the Act is corrected.

Statutory Change

Amend section 408(g)(3)(B)(v) of ERISA by deleting the word "options" and insert in lieu thereof "investments designated".

Amend section 4975(f)(8)(C)(ii)(V) of the Code by deleting the word "options" and insert in lieu thereof "investments designated".

Amend section 601(b)(3)(A)(i) by deleting the words "subparagraphs (B) through (F) (and so much of subparagraph (G) as relates to such paragraphs) of" and inserting after the word "1986" the following: "which are not covered by Part 4 of Title I of ERISA"

Amend section 601(b)(3)(C)(i)(I) by inserting at the beginning thereof the following: Except as the Secretary may otherwise provide by regulation, general notice on its website, or otherwise, "

Amend section 601(b)(3)(C)(ii)(I) by striking the following: "and section 4975(f)(8) (other than subparagraph (C) thereof)".

Amend section 601(b)(3)(C)(ii) by deleting subclauses (I) and (II), striking the words "and as are necessary to —" and inserting in lieu thereof a period.

Although we understand that there is some dispute among the conferees as to who they meant to apply the fee-leveling requirement to, we would like to take this opportunity to state that our members strongly indicate that the only way to make this requirement workable is to apply it to an individual providing advice. Otherwise, applying a fee-leveling requirement would be impractical, applying the entire audit and fee requirement to the corporation or affiliate offering the advice. It is only practical that the adviser's fee be leveled, which would disincent conflicted advice, and could be easily and readily audited.

2. Scope of IRA Class Exemption

Need for change

The provision clarifies that the IRA class exemption may apply to self-directed accounts are similar to IRAs, including Keogh plans. However, Keogh plans covered by Title I of ERISA would continue to be subject to the exemption for qualified plans.

Statutory Change

Amend section 601(b)(3)(A)(i) by deleting the words "subparagraphs (B) through (F) (and so much of subparagraph (G) as relates to such paragraphs) of" and inserting after the word "1986" the following: "which are not covered by Part 4 of Title I of ERISA."

3. Clarify Department of Labor Authority to Issue Exemptions for Advice

Need for change

There is concern that the directive by Congress in the Act could prejudice the ability of DOL in the future to issue exemptions for other advice arrangements.

Statutory Change

Amend section 601(b)(3)(C)(i)(I) by inserting at the beginning thereof the following: "Except as the Secretary may otherwise provide by regulation, general notice on its website or otherwise,"

4. Clarify Department of Labor Authority Regarding IRA Class Exemption

Need for change

As currently drafted, subclauses (I) and (II) have been interpreted to limit the class exemption's application to the type of guidance permitted under Interpretive Bulletin 96–1. The following change is intended to clarify the authority of the Secretary of Labor in granting a class exemption for IRAs if a computer model is determined not to be feasible.

Statutory Change

Amend section 601(b)(3)(C)(ii)(I) by striking the following: "and section 4975(f)(8) (other than subparagraph (C) thereof)".

Amend section 601(b)(3)(C)(ii)(I) by striking the following: "and as are necessary to —" and inserting in lieu thereof a period.

In the alternative, the following correction deleting subparagraph (C) is necessary to remove the fee leveling requirement should the IRA study determine that a computer model for IRAs is not feasible:

Amend section 601(b)(3)(C)(ii)(I) by striking the following: "and section 4975(f)(8) (other than subparagraph (C) thereof)".

5. Long-term Care Exchange Effective Date

Need for change

The Act specifies that long-term care *i* nsurance contracts are covered under section 1035 of the Code for exchanges occurring on or after January 1, 2010. Various transactions commonly take place today under group contracts, such as replacements of coverage (either between carriers or within the same carrier), that often are accompanied by a transfer or reallocation of reserves to reduce the premiums that otherwise would apply under the new coverage. These transactions are subject to various provisions of the Code and state law regarding continuation and conversion of coverage rights and replacements. *See, e.g.*, section 7702B(g)(2)(A)(i)(IV) and (V) of the Code.

There are also situations where individual long-term care insurance policyholders exchange their contracts for new contracts with improved features, *e.g.*, pursuant to state law rules requiring insurers to make new improved products available to existing policyholders. In addition, an exchange may occur in order to allow a policy or certificate to be treated as a "partnership" policy under the Medicaid laws, in accordance with the recently enacted Deficit Reduction Act of 2005 and the express intention of the conferees with respect to such exchanges (*see* H.R. Conf. Rep. 109–362, at 294).The replaced contract does not have a cash surrender value and, unlike an annuity, endowment or life insurance contract, income on the contract is not realized on its exchange that would be recognized if not deferred under Code section 1035. In each of the above cases, the "exchange" serves only to reduce premiums under the new qualified long-term care insurance policy, compared with the premiums that would apply without regard to the prior coverage.

The suggested language would clarify that such transactions do not result in any current taxation to the certificate holder or policyholder. In particular, the acceleration of the effective date would address any concerns that transactions between enactment and the otherwise applicable effective date would be adversely affected.

Statutory Change

Add the following provision to any technical corrections legislation to address this issue:

SEC. xxx—Technical Correction to Effective Date of Tax-Free Exchange Provisions.

(a) Correction of Effective Date.—Section 844(g) of the Pension Protection Act of 2006 is amended by striking paragraph (2) (regarding the effective date of amendments made to section 1035 of the Internal Revenue Code of 1986) and inserting in lieu thereof the following new paragraph:

"(2) Tax-Free Exchanges.—

"(A) In General.—Except as otherwise provided in subparagraph (B) of this paragraph, the amendments made by subsection (b) shall apply with respect to exchanges occurring after December 31, 2009.

"(B) Exchanges of Qualified Long-Term Care Insurance Contracts.—The amendment made by paragraph (4) of subsection (b) shall apply with respect to exchanges occurring on or after the date of enactment of this Act.

(b) No Inference.—Nothing in the amendments made by this section or by section 844(b)(4) of the Pension Protection Act of 2006 shall be construed to create an inference with respect to the treatment of exchanges of qualified long-term care insurance contracts under the Internal Revenue Code as in effect before such amendments.

(c) Effective Date.—The amendments made by this section shall take effect as if included in section 844 of the Pension Protection Act of 2006.

6. Section 1322 Treament of Death Benefits From Company-Owned Life Insurance

Need for change

Section 1322 of the Act adds a new section, section 101(j) to the Code. The general rule of section 101(j) limits the amount excluded from income under section 101(a) to the amount of premiums and other amount paid by the policyholder. Section 101(j)(2) provides exceptions to this rule. Under section 101(j)(2), the policyholder may exclude all death benefits received under a company-owned life insurance policy if certain notice and consent requirements are satisfied. Section 101(j)(2)(A)(ii)(II) provides an exception for employees who are highly compensated within the meaning of section 414(q) of the Code. Under section 414(q)(1)(B), whether an employee is highly compensated is determined by applying a test that considers whether the employee was highly compensated *for the preceding year.*

While the look back rule of section 414(q)(1)(B) can be applied readily in those situations where the employee was employed in the preceding year, a problem arises if the insured is a new employee of the policyholder. This is because there is no prior year salary history applicable to a newly-hired employee. The look-back rule essentially disqualifies those employees hired in the same year an employer is considering purchase of a company owned life insurance policy. This means they cannot be considered as part of the eligible pool of highly compensated employees. The impact of this look-back rule is particularly harsh on small employers seeking to purchase insurance on newly-hired key employees and on start-up companies. We do not believe that Congress intended this result when it enacted section 101(j).

Statutory Change

Therefore, we propose the following amendment to section 101(j)(2)(A)(ii)(II):

(II) a highly compensated employee within the meaning of section 414(q) (without regard to paragraph (1)(B)(ii) thereof, and, for purposes of this subsection only, by adding the words "current or" before "preceding year" in section 414(q)(1)(B)), or

We believe that this change will mitigate the problem created by the look-back rule that arises in the case of newly-hired key employees without changing the intent of Congress to limit the definition of highly compensated employees to those employees describe in either section 414(q) or section 105(h)(5).

7. Typographical Errors

Need for change

The following items involve errors in the nature of incorrect cross-references, etc.

Statutory Change

Amend section 4975(f)(8)(A) of the Code by deleting "subsection (b)(14)" and inserting in lieu thereof "subsection (d)(17)". [Subsection (b)(14) does not exist in the Code.]

Amend section 408(g)(3)(D)(ii) of ERISA by deleting subsection "(b)(14)(B)(ii)" and inserting in lieu thereof "subsection (b)(14)(A)(ii)". [(B) does not exist; we believe the drafters intended the reference to be (b)(14)(A).]

Amend section 4975(f)(8)(D)(iv) of the Code by deleting "(b)(14)(B)(ii)" and inserting in lieu thereof "subsection (d)(17)(A)(ii)". [Conforming previous change in the Code.]

Statement of API

I. INTRODUCTION

These comments are submitted by API, the national trade association of the U.S. oil and gas industry, in connection with U.S. House of Representatives Committee on Ways and Means request for comments from parties interested in H.R. 6265, the "Tax Technical Corrections Act of 2006." API represents nearly 400 member companies involved in all aspects of the oil and gas industry, including exploration, production, transportation, refining, and marketing.

API is proposing two technical corrections. The first concerns I.R.C. section 4082(a)(2) and the dyeing of untaxed diesel fuel. The second technical correction concerns I.R.C. section 6427(l)(4) and fuel used in commercial aircraft engaged in foreign trade.

II. Mechanical Dye Injection Equipment

Present and Prior Law

Federal excise tax generally is imposed on gasoline, diesel fuel and kerosene when the fuel is removed from a refinery or terminal rack. However, tax is not imposed on rack removals of diesel fuel and kerosene if, among other things, the fuel is indelibly dyed in accordance with regulations prescribed by Treasury. The presence of dye in the fuel indicates that the fuel is destined for a nontaxable use. Regulations have been issued that specify the allowable types and concentration of dye. The regulations do not specify the method of adding dye to the fuel.

New Law

Public Law 108–357 (the American Jobs Creation Act of 2004) amended I.R.C. Section 4082(a)(2) (relating to the exemptions from tax for diesel fuel and kerosene) to provide that tax will not be imposed on removals of diesel and kerosene if, among other things, the fuel is indelibly dyed by mechanical injection. In addition, the law added new I.R.C. Section 6715A which imposes penalties on persons who tamper with a mechanical injection system and on the operator of a mechanical dye injection system who fails to maintain security standards for such system as established by Treasury.

The reason for this change in the law, as stated by the Joint Committee on Taxation, was that "Congress remained concerned, however, that tax could still be evaded **through removals at a terminal** of undyed fuel that had been designated as dyed. Manual dyeing was inherently difficult to monitor. It occurred **after diesel fuel had been withdrawn from a terminal storage tank,** generally required the work of several people, was imprecise, and did not automatically create a reliable record. The Congress believed that requiring that untaxed diesel fuel be dyed only by mechanical injection will significantly reduce the opportunities for diesel fuel tax evasion." (Emphasis added.) (Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress (JCS–5–05), May 2005, at page 437–438.)

Technical Correction

The new law as written may be interpreted to apply to dyeing which occurs today within the bulk distribution system (such as dyeing by pipeline operators that routinely occurs as fuel is pumped out of intermediate tankfarm facilities to shipper terminals), whereas the legislative intent was to address the opportunity for evasion at the terminal rack. Therefore, the new law under section 4082(a) should be clarified as follows (omissions are struck out and additions are underlined):

SEC. 4082. **Exemptions for Diesel Fuel and Kerosene.**

(a) In General.—The tax imposed by section 4081 . . . shall not apply to diesel fuel and kerosene—

(2) which is indelibly dyed in accordance with regulations which the Secretary shall prescribe, and

(3) which meets such marking requirements (if any) as may be prescribed by the Secretary in regulations.

In the case of fuel that is dyed coincident with the removal from a terminal as described in section 4081(a)(1)(A)(ii), the requirement of paragraph (2) shall be satisfied only if the fuel is dyed by mechanical injection. Such regulations prescribed under this subsection shall allow an individual choice of dye color approved by the Secretary or chosen from any list of approved dye colors that the Secretary may publish.

III. Fuel Used in Commerical Aircraft Engaged in Foreign Trade—Refunds and LUST

Present Law

Excise tax is imposed on jet fuel (kerosene) when the fuel is removed from a registered pipeline or barge terminal (I.R.C. section 4081). Except in the case of airports directly served by such a terminal and which the Internal Revenue Service ("IRS") determines to be a "secure" airport, tax is imposed at a rate of 24.4 cents per gallon. At secure airports directly served by registered terminals, tax is imposed at 4.4 cents per gallon on jet fuel sold for use in commercial aviation (21.9 cents per gallon on noncommercial, or general, aviation use) when aircraft are fueled. Registered commercial airlines are liable for the tax on jet fuel taxed at 4.4 cents per gallon. In other cases, the position holder in the terminal is liable for payment of the tax. Commercial aviation is defined as transportation of persons or property for hire.

The jet fuel excise tax rates are comprised of two components: 4.3 cents per gallon (commercial aviation) or 21.8 cents per gallon (general aviation) dedicated to the Airport and Airway Trust Fund ("AATF"), and 0.1 cent per gallon dedicated to the Leaking Underground Storage Tank ("LUST") Trust Fund. Jet fuel removed for use in commercial aircraft engaged in foreign trade (sec. 4221(d)(3)) is exempt from the AATF, but not the LUST, portion of the tax.

The 24.4-cents-per-gallon rate (and the 4.4—or 21.9-cents-per-gallon rates on otherwise exempt jet fuel) exceed actual liability. Refunds of excess tax imposed under section 4081 are claimed under section 6427(l)(4) or section 6427(l)(5). Section 6427(l)(4) applies to commercial aviation while section 6427(l)(5) applies in all other cases.[1] Section 6427(l)(4) allows airlines to claim the refund directly (e.g., by crediting the excess tax against the airline's passenger or property excise tax liability) or to assign the refund to their ultimate vendors (if the vendors are registered with the IRS). Section 6427(l)(5) limits refunds to registered ultimate vendors.

New Law

As enacted by SAFETEA,[2] section 6427(l)(4) creates an ambiguity as to the proper treatment of refunds for jet fuel sold as supplies for aircraft engaged in foreign trade. The ambiguity arises because of a parenthetical exclusion in the introductory language of section 6427(l)(4)(A) for jet fuel used as "supplies for vessels or aircraft within the meaning of section 4221(d)(3)." The exclusion reflects the fact that this fuel, unlike jet fuel used in domestic commercial aviation, is not subject to the 4.3-cents-per-gallon AATF tax rate. However, the exclusion should not be interpreted to preclude comparable refund treatment for jet fuel sold for commercial use in foreign trade and identical fuel sold for use in domestic commercial aviation.[3] The IRS has issued rules denying commercial airlines the right to claim these refunds directly (by treating the fuel as described in section 6427(l)(5) rather than section 6427(l)(4)).

Technical Correction

Section 6427(l)(4) should be amended to clarify that excess tax collected under section 4081 on jet fuel sold for use as supplies for aircraft engaged in foreign trade may be refunded either to registered airlines or their ultimate vendors. The amend-

[1] The heading to section 6427(l)(5) states that the paragraph applies to fuel used in "noncommercial aviation."

[2] "SAFETEA" stands for the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users. SAFETEA was enacted on August 10, 2005 as Public Law 109–59.

[3] Airlines eligible for the section 4221(d)(3) exemption are commercial airlines that, like their domestic counterparts, currently collect the AATF excise taxes under section 4261 (in this case, the international arrival and departure excise taxes).

ment may be accomplished by deleting the current parenthetical "(other than supplies for vessels or aircraft within the meaning of section 4221(d)(3))" in section 6427(l)(4)(A), and adding a new flush sentence at the end of that subparagraph, as follows: "Clause (ii) shall not apply in the case of kerosene used as supplies for vessels or aircraft within the meaning of section 4221(d)(3)."

Contacts

For further information, please contact Anne Price Warhola, Mark Kibbe, or Teresa Dondlinger Trissell.

Statement of Citigroup Inc.

I. *Introduction.*

Citigroup Inc. is pleased to offer its comments on proposed Section 6 of H.R. 6264 and S. 4026, the Tax Technical Corrections Act of 2006 (the "TTCA"). Section 6 would revise section 470 of the Internal Revenue Code (as added to the Code by the American Jobs Creation Act of 2004, P.L. 108-357), principally by adding a new section 470(e), addressing the application of section 470's principles to partnerships.

Citigroup appreciates the importance of section 470 as it applies to leasing, and we also understand and accept the importance of ensuring that the Code does not countenance the development of highly-structured partnership arrangements that replicate all or most of the tax benefits of "LILO" and "SILO" lease structures. At the same time, Citigroup remains concerned that an overbroad provision aimed at forestalling the development of structured partnership successors to "LILOs" and "SILOs" could cause adverse unintended consequences for many *operating* partnerships—partnerships that actively conduct one or more trades or businesses—that have nothing in common with "LILO" and "SILO" leasing practices.

This issue is particularly important to Citigroup because one of our largest overseas affiliates is organized as a partnership for U.S. tax purposes, with a majority U.S. partner and minority foreign partners (which in turn are Citigroup subsidiaries that are taxed as "controlled foreign corporations"). The affiliate has thousands of employees, billions of dollars in annual revenue, in capital, and in assets (comprised predominantly of securities positions, but also including property described in section 470(c)(2)), and thousands of customers. At worst, an overbroad prophylactic partnership provision would deny Citigroup a deduction for depreciation and amortization of the affiliate's section 470(c)(2) assets, despite the fact that the partnership is actively engaged in a customer-driven business that bears no resemblance to LILO/SILO fact patterns. At best, an overbroad provision would introduce difficult interpretational and compliance issues for the IRS, for Citigroup, and for thousands of other operating partnerships across the U.S. economy.

The comments that follow are designed to honor the concerns that motivated Congress to introduce section 470 in 2004, and to preserve the general framework of Section 6 of the TTCA, as it is currently drafted. The overall purpose of our comments is to focus the language of Section 6 as it applies to operating partnerships more closely on the nature of the relationship between taxable and tax-exempt *partners* that can give rise to the same concerns that Congress addressed in section 470 with respect to a taxable *lessor* and a tax-exempt *lessee.*

Section II of this memorandum describes our overall theme in a little more detail. Section III then lays out our specific suggestions, and briefly summarizes our reasoning. Finally, we have attached for your convenience a copy of current Section 6 of the TTCA, marked to show our suggested changes.

II. *Translating Section 470 Principles into the Partnership Context.*

We believe that section 470, as it applies to its core subject (leasing), is premised on three principles that together define a "true" lease. Section 470 then develops rules to ensure that the relationship between a tax-exempt lessee and a taxable lessor does not to any significant extent vitiate any of these principles.

The three principles that section 470 uses to define a "true" lease when the lessee is a tax-exempt entity are as follows. First, the lessor must make a substantial investment of capital in the leased property. Second, the lessor must look to the lessee's rental obligations for one significant portion of the lessor's economic returns. And third, the lessor must also look to the residual value of the leased property for another significant portion of its economic returns.

Section 470(d) responds to these three principles with three basic operating rules. First, the lessor must make and maintain a significant investment in the leased property. (Section 470(d)(2).) Second, the lessee must not "monetize" (beyond relatively insignificant levels) its *obligation* to pay rent to the lessor, or its *option* to repurchase the leased property.[1] (Section 470(d)(1).) Third, the lessee must not assume any significant risk of loss relating to the residual value of the leased property (whether through a lessor "put" option or otherwise). (Section 470(d)(3).)

We believe that these principles and operating rules help put the operation of section 470(d)(1), in particular, into context, as can be illustrated by some common LILO/SILO fact patterns. To take one example, a loan from a tax-exempt lessee to a taxable lessor might be viewed as undercutting the first principle outlined above (that the lessor have an at-risk investment in the leased property); section 470(d)(1) accordingly addresses this fact pattern. A tax-exempt lessee's "defeasance" of its rental obligations to the taxable lessor might be viewed as undercutting the second principle (that the lessor look to the *lessee* for a significant portion of its return); section 470(d)(1) therefore addresses this fact pattern as well. And finally, a lessee fixed price option to purchase the leased property, *combined* with a "defeasance" arrangement, was seen by Congress as putting too much practical pressure on the third principle (that the lessor look to the residual value of the leased property for a significant portion of its return); section 470(d)(1) therefore also addresses this case.

Despite all the complexity of the "LILO" and "SILO" arrangements that impelled Congress to enact section 470, those transactions, like all leases, essentially boil down to simple bilateral agreements between a (taxable) lessor and a (tax-exempt) lessee. Accordingly, section 470(d)(1)(A) applies, first, to set-asides or other arrangements that run directly to the benefit of the lessor, or to any lender *to the lessor* (because that is what it means to be a "lender" in a leveraged lease transaction). The party providing these set-asides of course is the tax-exempt lessee, because that is the counterparty to the lessor (and the lessor's lender). Similarly, section 470(d)(1)(A) also applies to set-asides by the lessee that directly satisfy its own obligations under the lease—but again those obligations (and the destination of the lease rental payments) are to the lessor (the only counterparty to the lease), or to the lessor's lender. In either case, the presupposition is that there is a lessor investment or a lessee obligation to pay rent, the economic significance of which to the lessor is undercut by the arrangements entered into by the lessee.[2]

Section 470(e)(2)(A), as proposed by the TTCA, is patterned closely on current section 470(d)(1)(A), but we believe that partnerships are much more complex bundles of agreements than are leases. As a result, the partnership analogy to section 470(d)(1)(A) is more complex (and less inclusive) than how Section 6 of the TTCA in its current form might be read. First, partnerships that operate businesses engage in a wide range of transactions with suppliers, customers, counterparties, lenders and other third parties that have no direct analogy to the narrower sphere of activity embodied in a lease. Second, a partnership is simultaneously an entity (conducting business with third parties, for example) and a multilateral agreement among its partners (through partnership allocations). Third, a lender in a leasing arrangement is by definition lending to the owner of the property—the lessor. By contrast, a lender to a partnership indirectly is lending to *all* partners, including tax-exempt as well as taxable partners. Some aspects of this complex web of relationships can be analogized to a tax-exempt lessee monetizing its lease obligations, but many others cannot.

The difficulty, then, is to identify within the complex web of relationships that define a modern partnership (relationships between the partnership and its suppliers, customers and counterparties; relationships among the partners in allocating the returns from the partnership's business; relationships between a partnership and its lenders, etc.) those relationships that are analogous to a tax-exempt lessee setting aside "funds" for the benefit of the lessor, or the lender to the lessor. For example, we submit that, if a partnership borrows money from a third party to acquire depreciable property that the partnership operates directly in a manufacturing business, and posts collateral to the lender to secure the loan, that partnership is not, without more, engaged in a transaction that should fall within the scope of new section 470(e)(2)(A), regardless of the nature of the collateral, because the loan is made indirectly to tax-exempt as much as taxable partners.

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[1] As a strictly logical matter, the inclusion of the monetization of a lessee option to purchase the leased property probably does not necessarily follow from the three principles summarized earlier. The inclusion is best explained as reflecting a deep skepticism on the part of Congress that a tax-exempt lessee would ever *not* exercise a "defeased" purchase option, given the importance of the leased property in many cases to the lessee's operations.

[2] In the case of a fixed-price lessee purchase option, the lessee's collateralization of that option was viewed by Congress as undercutting the economic uncertainty of the exercise of the option.

Our suggested language seeks principally to clarify the application of new section 470(e)(2)(A) by focusing on those relationships that in fact are analogous to a tax-exempt lessee monetizing its obligations to a taxable lessor. As revised, the language looks to whether a tax-exempt partner has an obligation to a taxable partner (either directly or indirectly through the partnership), which obligation in turn has been "monetized" through any set-aside or similar arrangement. We believe that this clarification focuses new section 470(e)(2)(A) on the correct problem, while preserving its broad application (e.g., through fungibility of money principles) to prevent abuse.

III. *PROPOSED REVISIONS TO STATUTORY LANGUAGE.*

[All references to page and line numbers are to the official print of H.R. 6264 S. 4026]

1. Amend page 14, line 6, to read:

"such property is not described in paragraph (A) or (B), and, except as provided in regulations prescribed . . ."

Reason: New section 470(e)(2) is difficult to parse because the operative tests do not clearly relate back to the depreciable property described in new section 470(e)(1)(C). This amendment, and the following one, clarify this relationship. Neither changes the fungibility of money concept embodied in new section 470(e)(2)(A): that is, the "set aside" rule applies with respect to any set aside, even if the set aside serves as collateral (for example) for non-depreciable property, so long as there exists some obligation on the part of the tax-exempt partner relating to depreciable property (as described below). The consequence of failing the test, however, is relevant only to depreciable property described in new section 470(e)(1)(C).

2. Amend page 14, line 14, to read as follows:

"respect to any property described in subparagraph (1)(C) owned by the partnership . . ."

Reason: See above.

3. Page 14, strike lines 22 through 25, and Page 15, strike lines 1 and 2. Replace with the following:

"if the purpose or effect of the transaction described in clause (i) or (ii) is directly or indirectly to satisfy any obligation (whether current, future or contingent) of a tax-exempt partner relating to such property and owed to the partnership, any taxable partner of the partnership, any lender to the partnership, or any lender to a taxable partner of the partnership . . . "

Reason: This suggestion is designed to implement the fundamental point made in Part II, which is that the analogy to section 470(d)(1) here requires identifying an obligation that a tax-exempt partner has to a taxable partner that relates to property described in section 470(e)(1)(C), which obligation is directly or indirectly satisfied through the monetization transaction described in section 470(e)(2)(A)(i) or (ii). (Options are addressed in proposed section 470(e)(3), below.) The idea here is that simple co-ownership, even with preferred returns or the like, does not by itself give rise to an "obligation" of the tax-exempt partner (the lessee equivalent) that is being directly or indirectly monetized for the benefit of the taxable partner (the lessor equivalent).

It is intended, for example, that a simple purchase-money mortgage by which a partnership acquires property from a third party seller would in general fall outside the scope of revised section 470(e)(2)(A), both because there would be no set-aside of, similar arrangement with respect to "funds", and because the obligation of *both* partners to repay the purchase money indebtedness to the third party is not an obligation of *one* partner to the other partner. On the other hand, a tax-exempt partner's obligation (whether contingent or current) to fund a capital account deficit, for example, *is* an obligation that indirectly runs to the benefit of the taxable partner; if the parties require the tax-exempt partner to monetize that obligation, then section 470(e)(2)(A) would be triggered.

4. Page 16, strike lines 1 through 6, and replace with the following:

"(C) *ARRANGEMENTS*.—The arrangements referred to in this subparagraph include:

(i) a loan by a tax-exempt partner to the partnership, any taxable partner, or any lender to the partnership or a taxable partner,

(ii) to the extent of all tax-exempt partners' share thereof, a loan by the partnership to any taxable partner or any lender to a taxable partner, and

(iii) any arrangement referred to in subsection (d)(1)(B) that has the effect of a transaction described in clause (i) or (ii)."

Reason: This revision, like item 3, above, is intended to focus section 470(e)(2)(A) on those partnership arrangements that in fact are analogous to section 470(d)(1)(A)—that is, transactions in which a tax-exempt partner monetizes, whether directly or indirectly through the partnership vehicle, an obligation of that tax-exempt partner to a taxable partner. In addition, section 470(e)(2)(C) as currently written is difficult to parse, as it appears to contemplate, for example, a loan by a partnership to itself. The discussion in Part II and under item 3, above, applies with equal force here.

5. Strike page 16, line 18 through page 17, line 3 and substitute the following:

"TEST.—Funds shall not be taken into account in applying subparagraph (A) to property described in subparagraph (1)(C) if such funds bear no connection to the economic relationships among the partners (whether reflected in the partnership agreement or otherwise) with respect to items of income, gain, loss, expense or credit attributable to such property. For this purpose, funds described in section 956(c)(2)(J) or section 956(c)(2)(K) shall be deemed not to bear any connection to the economic relationships among the partners with respect to property described in subparagraph (1)(C)."

Reason: New section 470(e)(2)(D)(ii) is very difficult, if not impossible, for a taxpayer to apply, because as currently drafted it simply provides that a taxpayer shall not take into account funds if those funds "bear no connection to the economic relationships among the partners." But everythingthat a partnership does bears some connection to the economic relationships among the partners: every item of income, or deduction, etc. is shared on some basis among the partners. We believe that a more useful way to reformulate the test would be that funds should be excluded if they do not affect the economic deal with respect to the depreciable property being tested. The proposed replacement language reflects this understanding. Clause (ii) was dropped, because it was believed that the phrase "(whether reflected in the partnership agreement or otherwise)" more succinctly makes the same point. Finally, the last sentence of the proposed revision addresses explicitly the "self-funding" transactions that all financial institutions employ to acquire ownership or possession of securities in the ordinary course of business. Because the financial institution gives and receives equivalent value (or posts collateral on commercial terms directly in connection with a financial transaction), the transactions cannot be used to accomplish any of the monetization results that are the purpose of section 470(d) and new section 470(e).

As reformulated, this test will be useful primarily for any operating partnership in respect of the funding of its ongoing day-to-day operations. It would be very extraordinary, for example, for partners to be able to demonstrate that a funding arrangement in place at the outset of a partnership, or contemplated by the partnership agreement (or other operative documents), did not affect the economic relationships of the partners in respect of the partnership's section 470(e)(1)(C) property. This relatively narrow scope is appropriate, in light of the fact that new section 470(e)(2)(D)(ii) is intended as an exception from an anti-abuse rule.

For the reasons summarized above, we believe that the reformulated test will apply only in clearly delineated cases. If, however, there is residual concern that the contours of the proposed test need to be defined more sharply, consideration could be given to limiting the application of the test only to funds used by a partnership in connection with the conduct of an active trade or business. The Internal Revenue Code contains several "active trade or business" tests that might serve as a model. For example, one could fashion a rule that permitted partnerships to rely on the "no connection" test only in cases where no more than 20 percent of the partnership's gross income constituted "foreign personal holding company income" under the principles of section 954(c) (as modified by sections 954(h) and (i)) if the partnership hypothetically were organized as a controlled foreign corporation.[3]

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[3] Because section 954(c) and its implementing Treasury regulations address different concerns than does section 470, care would need to be taken to ensure that a cross-reference to the principles of section 954(c) would not bring with it rules and limitations that would be irrelevant to the test suggested in the text. For example, in applying the hypothetical "if the partnership were a controlled foreign corporation," what should be done about same-country limitation? Similarly, section 954(c)(1)(D) (dealing with foreign currency gains) probably is unnecessary in the section 470 contest. And finally, section 954(c) includes a number of temporary provisions, including section 954(h) and (i), both of which modify section 954(c)(1), and section 954(c)(6). To preserve the intended application of the cross reference here, we would suggest that the principles of section 954(c) would be defined as those principles that would apply in 2006 to a hypothetical controlled foreign corporation that was a calendar year taxpayer.

6. *Examples*. If our understanding of the purpose and scope of new section 470(e)(2)(D)(ii) is correct, then the revised statutory language can be illustrated in the legislative history with examples along the following lines:

Example 1. Partnership ABC has two partners, T (a taxable partner) and TE (a tax-exempt partner). Partnership ABC has been engaged in an active trade or business for many years, and owns many properties, both depreciable and nondepreciable. All items of partnership income are allocated 50–50 between T and TE. In 2007, Partnership ABC arranges for long-term nonrecourse financing, secured by a revolving pool of receivables generated by Partnership ABC in the ordinary course of its business, and guaranteed by a third-party financial guarantor. The lenders in the nonrecourse financing are unrelated third parties. Partnership ABC does not amend its partnership agreement in light of the nonrecourse financing, and there is no understanding between T and TE with regard to the sharing of the economics from their respective investments in Partnership ABC that is not reflected in the partnership agreement.

Under these facts, the nonrecourse financing does not affect the economic relationships among the partners with respect to any item of depreciable property owned by the Partnership. Accordingly, and without regard to whether the arrangement otherwise would be described in section 470(e)(2)(A), the nonrecourse financing is not taken into account for purposes of section 470(e)(2)(A), by virtue of section 470(e)(2)(D)(ii).

Example 2. Partnership DEF has two partners, T (a taxable partner) and TE (a tax-exempt partner). Partnership DEF is engaged in an active trade or business that it has conducted for many years. Under the DEF partnership agreement, TE has an obligation to invest additional funds in Partnership DEF under certain defined circumstances. To ensure that TE performs its obligation, the DEF partnership agreement provides that DEF will withhold 50 percent of the profits otherwise distributable to TE and set those funds aside in a portfolio of U.S. Treasury securities, the interest income on which will be allocated to TE and distributed currently to TE. DEF is permitted to withdraw assets from the portfolio and apply them to TE's capital contribution obligations if TE does not otherwise satisfy its obligation within 10 days of the obligation's arising.

Under these facts, the portfolio of Treasury securities constitutes a set-aside of funds that bears a connection to the economic relationships among the partners, because the existence of the portfolio gives T security that TE in fact will satisfy its contingent "capital call" obligation. Accordingly, partnership DEF may not rely on section 470(e)(2)(D)(ii). Moreover, under these facts the partnership has monetized an obligation that TE has to the partnership; accordingly, if the value of the portfolio of Treasury securities exceeds Partnership DEF's allowable partnership amount, the requirements of section 470(e)(2)(A) will not be satisfied, and section 470 will apply to Partnership DEF.

Example 3. Partnership GHI has two partners, T (a taxable partner) and TE (a tax-exempt partner). Partnership GHI has been engaged for many years in an active trade or business as a full-service investment banking firm, including dealing in a wide range of securities. Partnership GHI therefore is a dealer in securities, within the meaning of section 475(c)(1). In the conduct of its business, Partnership GHI maintains large positions in securities (as defined in section 475(c)(2)), the identity and quantities of which fluctuate daily, in response to customer demands and Partnership GHI's hedging and other business requirements. Partnership GHI also owns substantial depreciable and amortizable assets described in section 470(c)(2).

To finance its purchases of U.S. Treasury securities in the ordinary course of its activities as a dealer in securities, Partnership GHI engages in "sale-repurchase" ("repo") transactions, in each of which Partnership GHI "sells" a Treasury security to a "buyer" for cash in an amount equal to or slightly less than the fair market value of the Treasury security, and Partnership GHI simultaneously agrees to "repurchase" that Treasury security the next business day, for a price equal to the cash received on the first day, plus an additional amount equal to one day's interest on that amount. (The arrangement might also be defined to cover a specified longer term.) The "buyer" might be either a third party or an affiliate of GHI that in either case seeks to invest cash on a short-term basis. The "repo" arrangement is documented under industry-standard documentation. Under the terms of their repo agreement, Partnership GHI and the "buyer" of the Treasury securities agree to roll over the financing from day to day, unless and until either party terminates the transaction. The value of the Treasury securities is marked to market daily, and the net amount of cash transferred to Partnership GHI in turn is adjusted daily, such that the cash held by Partnership GHI in respect of the repo transaction never exceeds the fair market value of the Treasury securities "sold" to the repo "buyer."

Under these facts, the repo arrangement between Partnership GHI and the repo "buyer" constitutes a transaction described in section 956(c)(2)(K). Partnership GHI raises funds through the repo transaction, but at the same time Partnership GHI gives up possession of marketable securities having an equal or greater value. Because Partnership GHI employs the repo transaction in the ordinary course of its trade or business as a dealer in securities, for example to finance its purchases of U.S. Treasury securities, and because the conditions of section 956(c)(2)(K) are satisfied, therefore, without regard to whether the arrangement otherwise would be described in section 469(e)(2)(A), the repo financing is not taken into account for purposes of section 470(e)(2)(A), by virtue of section 470(e)(2)(D)(ii).

Example 4. The facts are the same as those of Example 3, except that, in addition to the financing described therein, Partnership GHI and TE enter into an arrangement described as a one-year sale-repurchase transaction, but in which TE extends $2 million to Partnership GHI in exchange for $1 million in Treasury securities, and Partnership GHI unconditionally promises to repurchase those securities one year in the future for $2 million, plus interest thereon. The arrangement falls outside the scope of section 956(c)(2)(K), because the cash received by Partnership GHI exceeds the value of the Treasury securities delivered by Partnership GHI. Moreover, the arrangement is not consistent with market practices among participants in the active repo financing markets.

Under these facts, the arrangement will be viewed as a $1 million sale-repurchase transaction, and an unsecured loan of $1 million by TE to Partnership GHI. The unsecured loan by TE falls outside the ordinary course of Partnership GHI's business and presumptively affects the economic relationships among the partners. Accordingly, unless Partnership GHI can otherwise demonstrate that the funds in fact do not affect the relationship between T and TE, Partnership GHI cannot rely on section 470(e)(2)(D)(ii) to exclude those funds from the possible application of section 470(e)(2)(A).

7. Amend page 17, line 14, to read as follows:

"respect to any property described in subparagraph (1)(C) owned by the partnership—"

Reason: This revision clarifies that those options to which new section 470(e)(3)(A) is addressed are options that relate to depreciable property owned by the partnership. Financial institutions routinely employ options over financial assets in the ordinary course of their trade or business. If a financial institution is organized as a partnership, it would be common for that partnership to enter into such financial options with its partners, as well as other customers. We believe that such options over financial assets, by way of example, have no relationship to the intended scope of new section 470(e)(3)(A). The proposed language confirms this result.

8. Amend p. 18, line 24, by removing the period and adding at the end thereof: ", other than a tax-exempt controlled entity (as defined in section 168(h)(6)(F))."

Reason: A tax-exempt controlled entity is itself a taxpayer. Whatever the purpose for the inclusion of such entities in determining the scope of section 168, in light of the fact that they are taxpayers, there does not appear to be any reason that we can determine for including these entities as possible devices by which a partnership could be employed to accomplish LILO/SILO-type results.

9. *Remaining Issues*. The suggestions made above do not address a fundamental issue with the current draft of new section 470(e), which is the *consequence* of failing the two-part test. Imagine, for example, that a tax-exempt partner in a $1 billion partnership improperly monetizes a $100 obligation to a taxable partner outside the partnership. What consequence should follow from that $100 monetization? As currently drafted, new section 470(e) appears to contemplate that all of the $1 billion partnership's depreciable assets would be tainted. We respectfully submit, however, that this consequence is wholly disproportionate to the problem. The issue does not arise in the context of actual leases, because there section 470 is applied on a lease-by-lease basis. As a result, the improper monetization of one lease taints only the property subject to that lease. We believe that some sort of proportionality rule is required in the partnership context. That rule need not be a dollar-for-dollar tainting. One can imagine, for example, a rule that provides that every $1 of improper monetization requires that $5 of depreciable property be subject to section 470. A similar issue arises in respect of the differing interests of taxable and tax-exempt partners in partnership property. Improper monetization of a *lease* implies that the taxable lessor has an impermissibly small true economic interest in the leased prop-

erty; as a result, section 470 applies to the entirety of the leased property. In the partnership context, by contrast, a taxable partner might (by way of example) bear 90 percent of the economic risk and reward with respect to the depreciable property accrued by the partnership. If a tax-exempt partner impermissibly monetizes an obligation to the taxable partner, the consequence of that monetization should be limited to the tax-exempt partner's interest in partnership property (in this example, 10 percent), because that represents the greatest extent to which the monetization might fairly be said to shift the attributes of the partnership's property to the taxable partner. These two issues—the "cliff effect" of the current draft of new section 470(e), and the failure to recognize a taxable partner's genuine investment in partnership property—go to the same ultimate point, which is that the *consequence* of failing the monetization test needs to be linked in at least an approximate manner to the extent of that monetization. Without such a limitation, new section 470(e) could be criticized as imposing tax liabilities wholly disproportionate to any possible abuse.

IV. *CONCLUSION*

Citigroup appreciates the opportunity to submit these comments. Please find on the following pages a marked up version of the legislation that includes our proposed edits.

Sincerely

Jeffrey R. Levey
Vice President, Director

[Citigroup Inc. Suggested Revisions]

SEC. 6. AMENDMENTS RELATED TO THE AMERICAN JOBS CREATION ACT OF 2004.

(a) AMENDMENTS RELATED TO SECTION 710 OF THE ACT.—

(1) Clause (ii) of section 45(c)(3)(A) is amended by striking "which is segregated from other waste materials and".

(2) Subparagraph (B) of section 45(d)(2) is amended by inserting "and" at the end of clause (i), by striking clause (ii), and by redesignating clause (iii) as clause (ii).

(b) AMENDMENTS RELATED TO SECTION 848 OF THE ACT.—

(1) Section 470 is amended by redesignating subsections (e), (f), and (g) as subsections (f), (g), and (h) and by inserting after subsection (d) the following new subsection:

"(e) EXCEPTION FOR CERTAIN PARTNERSHIPS.—

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

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

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

"(C) *such property is not described in paragraph (A) or (B), and,* except as provided in regulations prescribed by the Secretary under subsection (h)(4), the requirements of paragraphs (2) and (3) are met with respect to such property for such taxable year.

"(2) AVAILABILITY OF FUNDS.—

"(A) IN GENERAL.—The requirement of this paragraph is met for any taxable year with respect to any property *described in subparagraph (1)(C)* owned by the partner ship *partnership* if (at all times during the taxable year) not more than the allowable partnership amount of funds are—

"(i) subject to any arrangement referred to in subparagraph (C), or

"(ii) set aside or expected to be set aside,

to or for the benefit of any taxable partner of the partnership or any lender, or to or for the benefit of any tax-exempt partner of the partnership *if the purpose or effect of the transaction described in clause (i) or (ii) is directly or indirectly* to satisfy any obligation of such tax-exempt partners *(whether current, future or contingent) of a tax-exempt partner relating to such property and owed* to the partnership, any taxable partner *of the partnership, any lender to* the partnership, or any lender *to a taxable partner of the partnership.*

"(B) ALLOWABLE PARTNERSHIP AMOUNT.—For purposes of this subsection, the term 'allowable partnership amount' means, as of any date, the greater of—

"(i) the sum of—

"(I) 20 percent of the sum of the taxable partners' capital accounts determined as of such date under the rules of section 704(b), plus

"(II) 20 percent of the sum of the taxable partners' share of the recourse liabilities of the partnership as determined under section 752, or

"(ii) 20 percent of the aggregate debt of the partnership as of such date.

"(iii) NO ALLOWABLE PARTNERSHIP AMOUNT FOR ARRANGEMENTS OUTSIDE THE PARTNERSHIP.—The allowable partnership amount shall be zero with respect to any set aside or arrangement under which any of the funds referred to in subparagraph (A) are not partnership property.

"(C) ARRANGEMENTS.—The arrangements referred to in this subparagraph include:

"(i) a loan by a tax-exempt partner or the partnership to *the partnership,* any taxable partner, the partnership, or any lender *to the partnership or a taxable partner,*

"(ii) to the extent of all tax-exempt partners' share thereof, a loan by the partnership to any taxable partner or any lender to a taxable partner, and

"(iii) any arrangement referred to in subsection (d)(1)(B*) that has the effect of a transaction described in clause (i) or (ii).*

"(D) SPECIAL RULES.—

"(i) EXCEPTION FOR SHORT-TERM FUNDS.—Funds which are set aside, or subject to any arrangement, for a period of less than 12 months shall not be taken into account under subparagraph (A). Except as provided by the Secretary, all related set asides and arrangements shall be treated as 1 arrangement for purposes of this clause.

"(ii) ECONOMIC RELATIONSHIP TEST.—Funds shall not be taken into account under subparagraph (A) if such funds—*in applying subparagraph (A) to property described in subparagraph (1)(C) if such funds bear no connection to the economic relationships among the partners (whether reflected in the partnership agreement or otherwise) with respect to items of income, gain, loss, expense or credit attributable to such property. For this purpose, funds described in section 956(c)(2)(J) or section 956(c)(2)(K) shall be deemed not to bear any connection to the economic relationships among the partners with respect to property described in subparagraph (1)(C).*

"(I) bear no connection to the economic relationships among the partners, and

"(II) bear no connection to the economic relationships among the partners and the partnership.

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

"(3) OPTION TO PURCHASE.—

"(A) IN GENERAL.—The requirement of this paragraph is met for any taxable year with respect to any property *described in subparagraph (1)(C)* owned by the partnership if (at all times during such taxable year)—

"(i) each tax-exempt partner does not have an option to purchase (or compel distribution of) such property or any direct or indirect interest in the partnership at any time other than at the fair market value of such property or interest at the time of such purchase or distribution, and

"(ii) the partnership and each taxable partner does not have an option to sell (or compel distribution of) such property or any direct or indirect interest in the partnership to a tax-exempt partner at any time other than at the fair market value of such property or interest at the time of such sale or distribution.

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

(2) Subsection (g) of section 470, as redesignated by paragraph (1), is amended by adding at the end the following new paragraphs:

"(5) TAX-EXEMPT PARTNER.—The term 'tax-exempt partner' means, with respect to any partnership, any partner of such partnership which is a tax-exempt entity within the meaning of section 168(h)(6)***, other than a tax-exempt controlled entity (as defined in section 168(h)(6)(F)).***

"(6) TAXABLE PARTNER.—The term 'taxable partner' means, with respect to any partnership, any partner of such partnership which is not a tax-exempt partner.".

(3) Subsection (h) of section 470, as redesignated by paragraph (1), is amended—

(A) by striking ", and" at the end of paragraph (1) and inserting "or owned by the same partnership,",

(B) by striking the period at the end of paragraph (2) and inserting a comma, and

(C) by adding at the end the following new paragraphs:

"(3) provide for the application of this section to tiered and other related partnerships, and

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

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

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

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

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

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

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

(4) Paragraph (2) of section 470(c) is amended—

(A) by striking "and" at the end of subparagraph (A), by redesignating subparagraph (B) as subparagraph (C), and by inserting after subparagraph (A) the following new subparagraph:

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

(B) by striking the flush sentence at the end.

(5) Subparagraph (A) of section 470(d)(1) is amended by striking "(at any time during the lease term)" and inserting "(at all times during the lease term)".

(c) AMENDMENTS RELATED TO SECTION 888 OF THE ACT.—

(1) Subparagraph (A) of section 1092(a)(2) is amended by striking "and" at the end of clause (ii), by redesignating clause (iii) as clause (iv), and by inserting after clause (ii) the following new clause:

"(iii) if the application of clause (ii) does not result in an increase in the basis of any offsetting position in the identified straddle, the basis of each of the offsetting positions in the identified straddle shall be increased in a manner which—

"(I) is reasonable, consistent with the purposes of this paragraph, and consistently applied by the tax payer, and

"(II) results in an aggregate increase in the basis of such offsetting positions which is equal to the loss described in clause (ii), and".

(2)(A) Subparagraph (B) of section 1092(a)(2) is amended by adding at the end the following flush sentence:

"A straddle shall be treated as clearly identified for purposes of clause (i) only if such identification includes an identification of the positions in the straddle which are offsetting with respect other positions in the straddle.".

(B) Subparagraph (A) of section 1092(a)(2) is amended—

(i) by striking "identified positions" in clause (i) and inserting "positions",

(ii) by striking "identified position" in clause (ii) and inserting "position", and

(iii) by striking "identified offsetting positions" in clause (ii) and inserting "offsetting positions".

(C) Subparagraph (B) of section 1092(a)(3) is amended by striking "identified offsetting position" and inserting "offsetting position".

(3) Paragraph (2) of section 1092(a) is amended by redesignating subparagraph (C) as subparagraph (D) and inserting after subparagraph (B) the following new subparagraph:

"(C) APPLICATION TO LIABILITIES AND OBLIGATIONS.—Except as otherwise provided by the Secretary, rules similar to the rules of clauses (ii) and (iii) of subparagraph (A) shall apply for purposes of this paragraph with respect to any position which is, or has been, a liability or obligation.".

(4) Subparagraph (D) of section 1092(a)(2), as redesignated by paragraph (3), is amended by inserting "the rules for the application of this section to a position which is or has been a liability or obligation, methods of loss allocation which satisfy the requirements of subparagraph (A)(iii)," before "and the ordering rules".

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

Statement of Crowe Chizek and Company LLC

Proposed

Sec. 7. AMENDMENT RELATED TO THE JOBS AND GROWTH TAX RELIEF RECONCILIATION ACT OF 2003.

(a) AMENDMENT RELATED TO SECTION 302 OF THE ACT.—Clause (ii) of section 1(h)(11)(B) is amended by striking "and" at the end of subclause (II), by striking the period at the end of subclause (III) and inserting ", and", and by adding at the end the following new subclause:

"(IV) any dividend received from a corporation which is a DISC or former DISC (as defined in section 992(a)) to the extent such dividend is paid out of the corporation's accumulated DISC income or is a deemed distribution pursuant to section 995(b)(1).".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to dividends received on or after September 29, 2006, in taxable years ending after such date.

General Comments

Congress has a history of stimulating the export of goods from the United States. In the past, Congress attempted to increase exports by providing incentives to U.S. exporters by enacting the foreign sales corporation ("FSC") and its successor, the extraterritorial income exclusion ("ETI") legislation. However, because the World Trade Organization's ("WTO") challenge of the FSC and ETI regimes resulted in the repeal of both pieces of legislation, the only remaining export incentive for U.S. exporters is the domestic international sales corporation ("DISC").

Originally adopted in 1971, the DISC regime was intended to induce an increase in export activities for U.S. companies by allowing them to receive a deferral on a portion of the income attributable to their export activity. Under the DISC regime, a portion of the income attributable to the export activity was segregated in a separate legal entity, namely the DISC, which was not subject to U.S. income tax. U.S. foreign trading partners contended that the DISC regime was an illegal export subsidy because it allowed a portion of the DISC earnings to be retained tax free without an interest charge. In response, the U.S. introduced the "Interest Charge DISC." In order to comply with General Agreements on Tariffs and Trade requirements, the U.S. added an interest charge component to the DISC in 1984.

For federal income tax purposes, the DISC is classified as a domestic corporation whose income is derived almost exclusively from U.S. export-related activities. The DISC itself is not subject to income tax; however, DISC shareholders can be taxed on the DISC's income for actual or deemed distributions. Despite shareholders' taxation on DISC distributions, they still receive limited tax deferral on income from export sales and certain other services.

Under section 1(h)(11) created by the Jobs Growth Tax Relief Reconciliation Act of 2003 ("JAGRTA"), certain dividends earned by individual taxpayers are taxed at long-term capital gain rates. Section 1(h)(11) applies to virtually all dividends paid by domestic corporations and certain qualified foreign corporations. Further, this section provides that the reduced rate is rendered unavailable for certain excluded dividends listed under Section 1(h)(11)(B)(ii). A DISC is a domestic corporation by definition, and because DISC dividends are not listed on the excluded dividends list, they would qualify for capital gains rate treatment under the current law. If Congress enacts the proposed amendment, dividends from DISCs or former DISCs would be considered ineligible for capital gains rate treatment. DISC shareholders will no longer be able to take advantage of the favorable capital gains rate on the dividend payment from DISCs or former DISCs, which will ultimately be detrimental to the U.S. export industry. Without the incentive of favorable capital gains rates on dividends from DISCs or former DISCs, exports will go down thus having a negative impact on the U.S. economy.

Since the enactment of JAGTRA, two Tax Technical Corrections Acts have been submitted to Congress, both of which have not included an amendment to change the tax treatment of dividends from a DISC or former DISC under section 1(h)(11)(B). Congress' omission of this amendment in prior Tax Technical Corrections Acts was generally viewed by taxpayers as an indication that Congress had no intention of changing the language under section 1(h)(11)(B) to specifically exclude dividends received from a DISC or former DISC as qualified dividends subject to capital gains rate treatment. Many taxpayers opted to use the benefits originally provided under the Interest Charge DISC regime and spent considerable sums to utilize this business entity form. Their reliance on this structure has helped to build the economy and stimulate growth in the export industry. By taking no prior action, perhaps Congress was acknowledging that dividends from DISCs or former DISCs should be qualified under section 1(h)(11)(B).

If Congress pushes forward with the proposed amendment to section 1(h)(11)(B), we propose the following changes to the amendment:

Effective Date

At the very least, Congress should consider modifying the effective date to allow taxpayers to transition out of the structure. Enacting the amendment effective September 29, 2006, will affect taxpayers estimated tax payments because under the current law, DISC dividends and deemed dividends would still be qualified. By delaying the effective date, Congress will give taxpayers time to transition their business structures. We propose an effective date for years ending on or after January 1, 2008.

Taint Earnings and Profits

Congress should consider rewording the amendment so that dividends from pre-enactment earnings and profits ("E&P") are still eligible for capital gains rate treatment, while those dividends from post-enactment E&P fall under the proposed change as unqualified dividends under section 1(h)(11)(B). In essence, this will taint the E&P rather than the dividend stream and will allow taxpayers to take advantage of the benefits under the law as originally written. Currently, the amendment is written such that dividends from a DISC or former DISC will no longer be qualified under section 1(h)(11)(B). Any pre-enactment E&P of the DISC or former DISC, if distributed after the effective date, will be considered unqualified dividends taxed as ordinary income even though the E&P was created before the effective date. Taxpayers will not be able to take advantage of the lower tax rates to which they were initially entitled on the pre-enactment E&P, thereby making the proposed legislation, in effect, retroactive rather than prospective. A proposed solution is to apply the amendment to the E&P created after the effective date, and not to the dividend stream.

Making these proposed changes to Section 7 of the Tax Technical Corrections Act of 2006 will allow taxpayers the time to transition their business structures as well as take advantage of the benefits under the law as originally written.

Miller and Chevalier Chartered
October 31, 2006

Committee on Ways and Means U.S. House of Representatives Longworth House Office Building Washington, DC 20515–6348

We are writing to propose, as an addition to the pending technical corrections bill, a new technical correction to the provision of the American Jobs Creation Act of 2004 that extended the application of section 108(e)(8) of the Internal Revenue Code to partnerships. We have proposed this technical correction previously and have had discussions with the staff of the Joint Committee on Taxation with regard to the proposal. We would like to follow up on those discussions shortly.

As part of the American Jobs Creation Act of 2004, section 108(e)(8) was expanded to cover certain partnership contributions of debt in exchange for equity. As explained in more detail in the attached document we submitted to the Treasury Department last year, we are proposing that section 108(e)(8) be clarified to provide comparable scope to both partnerships and corporations. Currently, section 108(e)(8) does not apply to the contribution of debt to corporate equity when the company does not issue shares, such as when the shareholders make pro rata contributions of debt and the issuance of shares has no economic consequence. The proposed technical correction would make it clear that section 108(e)(8) similarly does not apply to pro rata debt contributions to partnerships, even though the partnership may make capital account adjustments pursuant to the section 704(b) safe harbor regulations. The proposal is described in more detail in the attached memorandum. We would also be open to discussing other alternatives to resolve this problem, such as the application of an exception for partnerships among members of a consolidated group.

We will follow up with the Joint Committee on Taxation staff to request a meeting to discuss this proposal. In the meantime, please call David Zimmerman (202–

626–5876), Steven Schneider (202–626–6063) or me (202–626–5828) with any questions or comments.

Sincerely,

David B. Cubeta

Proposed Technical Correction to Section 108(e)(8)—Recognition of Cancellation of Indebtedness Income Realized on Satisfaction of Indebtedness with a Partnership Interest

Background

In the American Jobs Creation Act of 2004 (the "2004 Jobs Act"), Congress extended the application of section 108(e)(8) to acquisitions of indebtedness by a partnership from a partner in exchange for a capital or profits interest in the partnership.[1] Prior to this amendment, section 108(e)(8) had by its terms only applied to corporations. As is discussed more fully below, because the safe harbor provisions of the section 704(b) regulations require that an adjustment be made to the partners' capital accounts when the partners contribute debt to the creditor partnership, the partnership may be deemed to have issued a capital interest for purposes of section 108(e)(8) even if the partnership does not formally issue a partnership interest in exchange for its indebtedness. As a result, the partnership will be unable to avoid the application of section 108(e)(8) in situations where the partners contribute their indebtedness to the partnership on a pro rata basis and no partnership interest was actually issued in exchange. In similar cases in the corporate context, a corporation has the ability to choose whether to be subject to section 108(e)(8) or section 108(e)(6) by the simple expedient of issuing, or refraining from issuing, stock. Because a corporation will generally recognize less cancellation of indebtedness income if section 108(e)(6) applies to the cancellation of the debt rather than section 108(e)(8), pro rata cancellations of shareholder debt, including acquisitions of debt from a sole shareholder, are usually structured as capital contributions.

Proposal

Amend section 108(e)(8) to clarify that this section will not apply to a pro rata contribution of indebtedness by partners to a partnership.

Specifically, we would recommend that the following sentence be added to section 108(e)(8):

If a debtor partnership acquires its indebtedness from its partners proportionate to the manner in which the partners share future profits and there have been no changes to any partner's profit sharing as a result of such contribution, then this paragraph shall not apply.

Current Law

If a corporation acquires its indebtedness from its sole shareholder or from each of its shareholders on a pro rata basis, the corporation and its shareholders will be indifferent as to whether additional shares are issued in the transaction. In such circumstances if the form of the transaction is respected, section 108(e)(8) will apply if the corporation issues its stock in satisfaction of the indebtedness and section 108(e)(6) will apply if the shareholders contribute the indebtedness to the corporation as a contribution to capital. If section 108(e)(6) applies, the corporation is treated as if it satisfied the indebtedness for an amount of money equal to the shareholder's adjusted basis in the debt. If section 108(e)(8) applies, the corporation will be treated as if it satisfied the indebtedness for an amount of money equal to the fair market of the stock issued in the exchange. The corporation will generally either realize the same or a lesser amount of cancellation of indebtedness income under section 108(e)(6) because the shareholder's adjusted tax basis in the indebtedness typically will be equal to or greater than the fair market value of the debt.

Although the IRS does not appear to have a formal ruling policy with respect to pro rata cancellations of debt in the corporate arena in "overlap" cases where the issuance of stock by the corporation in exchange for the debt would be economically meaningless and either section 108(e)(6) or section 108(e)(8) could be construed to apply to the cancellation, the private letter rulings that have been issued to date appear to have followed the taxpayer's form in every case.[2] In effect, the IRS does

[1] All section references are to the Internal Revenue Code of 1986, as amended.

[2] *See, e.g.,* PLR 9018005 (Nov. 15, 1989) (applying section 108(e)(8) to contribution of debt to a wholly owned subsidiary in exchange for subsidiary stock); PLR 9024056 (Mar. 20, 1990) (contribution of debt to a wholly owned subsidiary respected as capital contribution subject to section 108(e)(6) in accordance with form); PLR 8606032 (Nov. 8, 1985) (same); PLR 9215043 (Jan. 14, 1992) (same); PLR 9623028 (March 7, 1996) (same); cf. TAM 9822005 (May 29, 1998) (noting

not apply the authorities that might otherwise deem stock to be issued based on the "meaningless gesture" doctrine to section 108(e)(8) in situations where the taxpayer did not issue stock.[3] On the other hand, the IRS does not ignore the issuance of stock in situations where the taxpayer in form issued stock. This gives a corporation the flexibility to avoid having section 108(e)(8) apply to the cancellation.

Reasons for Change

The proposed amendment affords partnerships the same ability to avoid the application of section 108(e)(8) as is allowed to corporations under the Internal Revenue Service's informal ruling policy, and it would limit this flexibility to fact patterns where it would be a matter of economic indifference to the partnership and the partners whether to issue additional partnership interests in exchange for the indebtedness. This would be the case if the debt contribution is in proportion to each partner's interest in profits and there is no change in the profit allocations of any partner as a result of the contribution. In such circumstances, while capital account credit must still be assigned to the contributing partner to satisfy the section 704(b) safe harbor,[4] the capital account credit will be in proportion to each partner's profit sharing ratio and merely represents the same amount that the partners otherwise would receive as profits if the capital account were not adjusted. Thus, when coupled with the absence of any change to the partners' future profit sharing ratios as a result of the contributions, the capital account adjustment would be a matter of economic indifference to the partners (as in the pro rata case for corporations), and there would be no tax policy reason to require income recognition as a result of the contribution. Absent clarification, it is unclear whether a partnership is afforded comparable flexibility because the requisite adjustment to the capital account may properly be regarded as the issuance of a capital interest and, if so treated, would cause section 108(e)(8) to apply even in the case of a pro rata contribution of indebtedness. This change is consistent with the clear intent of the 2004 Jobs Act's revision as a whole—to treat corporations and partnerships in a like manner for purposes of section 108(e)(8). When Congress extended the application of section 108(e)(8) to partnerships it is reasonable to assume that Congress did not intend to disadvantage partnerships as compared to corporations. Nor, in the pro rata case, would there appear to be any tax policy justification for requiring a greater amount of cancellation of indebtedness income recognition, because there would be no meaningful change in the partners' economic sharing arrangement by reason of the contributions of debt. Consequently, in the pro rata case, the imposition of section 108(e)(8) on the partnership would create the potential for a tax "whipsaw" on the partners (ordinary income allocated to each partner with a corresponding capital loss incurred by each partner in its capacity as creditor) in a circumstance presenting no underlying economic change of any substance.

The following examples will help clarify this point.

Example 1. **Pro rata contribution in corporate context.** A and B are shareholders in Corporation. Each originally contributed $2,000 in exchange for 100 shares of stock and loaned $4,000 to Corporation. At a time when the fair market value of Corporation's assets is $12,000 and the liabilities are $8,000, A and B each contribute their debt to Corporation and do not receive any additional stock in return. Immediately before the contribution, the Corporation stock was worth $4,000 and immediately after the contribution the stock was worth $12,000. The value of each shareholder's equity interest has increased from $2,000 to $6,000 as a result of the contribution. If Corporation had instead issued an additional 200 shares to each shareholder in exchange for the contribution of the indebtedness, the value of an individual share would be unchanged, but the value of each shareholder's total equity interest would have increased from $2,000 to $6,000. In this example, the act of issuing additional stock would have been a meaningless gesture because A and B each will share in the $8,000 net value increase in the same 50:50 ratio whether new stock is issued in a 50:50 ratio or whether their historical stock, also held in a 50:50 ratio, increases in value.

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that there was a potential issue as to whether section 108(e)(6) or section 108(e)(8) should be the controlling authority in situations where both could apply; ruling did not resolve the issue because either section would give equivalent results under the assumed facts of the ruling).

[3] In certain circumstances, such as for purposes of section 351, the IRS and the courts will deem an exchange requirement to have been met even though no shares were issued in circumstances where the issuance of the shares would have been a "meaningless gesture." *See, e.g.,* Rev. Rul. 64–155, 1964–1 C.B. 138 (contribution to 100% owned corporation); *Lessinger v. Commissioner,* 872 F2d 5 19 (2d Cir. 1989) (section 351 applies to transfer by 100% shareholder); and *Warsaw Photographic Associates v. Commissioner,* 84 T.C. 21 (1985) (pro rata transfer by multiple shareholders).

[4] Treas. Reg. § 1. 704–1(b)(2)(iv)(b).

Example 2. **Pro rata contribution in LLC context—not liquidating in accordance with capital accounts.** Same as Example 1 except that the entity is an LLC that liquidates and shares profit in accordance with relative outstanding units. Like Example 1, it would be a meaningless gesture to issue additional units because the "profit" to each member from the increased net value of LLC would be the same whether reflected in an increased value of the historical units or in additional units with a constant value.

Example 3. **Pro rata contribution in LLC context—liquidating in accordance with capital accounts.** Same as Example 2 except that the LLC follows the section 704(b) safe harbors and liquidates in accordance with positive capital accounts. The LLC shares profits in accordance with the relative outstanding units, or 50% each to A and B. In this example, it would be a meaningless gesture for the LLC to issue additional units since they would be issued in the same ratio as the existing outstanding units and the issuance of the additional units would not affect the relative profit percentages. However, because the LLC follows the section 704(b) safe harbors, it must credit the member capital accounts in an amount equal to the net fair market value of their contributions. In this case, similar to Example 2, this credit increases the liquidation rights of the existing units by $4,000 each, which is in proportion to both the contributed debt and the members relative profit sharing percentages.

The results would be the same for an entity organized as a state law partnership rather than an LLC.

The progression shown by these examples demonstrates three identical economic fact patterns where the issuance of additional stock or LLC units would be a meaningless gesture. In all three cases, the contributions of debt and any corresponding section 704(b) capital account increases were "pro rata" to the manner in which the existing outstanding shares/units shared in the benefit of the increased net value of the entity resulting from the contribution. In other words, when the contribution of debt was pro rata to the owners' profit sharing percentages, the issuance or nonissuance of additional stock/units would be a meaningless gesture and would fit within the constraints of the proposed technical correction.

By providing a rule that defines pro rata based on the sharing of future profit, any existing partnership special allocations are already incorporated into the rule as part of the future profit sharing percentages. Similarly, the rules regarding partnership liabilities in section 752 would operate as they do under current law, and the manner in which the partners share liabilities for purposes of those rules would not impact the application of section 108(e)(8) because those sharing rules do not reflect the economic and tax policy analysis above.

The proposed technical correction is limited to excluding pro rata contributions of indebtedness by partners to partnerships from section 108(e)(8) treatment. We recognize that it may be logical to apply section 108(e)(6) in such circumstances. As section 108(e)(6) by its terms applies only to corporations, a further technical correction would be necessary to apply section 108(e)(6) in this context. We would be happy to provide you with additional input in this regard.

The Art Institute
Chicago, Illinois 60603
October 31, 2006

Honorable Charles E. Grassley, Chairman
Honorable Max Baucus, Ranking Member
Committee on Finance
U.S. Senate
219 Dirksen Senate Office Building
Washington, DC 20510

Honorable William M. Thomas, Chairman
Honorable Charles B. Rangel, Ranking Member
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Gentlemen:

We are writing to request that certain corrections be included in the Tax Technical Corrections Act of 2006 (S. 4026 and H.R. 6264). Our requests relate to the provisions on fractional interest gifts found in Section 1218 of the Pension Protection Act of 2006 (the "Act").

Background

The Art Institute is deeply concerned that the fractional gift provisions of the Act will curtail or even end partial interest gifts to museums and will thus deprive the public of the opportunity to see great works of art. Like many American museums, the Art Institute has received significant works as fractional gifts. Objects we have received as partial interest gifts—and that as a result are on public view at the museum—include works by Monet, Picasso, Van Gogh, and Cezanne, among others.

Museums rely on gifts to acquire such works for the public; in today's art market, museums cannot realistically expect to have the funds to purchase such major works on a regular basis. It is the public that gains when a museum receives gifts of art, since these masterpieces can now be viewed by anyone who visits the museum rather than being passed down in families or being sold to other private owners.

Given the critical importance of gifts of art, including fractional interest gifts, we are seeking the corrections described below.

Requested Corrections

1. Discrepancy Between Tax Liability and Deduction

Under Sections 2031 and 2512 of the Internal Revenue Code of 1986, as amended (the "Code"), estate and gift taxes are based on the fair market value of an object on the date of death or the date of the gift. Under Section 1218 of the Act, however, after a donor makes a gift of a fractional interest in an object, the deduction for all subsequent fractional interest gifts in the same object is limited to the appraised value at the time of the first gift. As a result, if a donor makes a gift of a 30% interest in an object in Year 1, the work appreciates in value, and he then dies in Year 8 with the remaining 70% interest going to the museum at that time, the estate tax will be based on the fair market value of the object in Year 8 but the deduction will be based on the lower appraised value from Year 1. A similar result occurs under the gift tax laws.

This discrepancy does not seem to promote any policy goal and produces a harsh result for individuals who are attempting to make charitable gifts. Not surprisingly, perhaps, donors have already informed us that because of this discrepancy, they will no longer make partial interest gifts. We therefore seek corrections that will eliminate this concern.

2. Gifts in Progress

When museums receive gifts of art, including fractional interests, they take the new work into account in developing exhibition and programming plans. In addition, they adjust their acquisition plans and priorities; having received an interest in a work by a particular artist, which brings with it the right to possess that work for some period and the expectation of eventually receiving full ownership, a museum will focus its acquisition plans on works by other artists or works from other periods. Unfortunately, in light of the uncertainty created by the Act and the new penalties contained in the Act, donors are suspending gifts that were in progress before the new law was enacted. Museums, in turn, are facing disruption to plans and a delay in receiving gifts that donors long intended to give. To avoid this result, the Act should not apply to fractional interest gifts in an object if the donor had made at least one fractional interest gift in the same object before the law was enacted.

3. Recapture Provision

The Act provides for recapture of income and gift tax deductions, plus a penalty, if the remaining interest in a work has not been contributed to the donee "before the earlier of

(I) the date that is 10 years after the date of the initial fractional contribution, or (II) the date of the death of the donor. . . ." One reading of this language is that the final interest has to have been contributed before the date of the donor's death, making it impossible for the gift to be completed upon death by way of a will, trust, or other instrument without recapture. If the donor dies within ten years of making the initial fractional gift, and if the work is in fact transferred to the donee upon the donor's death, recapture and penalties seem inappropriate.

4. Valuation of Subsequent Gifts

We are particularly troubled by the provision of the Act stating that subsequent gifts must be valued based on the lesser of the fair market value at the time of the initial gift or the fair market value at the time of the additional contribution. First, of course, this provision gives rise to the discrepancy discussed above between the deduction and the potential gift and estate tax liability. Second, faced with the likelihood of having to take a deduction in the future that does not represent the actual market value of the gift, donors may choose either not to give the gift at all or to delay and give the object as a bequest at death. From the museum's perspective, even a delay in making a gift poses a risk; a donor may change his mind about making the donation, the work could suffer damage, or the donor's circumstances may change such that he is forced to sell the work.

The concern reflected in this provision appears to be that donors are using inaccurate appraisals. Rather than requiring donors to use out-of-date valuations, however, an approach generally disfavored in other contexts, it would seem more appropriate to focus on assuring that appraisals are accurate. We therefore recommend that donors be permitted to deduct the current fair market value, but in any case in which the work as a whole is valued at $1 million or more, even if the gift in question is just a fractional interest, the appraisal should be reviewed by the IRS Art Advisory Panel.

5. Ten-Year Recapture Period

We also recommend a change to the provision in the Act requiring recapture and imposing penalties if the gift is not completed by the earlier of ten years from the date of the initial contribution or the death of the donor. Donors may wish to spread out a gift over more than ten years for legitimate reasons such as financial planning or personal attachment to the object. A ten-year time limit will likely deter donors from making gifts; a collector who owns an object valued at tens of millions of dollars may feel he simply cannot donate such a work over only ten years, given the contribution limit for gifts of tangible personal property, and thus may not give the work at all, while another collector may wish to have possession of a particularly treasured object for at least some periods throughout his life and therefore may decide simply to keep the object until his death. So long as the museum ultimately ends up with the object and meets the possession requirements during the course of the gift, the period of the gift should not matter. To assure that these goals are met, donees could be required to file information returns with the Internal Revenue Service in the event the gift is not completed or the possession requirements are not met. If either event occurs, prior income and gift tax deductions could be recaptured.

6. Possession

Under the Act, donors are subject to recapture and penalties if the donee does not have substantial physical possession of the work during the period of the gift. We suggest a clarification that the recapture and penalties do not apply in the event the donor dies before the donee has taken possession. In addition, we recommend the adoption of exceptions to the possession requirement for exceptional circumstances, such as a significant construction project at the museum that requires deinstallation of galleries or because of unique factors relating to the particular work of art in question.

We appreciate your consideration of our suggestions and your attention to the important role that fractional interest gifts play in allowing museums to build art collections for the benefit of the public.

Very truly yours,

James Cuno
President

Eloise W. Martin
Director

Julia E. Getzels
Executive Vice President, General Counsel and Secretary

Massachusetts Bay Transportation Authority
Boston, Massachusetts 02110
October 31, 2006

The Honorable Bill Thomas
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington D.C. 20515

Dear Chairman Thomas:

On behalf of the Massachusetts Bay Transportation Authority (MBTA), I wish to submit these formal comments pursuant to your request for written comments in connection with H.R. 6264, the "Tax Technical Corrections Act of 2006." These comments specifically regard the newly enacted section 4965 of the Internal Revenue Code. The MBTA is very concerned that this new law, depending on interpretation, could impose a retroactive and financially damaging excise tax on public sector, tax-exempt agencies which have taken part in "lease in-lease out" (LILO) and "sale in-lease out" (SILO) transactions.

The MBTA is the fifth largest mass transit system in the United States, serving over 1.1 million passengers daily. We operate the oldest continually operating subway system in the country and seven other modes of transit.

The MBTA's annual operating budget exceeds $1.3 billion and is funded from fare revenues, non-fare revenues generated by the MBTA, dedicated revenues pledged by the Commonwealth of Massachusetts and its communities as well as federal funds. The MBTA is in the midst of a fiscal crisis, including a potential $70 million budget shortfall for the MBTA's fiscal year ending June 30, 2007. This is mainly due to increased fuel costs, high debt service expenses and lower than anticipated sales tax revenues. The MBTA has taken appropriate steps to address this shortfall by reducing costs and increasing revenues with such actions as a fare increase anticipated to take effect in January of 2007. Even with these aggressive actions, the MBTA will not have the wherewithal to fund a substantial regressive federal excise tax that could be imposed on us.

The MBTA participated in four LILO transactions between 1996 and 1998, which is prior to the IRS including LILOs as listed tax shelters. In each case, the transactions were not only approved by the Federal Transit Administration but promoted by that agency as an innovative financing tool. The proceeds from these transactions were received by the MBTA as upfront payments and have been used to invest in the infrastructure of our system and to provide service to our customers. The imposition of a retroactive excise tax would have a profoundly negative impact on our ability to provide expected service to the public.

The central problem is that section 516 of the Tax Increase Prevention and Reconciliation Act does not provide clear definitions of "net income" and "proceeds" and, as a result, the Treasury and IRS have insufficient guidance in defining those terms as they proceed through the regulatory process. The MBTA, along with many other transit agencies, is very concerned that this lack of guidance may result in regulations with overly broad definitions which will make the MBTA subject to a substantial retroactive excise tax.

Mr. Chairman, as you and your Committee consider this issue, we respectfully request that you include in H.R. 6264 a provision which would clarify the meaning of the terms "net income" and "proceeds" and the appropriate allocation of such items to ensure that the new excise tax is not applied on a retroactive basis to public agencies like the MBTA.

Thank you for your consideration of our views. For a more detailed explanation of the issue, we have attached a copy of our comment letter to the Treasury Department and IRS. If you have any further questions, please feel free to contact me.

Very truly yours,

Jonathan R. Davis
Deputy General Manager and Chief Financial Officer

Wubbels and Duffy
November 3, 2006

Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington D.C. 20515

Re: Written Comments on H.R. 6264.

Dear Sir or Madam,

With regard to H.R. 6264, we are writing to express our disagreement with the amendment related to the Jobs and Growth Tax Relief Act of 2003. Included in Section 7 of H.R. 6264 is an amendment to Section 302 of the Jobs and Growth Tax Relief Act of 2003 which effectively excludes from the definition of qualified dividends "any dividend received from a corporation which is a DISC or former DISC . . .".

Because the intent of the DISC is to encourage U.S. companies to export domestically produced products, this amendment seems contrary to the original intent of the DISC. Essentially, this proposed amendment specifically singles out exporters for exclusion from qualified dividend treatment.

Why would Congress want to hurt U.S. Exporters?

We would appreciate your reconsideration of this amendment. We believe this amendment should be removed and that dividends paid by U.S. manufacturer/exporters using the DISC should receive at least equal treatment to that of other U.S. dividend paying companies.

Sincerely,

Tom Duffy

Lousiana District Export Council
New Orleans, Lousiana 70130
October 26, 2006

The Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Chairman Thomas and Committee Members:

This submission is being made on behalf of the Louisiana District Export Council, Inc. ("LADEC"), a non-profit organization incorporated under the laws of Louisiana. The purpose of LADEC is to promote and encourage U.S. exports from Louisiana by: (1) supporting Louisiana based businesses and/or Louisiana produced goods and services so as to strengthen individual companies, stimulate U.S. economic growth, and create Louisiana based export related jobs; (2) supporting the activities of the U.S. Commercial Service ("USCS") at the Delta U.S. Export Assistance Center located in New Orleans, LA; and (3) initiating or supporting such other export related activities as the LADEC Board of Directors with the concurrence by a majority of its Members may decide from time to time. We appreciate this opportunity to express our views on a matter of great concern to a significant number of Louisiana's small business exporters.

On September 29, 2006, H.R. 6264, the "Tax Technical Corrections Act of 2006" ("the Bill") was introduced by Chairman Bill Thomas. On the same date, Chairman Thomas requested written public comments for the record from all parties interested in H.R. 6264. The Website of the Committee on Ways and Means advises that such comments must be submitted by the close of business on Tuesday, October 31, 2006. This submission is being made within that time period.

Concerns re: H.R. 6264, Section 7

Included within its proposed "corrections" H.R. 6264 includes Section 7, which dramatically affects the tax treatment of dividends received by non-C corporation shareholders of Interest-Charge Domestic International Sales Corporations ("IC–DISCs"). This class generally includes those small business taxpayers receiving their IC–DISC dividends through an S corporation, or a partnership-owned IC–DISC. As proposed, Section 7 would deny "qualified dividend" treatment under Internal Revenue Code of 1986, as amended ("Code"), Section 1(h)(11)(B), for all IC–DISC dividend distributions.* Section 7 provides that such changed treatment be effective with respect to such "dividends received on or after September 29, 2006, in taxable years ending after such date."

It is respectfully submitted that Section 7 is not a "technical", but rather a substantive, change in the tax law treatment of all affected individuals receiving dividends from an IC–DISC. A change with such a substantial impact, although on an admittedly small segment of taxpayers, should neither be part of a "technical corrections" Bill, nor should it bear an effective date that, although stated as prospective from the date of introduction,has the practical effect of retroactivity to January 1, 2006.

Affected taxpayers have structured their eligible export transactions for calendar year 2006 in reliance on the law as it has existed for over three years, with the rea-

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*The practical effect of this provision would be to more than double the taxation of such affected individuals by taxing their IC–DISC dividends at as high as a 35 percent marginal rate rather than at the 15 percent rate currently in effect for qualified dividends.

sonable expectation that their IC–DISC tax transactions and dividend distributions for the calendar year 2006 would be taxed in accordance with existing law.

In accordance with the applicable IC–DISC transfer pricing rules of the Code, the applicable U.S. Treasury regulations, and IC–DISC related pronouncements of the Internal Revenue Service, these calculations are made, inter-company transaction are effected, and IC–DISC dividends are paid, generally only at or near the end of the calendar year concerned, when the required information is first available with reasonable certainty. Indeed, the IC–DISC "gross receipts" and "assets tests" of Code section 992(a) (1) (A) and (B) for DISC qualification can only be made at the end of the year. The practical consequence of enacting Section 7 of the Bill with its currently stated effective date would therefore be to impose a significant tax increase, in a retroactive fashion, on all those affected taxpayers.

Current Law Provisions

The IC–DISC provisions of Code sections 991–997, as now in effect, provide tax incentives for small businesses with respect to their export of U.S. manufactured goods and certain export related services, by permitting them to defer paying income tax on a limited amount of export profits. They may accumulate within the IC–DISC otherwise taxable profits attributable to qualified export receipts not exceeding $10 million per calendar year, but only if substantially all such accumulated DISC profits are reinvested in expanded export assets. The price of such deferral is the payment of an interest charge at an attractive Treasury Bill rate. Code section 995(f).

Alternatively, the IC–DISC may distribute some or all of such export profits as dividends to the IC–DISC's shareholders. Under current law such shareholders who are individuals, including those owning their interests in an IC–DISC through a flow-through entity, are taxed at a maximum rate of 15 percent on such dividends. Export profits of an IC–DISC on its export receipts in excess of $10 million per year are deemed distributed to the IC–DISC shareholders, who are taxed on such distributions as dividends. Code section 995(b) (1). If such shareholders are individuals, the current maximum rate of 15 percent also applies to such "deemed distributions".

Many U.S. manufacturers, particularly those with expanding businesses, may not be overly burdened by the reinvestment requirement for accumulating export profits within their IC–DISC subsidiaries. Such taxpayers should also now be deriving benefits from the domestic production deduction provided by Code section 199.

Need for a Different Approach to Solving the Perceived Problem

Many architectural and engineering firms, and small wholesalers and retailers that find foreign markets for, and then buy and immediately export, U.S. manufactured goods on a C.O.D. or short-term Letter of Credit basis, have neither a significant investment in export inventories nor require warehouses, nor are they eligible for the Code section 199 domestic production deduction with respect to their export sales or services. In addition, some "manufacturers" may not require significant investments in materials, or bricks and mortar type export assets, yet incur substantial additional costs in developing an export market for their wares. So these taxpayers, due to the peculiar circumstances of their export businesses, and although included within the intended recipients of the IC–DISC export tax incentives, are often unable to meet the reinvestment requirements and will be effectively shut out from all export tax incentives unless some form of meaningful, if limited, small business exception is made in the Bill's Section 7.

It is respectfully submitted that a responsible way to deal with the unintended consequences to the U.S. Treasury from granting access to the 15 percent qualified dividend rate for individuals would be to curtail access to this preferential treatment on unlimited amounts of deemed distributions from an IC–DISC, preferably on a truly prospective basis.

Recommended Solutions

The preferred 15 percent dividend rate would be retained, but only with respect to a very limited amount of dividends to benefit those small businesses that would otherwise be left out of the IC–DISC export tax incentive. This could be accomplished by retaining the preferred 15 percent rate on distributions of "DISC income" under Code section 995(f)(1), but denying it with respect to "deemed distributions" under Code section 995(b)(1).[†]

[†] The sole remaining beneficiaries of this limited access to the 15 percent qualified dividend rate would be individuals, and the amounts of tax benefits derived, in the aggregate, would be quite small in macroeconomic terms. Nevertheless, such treatment would still provide a limited

Continued

The effect of such a limited change would be to provide for continuation of the 15 percent rate with respect to annual dividends of the IC–DISCprofits from no more than $10 million of qualifying export receipts of the IC–DISC and its related supplier(s) within a modified controlled group. See Code section 995(b) (4).

For the typical small business exporter with, say, a 4% net-to-gross ratio, this would have the maximum effect of a 20 percentage point rate reduction in dividends of $400,000 of annual export profits, or an aggregate group tax reduction of $80,000. All export profits on the group's receipts in excess of $10 million each year would then be subject to the full ordinary income tax rate of up to 35 percent. Of course for many, indeed most, affected small businesses the actual benefit would be considerably less: their actual export sales volumes, the profits on which the beneficial rate would apply, would be considerably less than the annual maximum of $10 million.

These changes should be made prospective in a meaningful way, by making them applicable to dividends paid in taxable years of IC–DISCs beginning after the date of introduction (or, more preferably, after the date of enactment).

In order to accomplish these recommended changes,

(1) The indented sub-clause in paragraph (a) of Section 7 could be changed to read:

> '(IV) any dividend received from a corporation which is a
> DISC or a former DISC, as defined in section 992(a), to the
> extent such dividend is not paid out of its DISC income for
> such year (as defined in section 995(f) (1)).'

And,

(2) Paragraph (b) of Section 7 should then be changed to read:

'(b) Effective Date-The amendment made by this section shall apply to dividends paid in IC–DISC taxable years beginning after the date of enactment.'

On behalf of the Louisiana District Export Council, Inc., and the small business exporters of Louisiana who are attempting to recover from the ravages of Hurricane Katrina, we earnestly solicit your adoption of the proposed changes as discussed above, if it is found necessary to make any change to the existing rules regarding the tax treatment of IC–DISC dividends. Thank you for your consideration of these views.

Of course, if you have any questions or would consider further discussion helpful, the undersigned is available to your Staff at the above e-mail address or by phone at 251–625–4603.

Respectfully submitted,

Edward K. Dwyer, CPA
LADEC Member

The Honorable William M. Thomas
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Charles B. Rangel
Ranking Member
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Thomas and Ranking Member Rangel:

In response to Advisory Release No. FC–26 (September 29, 2006), the National Association of Real Estate Investment Trusts® (NAREIT) is submitting these comments regarding TTCA 2006, and in particular, the modifications to section 470,[1] which limits the deductions allocable to property used by governmental or other tax-

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but meaningful export tax incentive for those originally intended beneficiaries of the IC–DISC provisions. This class of taxpayers was certainly not the object of the World Trade Organization complaints concerning export tax incentives given to major U.S. corporations, and it is anticipated that there should be no reprisals within the WTO from the retention of such limited benefits to an even more limited group of individuals.

[1] For purposes of this letter, "section" refers to the Internal Revenue Code of 1986, as amended (Code), unless otherwise indicated. Also, "section 470" refers to section 470 as enacted by the American Jobs Creation Act of 2004 (AJCA), and "TTCA 2006, proposed section 470" refers to the proposed revisions to section 470 under section 6(b) of TTCA 2006.

exempt entities. NAREIT is the representative voice for U.S. real estate investment trusts (REITs) and publicly traded real estate companies worldwide. Members are REITs and other businesses that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service these businesses.

As further described below, NAREIT has two specific comments.

EXCUTIVE SUMMARY

First, NAREIT requests a statutory change or legislative history demonstrating that REITs should not be considered "pass-thru entities" for purposes of sections 168(h)(6)(E) and 470. This request is consistent with federal tax law's general treatment of REITs (with rare exceptions) as C corporations and not as pass-thru entities.

The second comment relates to the umbrella partnership (UPREIT) structure utilized by over 60% of the publicly traded REIT industry, by many private REITs and by some non-REIT C corporations. As further described below, an UPREIT owns and operates its entire property portfolio through an operating partnership (OP), the ownership units in which are held by the REIT and third parties who, typically after one year, have the right to exchange their partnership units for the fair market value equivalent of REIT stock or cash (at the REIT or OP's option). Because this exchange right does not protect the unitholders from risk of loss, but rather is a means to provide them with liquidity, NAREIT requests guidance that the existence or funding of this redemption right by the REIT or OP in the ordinary course of business, by itself, is not considered a "set aside" or "arrangement" resulting in the unintended application of the loss disallowance rules of section 470.

NAREIT also supports the more general comments to TTCA 2006 submitted by The Real Estate Roundtable.

DISCUSSION

I. *Background*

As enacted by the AJCA, and proposed to be amended by TTCA 2006, section 470 was designed to prevent taxpayers from claiming tax benefits generated in "Sale-In Lease-Out" (SILO) transactions,[2] which the IRS declared to be abusive tax avoidance arrangements.[3] Presumably to prevent SILO-like transactions from being replicated through special allocations made by partnerships, Congress extended section 470 to losses attributable to property owned by a "pass-thru entity" with one or more tax-exempt or foreign owners. Section 470 prohibits a taxpayer from claiming a deduction in excess of the taxpayer's gross income with respect to the lease of "tax-exempt use property."[4]

The term "tax-exempt use property" is defined by reference to section 168(h), which includes: 1) tangible property leased to tax-exempt entities;[5] and, 2) *any* property owned by a pass-thru entity with a tax-exempt entity as an owner if the pass-thru entity's allocation of items to the tax-exempt does not constitute a qualified allocation.[6] Thus, under section 168(h) and, in turn, section 470, tax-exempt use property includes not only property leased to tax-exempt entities, but also the proportionate amount of other property, regardless of its use, owned by a pass-thru entity and attributable to a tax-exempt or foreign owner.[7] Neither sections 470 and 168(h) nor the accompanying legislative history define a pass-thru entity for this purpose, and, furthermore, neither does TTCA 2006 address this issue. Adding to the uncertainty is the fact that, notwithstanding the general tax treatment of a

[2] H.R. Rep. No. 548, pt. 1, 108th Cong., 2d Sess. at 313–14 (2004) (noting that the prior law was ineffective in curtailing the ability of a tax-exempt entity to transfer tax benefits to a taxable entity through certain leasing arrangements); S. Rep. No. 192, 108th Cong., 1st Sess. at 198 (2003) (same).

[3] Notice 2005–13, 2005–9 I.R.B. 1 (designating SILOs as a listed transaction).

[4] Section 470(a).

[5] *Id.* § 168(h)(1).

[6] *Id.* §§ 168(h)(6)(A), (E).

[7] *Id.* § 168(h)(6)(A). TTCA 2006, proposed section 470(c)(2)(B) would change section 470 from limiting deductions proportionately based on the ownership interests of a tax-exempt or foreign partner in a partnership to being completely disallowed. NAREIT opposes this change and agrees with the comments of The Real Estate Roundtable which discuss this opposition in more detail.

REIT as a corporation,[8] there are a few instances in the Code in which a pass-thru entity is defined to include a REIT.[9]

II. *Guidance Requested That REITs Are Not "Pass Thru Entities" Under Section 470*

Much of the discussion below was set forth in a February 25, 2005, letter to Treasury Department and IRS officials requesting regulatory guidance on this issue. NAREIT understands that regulatory guidance may not have been issued in the past given the expectation of technical corrections to section 470. Recognizing the difficulty in applying section 470 to pass-thru entities in an appropriate manner, the IRS issued Notice 2005–29, 2005–13 I.R.B. 796, and then Notice 2006–2, 2006–2 I.R.B. 278, which provide that in the case of partnerships and pass-thru entities described in § 168(h)(6)(E), for taxable years that began before January 1, 2006, 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). Because TTCA 2006 now has been proposed without addressing the issue of a REIT being treated as a pass-thru entity for purposes of section 470, and the moratoria have expired, now would be the appropriate time to provide certainty to REITs and their investors by resolving this issue.

This issue is particularly important because, as further described below, TTCA 2006 attempts to provide an exception from the application of section 470 for certain "partnerships." However, "REITs" neither would be included in the definition of "partnerships" for purposes of this exception, nor excluded from the general definition of "pass thru entities" under the general application of section 470. As a result, it is still possible that section 470 could apply to REITs, even under TTCA 2006's proposal and without the benefit of the proposal's exceptions from section 470). This clearly would be an inappropriate result; section 470 simply should not apply at the REIT level.

The statutory language and legislative history clearly indicate that REITs were not the target of this provision. First, a REIT by definition is required to be taxable as a domestic corporation.[10] Further, section 1361(a)(2) states that "[f]or purposes of this title" the term "C corporation" is defined as a corporation that is not an S corporation. Thus, REITs are C corporations for all purposes of the Code unless a Code section otherwise expressly provides. As you know, widely held C corporations rarely are considered pass-thru entities for federal income tax purposes because they cannot pass through losses or credits to their shareholders.[11] In fact, we are not aware of any IRS guidance holding that a REIT is a pass-thru entity in the absence of express statutory direction. Unlike other Code sections, neither section 168 nor section 470 provides that REITs are pass-thru entities rather than C corporations.

Second, even prior to the enactment of section 470, REITs generally had no incentive to engage in a SILO-type transaction because, unlike traditional pass-thru entities (*e.g.*, partnerships), REIT-level losses or credits do not flow through to shareholders regardless of whether the REIT issues a single class of stock or multiple classes of stock. Further, a REIT generally has little or no taxable income or tax liability to offset with something like SILO deductions or credits because it may deduct dividends paid to shareholders, and it must distribute most of its taxable income as dividends.[12] Given the tax treatment of REITs, there was no benefit to its shareholders for a REIT to acquire tax deductions or credits through a SILO arrangement.[13] The only practical way that a REIT shareholder could offset its REIT

[8] Treas. Reg. § 1.856–1(e) (stating that, to the extent not inconsistent with the REIT provisions of the Code, other provisions of chapter 1 of the Code, such as sections 301 (property distributions); 302 (distributions in exchange for stock), and 316 (definition of a dividend), apply to a REIT and its shareholders "in the same manner that they would apply to any other organization which would be taxable as a domestic corporation." *See also* Treas. Reg. § 1.368–2 (tax-free reorganization rules apply to REITs as corporations); Rev. Rul. 66–106, 1966–1 C.B. 151 ("provisions of subchapter C pertaining to corporate distributions, are applicable with respect to both REITs and their shareholders in the same manner that they would apply to any other unincorporated trust which would be taxable as a domestic corporation").

[9] §§ 1(h)(10)(B); 860E(e)(6)(B); 1260(c)(2).

[10] Section 857(a)(3).

[11] *See*, *e.g.*, section 469(a)(2), which applies the passive loss rules only to individuals, estates, trusts, personal service corporations, and **closely held** C corporations.

[12] *Id.* § 561.

[13] To the extent that it could be argued that preferred shares of REITs could be issued to tax-exempt investors as some way to approximate SILO transactions, the existing fast pay preferred stock regulations of Treas. Reg. § 1.7701(1)–3(c)(2) prohibit such abuse and is a more targeted anti-abuse method than channeling all REITs into the definition of "pass-thru entity" under section 470. *See* C. Kulish, J. Sowell, and P. Browne, *Section 470 and Pass-thru Entities: A Problem*

taxable income or associated tax liability would have been to enter into a SILO transaction on its own outside of—and separate and apart from—the REIT.

In fact, one of the most attractive features of investing in a REIT is earning positive income through the high dividend yield that results from the requirement that a REIT must distribute at least 90 percent of its taxable income annually.[14] In most cases, investing in a SILO arrangement actually would have an adverse effect on a REIT because the losses associated with a SILO would decrease REIT taxable income, which, in turn, would decrease the all-important dividend yield of the REIT's stock. REITs had (and have) little incentive to enter into SILO-like arrangements because they already receive a deduction for dividends paid and expend significant resources in order to comply with the REIT rules in order to receive this deduction. Thus, SILO transactions are unattractive to REITs because they would generate less cash to REITs and their investors compared alternative investments such as leasing transactions with real economics that are the basis on which REIT investors evaluate REIT management.

A REIT is principally evaluated by the public markets based on the consistency of its income generating capacity and its ability to grow the income stream over time. Thus, a REIT property usually does not generate deductions in excess of income, other than when it is newly constructed or renovated and has not yet "stabilized" its tenant base. Yet, even though section 470 would rarely operate to suspend losses for a REIT property, an SEC-registered REIT would be compelled to undertake substantial verification procedures to document each property's profitability. Public REITs already are expending millions to comply with section 404 of the Sarbanes-Oxley Act, and to layer on top of this extensive review procedure additional inquiries for the rare instance when a property generates a net loss that cannot even be allocated to a REIT shareholder is excessive, unnecessary, and unproductive both for the REIT and the IRS.

In order to avoid the unintended application of the loss limitation rules of section 470 to REITs with tax-exempt or foreign shareholders, NAREIT respectfully requests that Congress provide guidance (by statutory changes to TTCA 2006 or in its legislative history) stating that a REIT is not pass-thru entity for purposes of sections 470 and 168(h)(6)(E). Note that even under such guidance, a REIT's lease of property to a tax-exempt lessee still could be subject to section 470 if it uses a partnership; however, the REIT itself would not be a "pass thru entity" subject to section 470.

III. *Guidance Requested that the Typical UPREIT Redemption Right Does Not, By Itself, Cause REIT OPs to Be Subject to Section 470*

Recognizing that "[t]he manner of application of section 470 in the case of property owned by a partnership in which a tax-exempt entity is a partner is unclear," [15] TTCA 2006 proposes a number of changes to section 470's application to partnerships.

A. *TTCA 2006 Proposals*

As relevant to NAREIT's comments, the loss limitation provisions under section 470 as amended by TTCA 2006 generally would not apply to a partnership if two requirements are met: the "no set asides" requirement, and the "no fixed price option" requirement.[16] First, under the "no set asides" requirement, proposed section 470 would not apply to a partnership with a tax-exempt/foreign partner so long as there are no "arrangements" [17] or "set asides" [18] to, or for the benefit of (among others) a taxable or tax-exempt partner of the partnership. Although a limited amount of partnership funds could be aside with no time limit [19] or an unlimited amount of partnership funds could be set aside for up to 12 months [20] (with "related" set-asides and arrangements treated as one arrangement),[21] no amount could be set aside or expected to be set aside by an entity outside of the partnership (such as

in Need of a Solution, 7 Bus. Entities 12, 25–26 (2005), for a more detailed explanation of this issue.

[14] *Id.* § 857(a)(1).

[15] Joint Committee on Taxation, *Description of the Tax Technical Corrections Act of 2006* (JCX–48–06), October 2, 2006, at page 6.

[16] TTCA 2006, proposed section 470(e)(1)(C).

[17] TTCA 2006, proposed sections 470(e)(2)(A)(i) and 470(e)(2)(C); section 470(d)(1)(B).

[18] TTCA 2006, proposed section 470(e)(2)(A)(ii).

[19] TTCA 2006, proposed section 470(e)(2)(B).

[20] TTCA 2006, proposed section 470(e)(2)(D)(i).

[21] *Id.*

by another partner) to or for the benefit of, among others, a taxable or tax-exempt partner of the partnership.[22]

In addition to this requirement, under the "no fixed price option" requirement, no tax-exempt partner could have an option to purchase or compel the distribution of partnership property or any interest in the partnership for other than at fair market value.[23] Similarly, neither the partnership nor any taxable partner could have an option to sell or compel distribution of partnership property or any interest in the partnership to a tax-exempt partner for other than at fair market value.[24]

While funds would be treated as set aside only if a reasonable person would conclude, based on the facts and circumstances, that funds are set aside or expected to be set aside, no such "reasonable person" test applies to an "arrangement," which is defined to include, among other things, "a defeasance arrangement, a letter of credit collateralized with cash or cash equivalents, a payment undertaking agreement, and any similar arrangement."[25]

B. *Application of TTCA to UPREITs*

Arguably, this rule could result in loss disallowance to partners in OPs owned in part by REITs in an UPREIT structure, which is utilized by over 60% of the publicly traded REIT industry, by many private REITs and by some non-REIT C corporations[26].

As further described below, because third party partners of the OP have the ability to require the OP or REIT to repurchase at fair market value of their partnership units for cash or REIT stock, it is possible this structure could prevent the UPREIT structure from satisfying the "no set asides" requirement. Because section 470 could apply to these non-tax shelter transactions conducted in the ordinary course of the REIT's business, NAREIT requests statutory language or legislative history clarifying that these transactions are not set-aside/arrangements contemplated by TTCA 2006.[27]

A general overview of the UPREITs format is below. While the structure of specific UPREITs may vary in the details, most will be very similar in most, if not all, respects with respect to the matters outlined in this overview.

Characteristics of an "UPRIET"

An UPREIT generally consists of a publicly traded REIT that owns substantially all of its assets and conducts substantially all of its operations through an "operating partnership." As a general rule, the REIT will own a number of "common units" in the OP equal to the number of shares of common stock that the REIT has outstanding. If the REIT has preferred stock outstanding, the REIT will own "preferred units" in the OP that correspond to the shares of preferred stock the REIT has outstanding.

The limited partnership interests held by partners in the OP other than the REIT also are denominated as "units." Because the REIT owns substantially all of its assets and conducts substantially all of its operations through the OP, and because the REIT owns a number of OP units equal to the number of shares of common stock that it has outstanding, there is effectively an economic identity of interest between the units in the OP that are owned by the outside limited partners and the shares of common stock outstanding in the REIT.

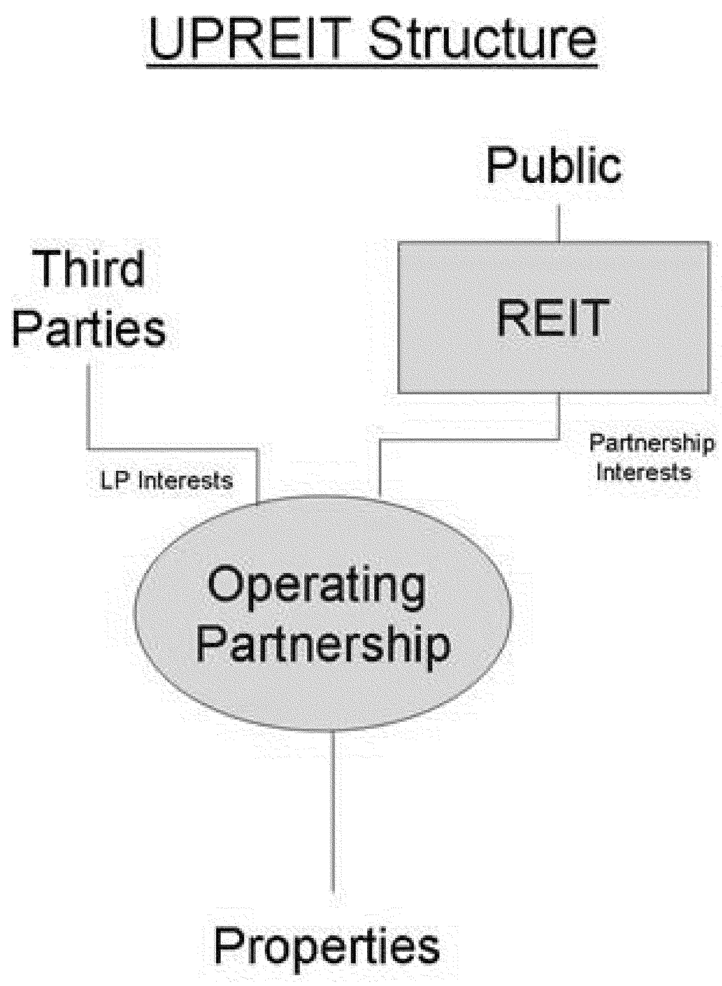
Typically, the REIT acquires its interest in the OP in one of two ways, both evidencing a substantial equity investment in the OP. First, the REIT may sell its shares in an initial public offering and contribute the cash proceeds to the OP. Alternatively, the REIT may contribute real property or partnership interests in partnerships that own real property to the OP. Then, the REIT (or a subsidiary) typically acts as the sole general partner of the OP, and has the exclusive right to manage the affairs of the OP, subject to limitations intended primarily to: 1) preserve the effective economic identity of interest that exists between the units and the REIT shares; and, 2) avoid the REIT or OP taking actions that would eliminate or adversely affect the redemption/exchange right for unitholders described below.

[22] TTCA 2006, proposed section 470(e)(2)(B)(iii).
[23] TTCA 2006, proposed section 470(e)(3)(A)(i).
[24] TTCA 2006, proposed section 470(e)(3)(A)(ii).
[25] Section 470(d)(1)(B).
[26] The discussion herein should apply to a parallel structure known as "DownREITs". A DownREIT is similar to an UPREIT except that in a DownREIT, the REIT may own property directly (in addition to an interest in a lower-tier partnership), while in an UPREIT, virtually all of the REIT's holdings are through the OP. Our data indicates that approximately 10% of publicly traded REITs (by equity market capitalization) are DownREITs.
[27] While these concerns also apply to the application of existing section 470, they are even more valid here given the attempt to clarify section 470's application to partnerships.

The third party unitholders typically acquire their interests in the OP in one of two ways: 1) contributing their direct interests in real property to the OP in exchange for OP units, or, 2) contributing their interest(s) in pass through entities that own real property to the OP in exchange for OP units.

If new partners are admitted to the OP, the REIT's interest in the OP diminishes over time, typically not below 50%. Conversely, as a REIT issues secondary offerings and contributes cash to the OP (probably the norm), the REIT's interest in the OP increases. The REIT's interest also may increase as unitholders exercise their redemption/exchange rights described below.

See the diagram below for the basic structure of an UPREIT



Reasons for UPREIT Formation

The UPREIT structure was developed to facilitate the desire of real estate owners to be able to access the public capital markets while deferring the immediate recognition of taxable gain that would result if they were to transfer their properties or property-owning partnership interests directly to the REIT in exchange for REIT shares, rather than to the OP in exchange for units.[28] This tax gain can be deferred if the property owner instead receives OP units, rather than REIT shares. The IRS has indicated that it does not consider the UPREIT structure abusive. See Example 4 of Treas. Reg. § 1.701–2 (the partnership anti-abuse regulations). Further, the IRS has issued dozens of rulings involving UPREITs.[29] Since much of the real estate industry holds real estate in partnership form, the use of an UPREIT structure does not represent a significant departure from that of the structures used by non-REIT real estate investors.

In general, tax-exempt entities generally do not own OP units directly. As noted above, the principal reason for the UPREIT structure is to permit a property to defer the recognition of gain through the receipt of a partnership interest, rather than shares of REIT stock, typically a non-issue for a tax-exempt entity. With that said, there may be situations when a tax-exempt (or foreign) entity does own OP units.[30] If tax-exempt entities are unitholders, their redemption/exchange rights (described below) are likely to be virtually identical to those of taxable entities.

Publicly traded REIT shares typically are held in "street name," and although publicly traded REITs monitor the ownership of more than 5% shareholders through Forms 13D and 13G filed with the SEC, a publicly traded REIT may not always be aware of tax-exempt investors that own relatively small indirect interests in its OP, meaning the REIT may face uncertainty in whether section 470 may apply in the first instance and may even be forced to assume it might apply.

Redemption/Exchange Right Provides Liquidity/Does Not Limit Risk of Loss

In the typical UPREIT structure, the holder of OP units generally have the right to require the REIT or the OP to redeem all or some of its units for an amount of cash equal to the agreed upon "value" of those units. Under the typical partnership agreement for an UPREIT, the "value" of a unit is defined as equal to the value of a common share of stock of the REIT so long as the stock of the REIT is publicly traded. Typically, the value of a share of the common stock is in fact the best approximation of the value of an OP unit.[31]

Although the unitholder's redemption/exchange right is typically expressed as the right to receive cash equal to the value of a REIT share, the OP and/or the REIT normally have the right, in lieu of paying cash, to satisfy the redemption obligation with one share of REIT common stock for each OP unit that is redeemed. It is generally the parties' expectation that the REIT will elect to satisfy the redemption rights with shares of REIT stock, rather than cash, but this is not typically required. In some cases, the unitholder will have a contractual right directly with the REIT to exchange the units for shares of common stock on a one-for-one basis.

In the typical UPREIT, the common unitholder *does not have the right* to get a fixed amount of cash or notes that is predetermined at the time the unit is acquired. Rather, the common unitholder only has a right to receive cash in an amount (or at the election of the REIT or OP, REIT shares with a value) equal to the agreed upon value of the OP units at the time the redemption/exchange right is exercised. The redemption/exchange right most typically is set forth in the partnership agreement for the OP, although in some cases there will be a separate contractual agreement between the unitholder and the REIT and/or OP.

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[28] Under Section 351(e) of the Internal Revenue Code, a transfer of property to a REIT in exchange for REIT shares in connection with the formation of the REIT and an IPO by the REIT often will result in the recognition of gain for tax purposes, even though most business owners who transfer their businesses to a corporation in connection with an IPO would not recognize gain. Nevertheless, the IRS has ruled that in certain circumstances property transfers to an existing REIT do not trigger income under section 351(e). *See*, *e.g.*, PLRs 200450018, 200011036, 199915030, 9801016.

[29] *See*, *e.g.*, PLRs 200011036, 199952071, 9832022.

[30] The most likely situation would be where a tax exempt entity is an investor with taxable entities in a fund or partnership that transfers property to an OP for units, with the fund or partnership retaining the units that it received for a period of time.

[31] Because the REIT generally does not own significant assets other than its interest in the OP, and because it owns a number of OP units equal to the number of common shares that it has outstanding, the value of a share of the common stock is in fact the best approximation of the value of an OP unit. In fact, NAREIT assumes that because the purchase price of the OP unit would be at fair market value, the "no fixed price purchase option" requirement would be met.

Typical UPREIT Does Not Provide For Defeasance/Collateralization of "Redemption/Exchange" Right for OP Unitholders

As described below, in the typical UPREIT, there is no collateralization or other similar arrangement with respect to the unitholders' redemption or exchange right. With that said, because either the REIT or OP stands ready to fund the redemption/exchange right, practitioners have expressed a concern that there is ambiguity as to whether the "no set aside" requirement to avoid application of section 470 would be met.

We are not aware of any REIT that has (or is required to) set aside cash to provide for payment of the redemption price when the unitholders exercise their redemption right. If, and to the extent that, the REIT elects to pay cash in connection with the exercise of the redemption right, it generally will fund that cash with operating cash flow, borrowings on an existing line of credit or other debt arrangement (available and used for other cash needs as well), or the proceeds of a new equity issuance. Thus, the REIT may use the cash proceeds on hand after sale of a particular property (or after the sales of multiple properties) with which to fund a repurchase request. The REIT, however, is under no contractual obligation to maintain cash on hand, a line of credit or other similar credit facility to permit the payment of cash upon exercise of the redemption/exchange right.

If the REIT (or OP) elects (or is required) to issue shares of REIT stock in connection with the exercise of a unitholder redemption/exchange right, the REIT generally will use "newly issued" shares of REIT stock. The unitholder typically will want to ensure that the REIT has the ability to issue these shares of REIT stock and that the unitholder has liquidity for the REIT shares that it receives. This objective most typically is achieved by requiring that, once the OP units become redeemable or exchangeable, the REIT register with the SEC under the Securities Act of 1933 the shares to be issued on redemption/exchange of the OP units. The registration of these shares merely ensures that when the unitholder exercises the redemption or exchange right, 1) the REIT will be legally permitted under the securities laws to deliver the shares of REIT stock that it has the option to deliver; and, 2) that the unitholder receiving those shares of REIT stock will be permitted under the securities laws to resell the shares without significant restrictions. This registration is accomplished by filing a registration statement with the SEC in accordance with the applicable SEC rules.[32]

There generally is no obligation for the REIT or the OP to repurchase any shares of REIT stock from the unitholder that are issued pursuant to the redemption/exchange right. Furthermore, because the exercise of the redemption/exchange right is a taxable transaction, and its availability provides the OP unitholder with the flexibility of deferring taxation until such time that the unitholder has the cash or the liquid publicly traded company stock with which to pay the corresponding tax liability, neither the OP nor REIT typically has the right to require redemption of the unitholder.

Guidance Requested to Prevent Inadvertent TTCA 2006 Proposed Section 470 From Applying to Typical UPREIT Structures

There is ambiguity as to whether proposed section 470 under TTCA 2006 could apply inadvertently to typical UPREIT structures for the following reasons. First, while unusual, it is possible that a REIT's OP could have at least one tax-exempt or foreign partner, resulting in the potential treatment of all of the OP's property as "tax-exempt property" subject to section 470's loss limitation provisions absent satisfaction of the "no set asides" and no "fixed price purchase option" provisions. Second, the "no set asides" requirement to avoid application of section 470 could apply inadvertently to the typical UPREIT structure (or, at the very least, cannot be considered by the publicly traded REIT clearly not to apply, resulting in the potential of having to account for uncertain tax positions and having to disallow certain deductions) to the typical UPREIT structure if either the OP or REIT's standing ready to fund a theoretical tax-exempt or foreign partner's repurchase request with REIT stock (marketable securities) or cash could be viewed as either: i) a set aside if it is impossible to determine that a reasonable person would not so conclude; or, ii) as an "arrangement" (regardless of a reasonable person's conclusion that it was not) despite that the IRS already has viewed this structure as non-abusive in the partnership anti-abuse regulations.

The absence of clear guidance in this area raises serious tax, accounting, and capital market-related issues for the publicly traded REIT industry and REIT share-

[32] In some cases, rather than registering the shares when the redemption/exchange right first becomes exercisable, the REIT will agree to register the shares for "resale" when they are actually issued, but this alternative is more cumbersome and much less common.

holders. For this reason, NAREIT respectfully requests statutory language or legislative history providing that the redemption/exchange right present in the typical UPREIT structure is not considered to be a set-aside or arrangement causing the operating partnership in such structure to be subject to section 470.

NAREIT would welcome the opportunity to discuss our comments with you or others in more detail. Please contact me at (202) 739–9408 or Dara Bernstein at (202) 739–9446 if you have further questions. Thank you.

Respectfully submitted,

Tony M. Edwards
Executive Vice President & General Counsel

Export Assist
San Francisco, California 94104
October 30, 2006

The Honorable Bill Thomas
Chairman, Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Chairman Thomas,

Export Assist, Inc. has provided export finance management services to over 2000 U.S. exporters, most of whom are small to medium-sized companies. We appreciate this opportunity to comment on Section 7 of the Tax Technical Corrections Act of 2006 (HR6264 and companion S4026).

Section 7 repeals the 15% Interest Charge Domestic International Sales Corporation (IC–DISC) dividend rate as of September 29, 2006. This provision could adversely impact privately-held exporters, many of whom operate small businesses and work hard to compete in the global marketplace. These individuals have invested time, effort and money to set up and operate an IC–DISC based upon the legality of the 15% dividend rate, as legislated in the Jobs and Growth Tax Relief Reconciliation Act of 2003, and the fact that the IC–DISC conforms with the GATT findings adopted in 1981. To abruptly remove this tax benefit from them without warning not only creates a financial hardship but could threaten the success of their export business. Many of these small to medium-sized exporters with IC–DISCs are growers in California's San Joaquin Valley.

In order to maintain the ability of U.S. exporters to effectively compete worldwide, we propose removing Section 7 from the Bill. If the Committee wishes to address the 15% IC–DISC dividend rate, they should do so in a way that gives exporters time to debate the ramifications of this change in the legislation. These small to medium-sized exporters have planned and acted in good faith. We can understand your Committee's action but it seems too short a time frame for them to adequately respond.

In addition, please keep in mind that at year-end all export tax benefits end except the IC–DISC. More than ever, U.S. exporters and Congress need to work together. It is important to have export tax benefit legislation that enables exporters to effectively compete internationally which in turn helps to reduce the U.S. trade deficit which is rapidly approaching $1 trillion a year.

In the interest of our small and medium-sized export clients, Export Assist urges the Committee, before it votes on Section 7, to consider the immediate financial hardship that these exporters would experience should the Bill pass with Section 7 included. We are available to answer any questions that you might have.

Sincerely,

Joseph G. Englert
President

Equipment Leasing Association
Arlington, Virginia 22203
September 30, 2005

The Honorable William Thomas
Chairman
House Ways and Means Committee
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Charles Rangel
1106 Longworth House Office Building
Washington, DC 20515

Dear Chairman Thomas and Congressman Rangel,

The Equipment Leasing Association of America (ELA), the trade association for the equipment leasing and finance industry, commends you for taking the lead in the enactment of bipartisan emergency tax relief for the victims of Hurricane Katrina. We also look forward to working with you as you examine other tax incentives designed to encourage rebuilding and reconstruction in the areas that were devastated by Hurricanes Katrina and Rita.

The availability of leasing capital will be an important component of any plan for rebuilding and reconstruction in the areas affected by Katrina and Rita. For example, through the use of lease financing, businesses in the affected areas will be able to finance 100% of the cost of new and replacement equipment, as compared to debt financings that normally requires a down payment of some amount.

For this reason, ELA would urge you to consider the following proposals that would enhance the utility of lease financings.

- *Eliminate the Mid-quarter Depreciation Convention for the Current Year*

Under current law, taxpayers are discouraged from placing substantial property in service during the last three months of the current taxable year, because the "mid-quarter depreciation convention" could apply to reduce the first year's depreciation deduction. After 9/11, the Internal Revenue Service recognized that the mid-quarter convention distorts decisions about the timing of equipment acquisitions, and provided a one-time election to ignore this depreciation convention for property placed in service in the tax year that included September 11, 2001(See, IRS Notice 2001–70). As the staff of the Joint Committee on Taxation recommended in its 2001 simplification report, the permanent elimination of the mid-quarter convention would reduce complexity in the tax code. ELA agrees with this recommendation and strongly supports the current year elimination of the mid-quarter depreciation convention as a means to encourage investment at this crucial time.

- *Enhance the New Markets Tax Credit.* On September 9, 2005, Treasury Secretary Snow announced changes to the New Markets Tax Credit (NMTC) program to assist recovery efforts in areas affected by Hurricane Katrina. ELA supports this initiative and recommends the following additional modifications to the NMTC program: (1) the program should be more amenable to investments structured as leases (as mentioned above, lease financing allows for 100% financing of new and replacement equipment); and (2) The NMTC program should be streamlined to reduce and eliminate the existing cumbersome application process that now applies.

In the case of these and any other tax incentives for reconstructing after Katrina and Rita, it will be important to allow the incentives to be used for both regular and alternative minimum tax purposes.

Thank you for considering these important proposals as part of your initiative to provide tax incentives to encourage rebuilding and reconstruction in the aftermath of Hurricanes Katrina and Rita. Please feel free to contact me or ELA's Vice President of Federal Government Relations, David Fenig, if you have any questions or would like to discuss this proposal further. We can be reached at (703) 527–8655.

Sincerely,

Michael Fleming, CAE
President

National Marine Manufacturers Association
Chicago, Illinois 60601
October 30, 2006

The Honorable Bill Thomas
Chairman, House Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Chairman Thomas:

The National Marine Manufacturers Association (NMMA) appreciates the opportunity to offer comments regarding H.R. 6264, the Tax Technical Corrections Act of 2006.

NMMA is the nation's largest recreational marine industry association, representing over 1,600 boat builders, engine manufacturers and marine accessory manufacturers. NMMA members collectively produce more than 80 percent of all recreational marine products made in the United States. Recreational boating is a popular American pastime and a major economic engine, with almost 71 million boaters nationwide and some 13 million registered boats. In 2005 alone, annual expenditures on marine recreational products and services totaled over $37 billion.

Although NMMA supports efforts to clarify the tax code through technical corrections, we are concerned that Section 7 of H.R. 6264, which deals with interest charge-Domestic International Sales Corporations (IC–DISC), is a substantive rather than a technical change to the law. Currently, under provisions implemented in the Jobs and Growth Tax Relief and Reconciliation Act of 2003, small and medium, privately-held American exporting companies may defer a portion of their export-related income by paying a tax-free commission to a DISC, reducing their overall tax liability and paying dividend taxes on shareholder income at the capital gains rate of 15 percent. In 2005, the American boat and engine export market increased by double digits, with exports totaling about $2.2 billion.

As you know, American manufacturers face substantial and increasing structural costs, including the rising price of health care and energy, unfair foreign competition, unnecessary and cumbersome regulation and an overly-complex tax code. Given a level playing field, American producers can compete with any company in the world. However, reducing the overall cost of doing business in America is important, particularly for small—to medium-sized companies.

NMMA respectfully urges the Committee to reconsider its inclusion of Section 7 regarding the tax treatment of dividends from IC–DISCs in H.R. 6264, since we believe this is a substantive change in the tax code and that a technical corrections bill is not the appropriate vehicle for such a modification.

Again, NMMA appreciates the opportunity to share its views with the Committee. Please do not hesitate to contact Mathew Dunn, Manager, Natural Resources and Economic Policy, with any questions or if you need additional information.

Respectfully Submitted,

Monita W. Fontaine, Esq.
Vice President and Senior Counsel

Statement of Food Donation Connection, Knoxville, Tennessee

These comments call attention to a technical correction needed to the charitable giving incentives created by recent tax legislation found in H.R. 4, the Pension Protection Act of 2006, Section 1202—"Extension of Modification of Charitable Deduction for Contributions of Food Inventory". This correction would bring the provision in line with the original intent of Congress to encourage food donations by all business entities.

Food Donation Connection (FDC) coordinates the donation of wholesome prepared food from restaurants and other food service organizations to local non-profit agencies that help people in need. Federal tax code (IRC Section 170(e)(3)) has provided incentive for C corporations to donate their food inventory since 1986. Since its founding in 1992, FDC has been involved in the effort to pass charitable giving incentives for food donations for all business entities and is currently working with several restaurant companies that have agreed to donate food if this issue is resolved. FDC has coordinated the donation of over 80 million pounds of prepared food for companies like Yum! Brands (Pizza Hut, KFC, Taco Bell, Long John Silver's, A&W) and Darden Restaurants (Red Lobster, Olive Garden, Smokey Bones). We currently coordinate donations from 6,300 restaurants to 3,200 non-profit agencies nationwide.

In our discussion with Yum! Brands franchisees about the charitable giving incentives contained in H.R. 4 (Pension Protection Act of 2006, which extended the provision of H.R. 3768 (KETRA) to December 31, 2007) we discovered an issue in the tax code that negate the tax savings for S corporations that donate food. Individual S corporation shareholders may not be able to take the deduction for the donation of food inventory, depending on their basis in the corporation. In working with S corporations we have learned the following:

- S corporation income is distributed to each shareholder based on each shareholder's ownership percentage and therefore the deductibility of the deduction depends on each shareholder having sufficient basis (i.e. at IRS risk rule) in the company to permit deduction at the individual level.
- S corporations make ongoing distributions to shareholders rather then retain excess funds in the company and therefore S corporation shareholders have no basis (i.e. distributions reduce basis).
- As a result, S corporation shareholders do not believe they are entitled to a tax deduction and do not benefit from recent tax law changes and are therefore not motivated to donate.

Under this current situation, the shareholder basis rule trumps the intention of Congress to extend the special rule for certain contributions of food inventory to S corporations (H.R. 4 extension of H.R. 3768 Sec.305, which modified IRC section 170(e)(3)).

To remedy this situation, a technical correction could be made to the language of H.R. 4, the Pension Protection Act of 2006. The following wording would be added to H.R. 4 section 1202:

(c) In General—Section 170(e)(3)(C) of the Internal Revenue Code of 1986 (relating to special rule for certain contributions of inventory and other property) is amended by redesignating (iv) as (v) and inserting after (iii) the following new paragraph:

'(iv) S corporation BASIS LIMITATION—In the case of food contributions from S corporations, limitations on individual shareholder's deductions due to shareholder basis (section 1366(d)(1)) on stock and debt do not apply. However, shareholder's basis continues to be adjusted consistent with section 1367(a).'

The immediate impact of this change would mean that over 721 restaurants in 26 states would be eligible for this deduction for donating food, and therefore willing to donate. See the list below for additional details.

It is the intent of Congress to address the needs of Americans by providing valuable resources to charitable organizations. This technical correction would fulfill the original intent of the legislation by allowing S corporations to take advantage of this charitable deduction for contributions of food inventory.

Thank you for considering these comments.

Sincerely,

Jim Larson
Program Development Director

Yum! Brand Franchisees Willing to Donate with S Corp Basis Cost Resolution

The passage of H.R. 4 has roused the interest of many Yum! Brands franchisees to donate food. A number of franchised operators of Pizza Hut, KFC and Long John Silver's restaurants that have told Food Donation Connection they would start a Harvest food donation program if the issue with S corporation basis costs can be corrected.

The following chart lists the number of new restaurants and the pounds of food donations that can be projected from these restaurants. The poundage projections are based on averages from Yum! Brands operated restaurants. These donations include cooked prepared pizza, breadsticks, chicken, fish, mashed potatoes, vegetables, biscuits and other items that have been properly saved, packaged and chilled or frozen. The saved food would be picked up on a regular basis by local food banks and hunger relief agencies and used in the local community.

Yum! Brands has been donating surplus food from its restaurants since 1992. In 2005, over 1,800 local hunger relief agencies received about 12 million pounds of prepared food from 3,926 company-operated restaurants. This food has been a tremendous help for these agencies, as donated food frees up their limited resources for other needs.

The list of 721 restaurants represents a broad spectrum of communities across 26 states and 140 congressional districts. These restaurants are operated by 15 different franchised groups. Since the Yum! Brands system is over 75% franchised, resolution of the S corporation tax deduction issue will result in many more opportunities to encourage donation of wholesome prepared food.

State	District	Representative	# Restaurants	Lbs per Year
AL	05	Robert E. (Bud) Cramer Jr.	2	10,350
AZ	01	Rick Renzi	6	17,197
AZ	03	John B. Shadegg	2	5,732
AZ	07	Raúl M. Grijalva	11	31,529
AZ	08	Jim Kolbe	14	40,127
CA	24	Elton Gallegly	1	5,175
CA	26	David Dreier	2	10,350
CA	27	Brad Sherman	5	25,875
CA	28	Howard L. Berman	4	20,700
CA	29	Adam B. Schiff	2	10,350
CA	30	Henry A. Waxman	4	20,700
CA	31	Xavier Becerra	2	10,350
CA	32	Hilda L. Solis	2	6,511
CA	33	Diane E. Watson	4	20,700
CA	35	Maxine Waters	1	5,175
CA	36	Jane Harman	1	5,175
CA	38	Grace F. Napolitano	4	16,861
CA	46	Dana Rohrabacher	1	1,336
CO	03	John T. Salazar	4	20,700
CO	05	Joel Hefley	1	5,175
DC	Delegate	Eleanor Holmes Norton	1	5,175
FL	03	Corrine Brown	1	5,175
FL	05	Ginny Brown-Waite	5	14,331
FL	07	John L. Mica	3	15,525
FL	08	Ric Keller	2	10,350
FL	12	Adam H. Putnam	1	5,175
FL	13	Katherine Harris	2	10,350
FL	15	Dave Weldon	6	31,050
FL	16	Vacant	3	15,525
FL	17	Kendrick B. Meek	5	25,875
FL	18	Ileana Ros-Lehtinen	4	20,700
FL	20	Debbie Wasserman Schultz	2	10,350
FL	21	Lincoln Diaz-Balart	2	10,350
FL	22	E. Clay Shaw Jr.	5	25,875
FL	23	Alcee L. Hastings	2	10,350
FL	24	Tom Feeney	5	25,875
FL	25	Mario Diaz-Balart	1	5,175
GA	09	Charlie Norwood	4	11,465
GA	10	Nathan Deal	2	5,732
IA	05	Steve King	8	22,930
IL	12	Jerry F. Costello	1	2,866
IL	15	Timothy V. Johnson	3	8,599
IL	19	John Shimkus	4	11,465
IN	01	Peter J. Visclosky	2	5,732
IN	02	Chris Chocola	4	11,465
IN	03	Mark E. Souder	1	2,866
IN	04	Steve Buyer	1	2,866
IN	05	Dan Burton	5	16,640
IN	08	John N. Hostettler	2	5,732
IN	09	Michael E. Sodrel	1	2,866
KY	01	Ed Whitfield	2	5,732
KY	02	Ron Lewis	2	5,732
KY	04	Geoff Davis	3	8,599
KY	05	Harold Rogers	7	20,064
LA	01	Bobby Jindal	6	31,050
LA	02	William J. Jefferson	8	41,401
LA	03	Charlie Melancon	1	5,175

State	District	Representative	# Restaurants	Lbs per Year
LA	06	Richard H. Baker	9	46,576
MD	01	Wayne T. Gilchrest	5	23,567
MD	02	C. A. Dutch Ruppersberger	4	20,700
MD	03	Benjamin L. Cardin	3	15,525
MD	04	Albert Russell Wynn	1	5,175
MD	05	Steny H. Hoyer	7	36,226
MD	07	Elijah E. Cummings	1	5,175
MI	01	Bart Stupak	9	25,796
MI	02	Peter Hoekstra	2	5,732
MI	03	Vernon J. Ehlers	16	45,860
MI	04	Dave Camp	3	8,599
MI	05	Dale E. Kildee	1	2,866
MI	06	Fred Upton	7	20,064
MI	07	John J. H. “Joe” Schwarz	8	22,930
MI	10	Candice S. Miller	2	5,732
MS	01	Roger F. Wicker	11	56,926
MS	02	Bennie G. Thompson	10	51,751
MS	03	Charles W. “Chip” Pickering	10	51,751
MS	04	Gene Taylor	19	98,326
NC	01	G. K. Butterfield	2	5,732
NC	02	Bob Etheridge	7	31,608
NC	04	David E. Price	25	106,846
NC	05	Virginia Foxx	14	53,980
NC	06	Howard Coble	9	46,576
NC	10	Patrick T. McHenry	5	14,331
NC	11	Charles H. Taylor	23	65,924
NC	12	Melvin L. Watt	5	25,875
NC	13	Brad Miller	29	122,371
NE	01	Jeff Fortenberry	11	31,529
NE	02	Lee Terry	14	40,127
NE	03	Tom Osborne	12	34,395
NJ	05	Scott Garrett	5	25,875
NJ	06	Frank Pallone Jr.	1	5,175
NJ	07	Mike Ferguson	3	15,525
NJ	09	Steven R. Rothman	6	31,050
NJ	10	Donald M. Payne	5	25,875
NJ	11	Rodney P. Frelinghuysen	4	20,700
NJ	12	Rush D. Holt	1	5,175
NJ	13	Vacant	8	41,401
NY	07	Joseph Crowley	1	5,175
NY	13	Vito Fossella	3	15,525
NY	16	José E. Serrano	8	41,401
NY	17	Eliot L. Engel	3	15,525
NY	18	Nita M. Lowey	2	10,350
NY	20	John E. Sweeney	1	2,866
NY	23	John M. McHugh	16	52,786
NY	24	Sherwood Boehlert	7	36,226
NY	25	James T. Walsh	8	41,401
OH	02	Jean Schmidt	2	5,732
OH	08	John A. Boehner	1	2,866
OH	10	Dennis J. Kucinich	11	56,926
OH	11	Stephanie Tubbs Jones	16	82,801
OH	13	Sherrod Brown	10	51,751
OH	14	Steven C. LaTourette	7	36,226
OH	16	Ralph Regula	2	10,350
OH	17	Tim Ryan	2	10,350
PA	01	Robert A. Brady	1	5,175
PA	05	John E. Peterson	2	5,732
PA	06	Jim Gerlach	1	5,175
PA	09	Bill Shuster	1	5,175
PA	10	Don Sherwood	2	5,732
PA	13	Allyson Y. Schwartz	1	5,175
PA	16	Joseph R. Pitts	4	20,700

State	District	Representative	# Restaurants	Lbs per Year
PA	17	Tim Holden	4	20,700
PA	19	Todd Russell Platts	8	41,401
SC	01	Henry E. Brown Jr.	12	34,395
SC	02	Joe Wilson	14	40,127
SC	03	J. Gresham Barrett	3	8,599
SC	04	Bob Inglis	6	17,197
SC	05	John M. Spratt Jr.	6	17,197
SC	06	James E. Clyburn	5	14,331
TN	04	Lincoln Davis	1	2,866
TN	07	Marsha Blackburn	4	20,700
TN	08	John S. Tanner	1	5,175
VA	01	Jo Ann Davis	3	8,599
VA	02	Thelma D. Drake	2	5,732
VA	05	Virgil H. Goode Jr.	3	10,908
VA	06	Bob Goodlatte	2	5,732
VA	07	Eric Cantor	1	2,866
VA	09	Rick Boucher	13	37,261
WI	03	Ron Kind	7	20,064
WI	07	David R. Obey	1	2,866
WV	03	Nick J. Rahall II	6	17,197
		Totals	**721**	2,930,650

Supplemental Sheet to H.R. 4 Technical Tax Comments

Food Donation Connection (FDC) administers the *Harvest Program* to coordinate the distribution of excess food from restaurants and other food service organizations to qualified local non-profit organizations that help people in need. FDC has coordinated prepared food donation programs since 1992 involving the donation of over 80 million pounds of quality surplus food. We currently coordinate donations from 6,300 restaurants to 3,200 non-profit agencies nationwide.

Association of Art Museum Directors
October 30, 2006

Honorable Charles E. Grassley, Chairman
Honorable Max Baucus, Ranking Member
Committee on Finance
U.S. Senate 219
Dirksen Senate Office Building
Washington, DC 20510

Honorable William M. Thomas, Chairman
Honorable Charles B. Rangel, Ranking Member
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Gentlemen:

The Association of Art Museum Directors, founded in 1916, represents 170 art museums nationwide. On behalf of the membership, we write to express concern about the amendments to the Internal Revenue Code of 1986, as amended (the "Code") dealing with gifts of fractional interests contained in the Act. As we review the legislation, we believe that Congress's intention was to permit fractional gifts to be made, but to curb perceived abuses under the old law. Unfortunately, we hear from our members that various provisions in the law will effectively end fractional gifts, thereby depriving museums of a means to acquire great works of art for the benefit of the public. The loss will be to the public, to the nation's art museums and to the communities that they serve in all states. In order to avoid this result, certain technical corrections should be made as soon as practicable to avoid what appear to be unintended consequences that will paralyze the completion of gifts in progress.

1. **Grandfather existing gift programs.** To avoid the disruption of pre-existing acquisition, program and development plans by museums, the new law should not

apply to subsequent gifts of fractional interests in property if the donee institution already owned a fractional interest in such property on the effective date.

Because the exception would apply only to works in which fractional interests were given prior to enactment, there is no risk that the recommended provision will give rise to a pre-effective date flurry of fractional gifts. Without this change, donors who have already made gifts of fractional interests will be unlikely to give additional interests out of fear of becoming subject to the new law's uncertainties and harsh penalties, which means that the next installment of fractional gifts already in process will most likely not come to the museum until the death of the donor.

2. **Correct the mismatch between the estate and gift tax consequences.** The Act restricts a decedent's charitable deduction for subsequent fractional interest gifts (after the first such gift) in a work of art to the initial value at the time of the first fractional gift, but Sections 2031 and 2512 of the Code provide that for purposes of computing the estate tax and the gift tax, the valuation will be the fair market value on the date of death or date of the gift. The result is a limitation on the amount of the charitable deduction which, assuming that the work of art has increased in value from the time of the first fractional gift, will be significantly less than the valuation for estate or gift tax purposes.

For example:

For purposes of the gift tax, a donor could conceivably give the entire interest in a work of art to a museum during his/her lifetime (and within the 10 years provided by the statute) and incur a gift tax because the value of the work increases between the first fractional gift and any subsequent fractional gift;

For purposes of the estate tax, a donor could donate fractional interests during his/her lifetime and complete the transfer as part of his/her estate plan (and within the 10 years provided by the statute), i.e., as part of a disposition by will or trust, and incur an estate tax because the value of the work increases between the first fractional gift and the donation after death.

Many have indicated to us that this potential mismatch, because it could result in an unintended estate or gift tax, will preclude fractional gift giving in the future because the risk is simply too great.

3. **Eliminate the recapture of income and gift tax deductions and recapture penalty when property is transferred to a charity at death.** The new statute provides that any income or gift tax deductions are recaptured if the remaining interest in the work is not transferred before the earlier of 10 years of the initial fractional contribution or the date of death. In addition, there is a 10% recapture penalty on the amount recaptured. This language could be construed to mean that the gift must be completed before death and would not allow a gift of the remainder interest by will or trust after death.

For example:

If a donor is on schedule to complete a gift in 10 years, but dies in year eight, his/her estate could be responsible for recapture, interest and penalties because the gift was not completed BEFORE the death of the donor.

We suggest in such circumstances there be no recapture since the work of art ultimately is owned by the museum.

We are mindful of concerns that have been expressed that fractional gifts could result in a current income tax deduction without the museum receiving the ultimate benefit of a work of art. We support the concept in the legislation that a fractional gift should be coupled with a commitment to transfer the entirety of the work, ultimately, to the museum. Nevertheless, the legislation as drafted (even with the corrections to the unintended consequences identified above) would continue to discourage generous donors from supporting museums by transferring their private wealth to the common good. In order to encourage donors in their philanthropy and at the same time increase enforcement we recommend the following corrections.

4. **Eliminate the mandatory 10-year period for recapture purposes.** There does not appear to be any specific policy advanced by requiring recapture of deductions and penalties if the remaining interests in the property are not transferred prior to the earlier of 10 years from the initial transfer or death. Donors, who willingly give partial interests in a valuable museum quality work of art, should be able to avail themselves of the flexibility of giving their gift over their lifetimes if that best suits their financial and personal needs and desires. So long as the possession requirements are met, taxpayers should be permitted to make fractional interest gifts over any period of time without risking recapture of the deductions.

In place of a limited time period, we suggest that a donor be required to pledge at the time of the initial fractional contribution that the balance of the interest will be transferred either during lifetime or at death. In addition, if the donor failed to complete the gift of the entire interest or failed to provide physical possession as suggested below, the donee would provide an information return to the Internal

Revenue Service and, in such event, all prior income and gift tax deductions would be recaptured. A binding contract with reporting provisions would help ensure that any work for which a deduction was taken will ultimately go to the donee museum.

5. **Provide limited exceptions to recapture where required possession and use is not practical.** The new statute requires recapture where the donee does not take physical possession of the property. We support the concept that substantial physical possession should occur during each 10-year period until the gift is completed (this assumes that the mandatory 10-year gifting period is eliminated). As a practical reality, however, very fragile, very large, or very rare works often should not be subject to travel or frequently moved. We suggest that physical possession can be waived if: (a) the donee museum certifies that physical possession would not be in the best interest of the work of art, the museum or the public because (i) the museum's construction commitments would prevent possession of the work during the period, or (ii) packing and transporting the work may damage the work because of its fragility; or cause serious financial hardship to the museum because of the cost of transporting and assembling a large work of art, or (b) the donor dies before the donee has an opportunity to possess the work.

6. **Restore the fair market value deduction.** With the addition of enhanced protections to the appraisal process in Section 170(f)(11)(E) of the Code and the recently issued guidance in Notice 2006–96, 2006–46 IRB, the possibility for abusive appraisals is significantly reduced. Furthermore, we recommend that appraisals of works with a total value (not just the proposed gifted interest) exceeding $1,000,000 be subject to automatic review by the IRS Art Advisory Panel. With these changes, the donors should be allowed to use the actual value of a donated interest rather than the historic and potentially unrealistic value as now required by the Act. Furthermore, there seems little logic or policy justification to continuing to allow a fair market deduction for gifts of fractional interests in real estate to charities and yet disallow such a deduction for gifts of works of art.

The suggested changes will ensure that one of the most significant sources for great works of art will continue to come into the public domain. We appreciate your willingness to consider these changes.

Very truly yours,

Millicent Hall Gaudieri
Executive Director

Anita M. Difanis
Director of Government Affairs

Solomon R. Guggenheim Foundation
New York, New York 10128
October 31, 2006

Honorable William M. Thomas, Chairman
Honorable Charles B. Rangel, Ranking Member
Committee on Ways and Means
United States House of Representatives
Washington, DC 20515

Gentlemen:

Although the current provisions of the Technical Corrections Act of 2006 (H.R. 6264, S.4026) (the "Technical Corrections Act") do not apply to the PPA, we understand that you are accepting comments for technical corrections to the PPA. We therefore are writing at this time to express our general concerns with respect to the impact on museums of Section 1218 of the PPA regarding Contributions of Fractional Interests in Tangible Personal Property ("Section 1218"), and to highlight two issues that we believe would be most appropriately addressed in the Technical Corrections Act.

The Solomon R. Guggenheim Foundation (the "Guggenheim") was founded in 1937 for the "promotion and encouragement and education in art and the enlightenment of the public." It has fulfilled this goal through the establishment of an international network of museums and exhibition spaces around the world. The Guggenheim currently administers museums in Venice, Bilbao, Berlin, and Las Vegas, as well as its landmark Frank Lloyd Wright-designed museum in New York. Its museums attract over 2.5 million visitors per year, nearly 40 percent of whom are visitors to the flagship New York museum. Each year, the Guggenheim mounts between 20 and 30 original exhibitions, which are usually displayed in one of its

United States museums, and may travel within the Guggenheim's network and to other museums throughout the world.

The Guggenheim's renowned collection began with gifts from its founder, Solomon R. Guggenheim and has been expanded in large part by gifts received from art collectors over the years. In the current era of formidable and rapidly escalating prices for art, the Guggenheim and many other museums have had to rely heavily on gifts and bequests from generous donors to allow them to continue to build their collections. The prior law governing fractional gifts of art provided museums with an effective vehicle to encourage donors to make gifts of art, particularly those significant (and valuable) works of art that are so difficult for museums to acquire by purchase. We are concerned that Section 1218 of the PPA will have a chilling effect on such gifts and, therefore, on the ability of museums to acquire works of art for the benefit of the public.

I. *Overview of the Tax Law Applicable to Fractional Gifts*

Under prior law, donors of fractional interests in tangible personal property were allowed to deduct a *pro rata* share of the fair market value of the property proportionate to the percentage interest of the gift, based on an appraisal at the time of each fractional gift. There was no requirement regarding the amount of time over which the gift had to be completed; and many donors reserved the right to retain their remaining interest in the property until the later death of the donor and the donor's spouse. With each fractional gift, the donee institution received the right to possession of the work for a fraction of each year proportionate to its ownership interest in the work; although case law determined that the institution did not have to exercise such right each year, so long as it had the unfettered right to possession.

Section 1218 has changed the law to require a donor to complete a fractional interest gift within ten years after the initial fractional interest gift (or upon the donor's earlier death); and limits the income, estate and gift tax deductions that the donor is entitled to receive for each fractional gift to the lesser of a proportionate share of (i) the fair market value of the work at the time of the initial gift, and (ii) the fair market value at the time of each fractional gift. Section 1218 also requires that the donee institution take "substantial physical possession" of the property during the period of co-ownership by the donor and the donee institution. If the property is not used for the donee's tax-exempt purpose, the gift is not completed within ten years, or the donee fails to take substantial physical possession of the work during the period of co-ownership, Section 1218 provides for the recapture of all income, estate and gift tax deductions the donor has taken with regard to the gift of the property, with interest and a 10% penalty tax on the amount of deductions previously taken.

We fear that the rigidity of these rules and the harsh penalties to which donors may become subject will drastically reduce the number of gifts museums receive through the very useful charitable giving vehicle of fractional gifts. With fewer incentives to give works of art to museums, more donors are likely to delay making commitments to museums. As a result, more works will remain in private hands or be sold upon the death of the collector, rather than be given to museums for the enjoyment of the public.

II. *Importance of Fractional Gifts to Museums*

Fractional gifts have been very useful to museums, in part because they allowed the institution to encourage a donor to begin giving a work of art, even if the donor was not yet willing to commit to giving up all possession of the art during her lifetime. A donor of a particularly valuable work of art would often choose to give a fraction of the work the proportionate value of which was an amount the donor would be able to deduct for income tax purposes, taking into account the contribution limit for gifts of tangible personal property (approximately 30% of the donor's adjusted gross income), and the five-year carry-forward for the value of the gift in excess of the contribution limit. The donor had to relinquish dominion and control of the art to the museum only for the portion of the year equal to its ownership interest in the work. The promise of additional fair market value tax deductions was incentive to encourage the donor to make additional fractional interest gifts once she had exhausted the carry-forwards from her initial gift. With each subsequent fractional interest gift, the institution would gain increasing rights of possession, and greater decision-making power over the location, care and treatment of the work. Even if the museum chose not to take possession of a work for its fractional share of a given year, because it would not be able to display the work that year, or because frequent packing and shipping of the work might damage it or be prohibitively costly, the curators knew that the museum would be entitled to possession of the work when it "needed" it, for inclusion in exhibitions.

The ability to take possession of a fractional interest gift when needed means that a museum can truly rely on such a gift in its collecting strategy, and does not have to continue to seek to acquire a similar work by gift or purchase. This distinguishes fractional gifts importantly from "promised gifts," in which the museum gets no ownership interest until the donor decides to give the work (usually upon death). For these reasons, it is appropriate that donors of fractional interests receive income tax deductions for the very real present-interest they give in works of art, while no income tax deduction is available to those who make promised gifts, or give future-interests.

If there were abuses under the prior law, instances where institutions had side agreements with donors that they would not take possession of the works during the donors' lifetimes, they were not widespread, and could be curbed by less drastic means than those of Section 1218. By taking away the incentive of fair market value deductions for subsequent fractional interest gifts (after the initial fractional interest), and the flexibility of allowing a donor to choose his or her own schedule for giving, we fear that the PPA has stripped fractional gifts of the attributes that made them attractive to donors and a key vehicle for museums to start a dialogue with donors, encouraging them to begin to give important works of art.

Although we are hopeful that Congress will consider these concerns and modify Section 1218 in the next Congress, we realize that addressing some of these issues is beyond the scope of a technical correction. There are however, two matters of a technical nature, which we hope will be addressed in the Technical Corrections Act.

III. *Proposed Technical Corrections*

A. *Charitable Gifts Should Not Trigger Estate or Gift Taxes*

Section 1218(b) and (c) provides for caps on the estate and gift tax deductions available for "additional contributions" of fractional interests, after an initial contribution, at the lesser of a proportionate share of (i) the fair market of the property at the time of the initial contribution, and (ii) the fair market value of the property at the time of the additional contribution. While these provisions mimic Section 1218(a), which limits the income tax deduction, they would produce, in most cases, the clearly unintended result of creating gift or estate tax liability for contributions of additional fractional interests to a museum, if the work of art has appreciated in value since the initial contribution. In fact, in some instances, the resulting estate and gift tax liabilities could exceed the value of the income tax deductions to the donor, resulting in a net cost to a donor to make a charitable gift.

An example of the application of Section 1218(b) would be a donor who gave an initial 10% fractional interest in a work of art worth $1 million, and gave the remaining 90% of the work to the museum as a bequest in his will when he died five years later. If at the time of the donor's death the work of art was worth $2 million, the $1.8 million dollar value of the donor's 90% interest in the work would be includable in his estate for estate tax purposes. However, his estate tax deduction for the gift of his 90% interest in the work would be limited to $900,000 (90% of the $1 million value at the time of the initial contribution). Therefore, the donor's estate would be liable for estate tax on $900,000 (the $1.8 million value, less the $900,000 deduction), despite an entirely charitable transfer of the art. This result occurs despite the fact that the donor is not responsible for or able to manipulate the market value of the work of art, and the fact that the donor has complied with the time requirements for completing the gift under Section 1218, and had allowed the institution to enjoy substantial possession of the work during the period of co-ownership.

Section 1218(c) would cause a similar result in the gift tax context. If the donor in the example above did not die, but gave an additional contribution of 10% of the work five years after the initial gift, his income tax deduction would be limited to $100,000 (10% of the fair market value on the date of the initial gift), and so would his charitable gift tax deduction. However, the donor would incur gift tax on the $200,000 value of the gift on the date of the additional contribution, offset only by the $100,000 deduction. There is no policy reason served by causing a donor to pay gift tax (or use up his lifetime exemption from gift tax) for making the second charitable transfer, which resulted in an increase in the donee museum's ownership interest in the work and greater rights of possession.

We have already heard from counsel for donors that they will advise their clients not make any new fractional gifts, for fear of such illogical and unjust results. Thus, unless this technical correction is made, the enactment of Section 1218 is likely to have the unintended consequence of eliminating the ability of museums to receive fractional gifts entirely.

B. ***Fractional Gifts in Progress Should be Grandfathered***

Donors who made one or more fractional interest gifts to a museum prior to the enactment of the PPA should be allowed to give their remaining interest in those works under the rules of the prior law. Without this change, it appears that donors of such gifts-in-progress will "freeze" their gifts, to avoid having them come under the PPA, and the potential for harsh penalties under Section 1218. Museums would then have to wait until the death of the donor to receive the remaining fractional interest in the work, although that may not have been the intention of the donor when he or she began giving fractional interests. We do not believe that the intention behind this new law is served by slowing-down the process of giving to institutions; it would be an unfortunate consequence of the law if museums had to endure longer periods with smaller ownership interests in works of art than either the institution or the donor had intended when the initial fractional gift was made. Since the proposed exception could be drafted to apply only to the defined group of donors who have made documented fractional interest gifts prior to the effective date of the PPA, there would be no potential for abuse or a "flood" of gifts in avoidance of the new law if such gifts were "grandfathered" under the prior law.

* * *

We urge you to include in the Technical Corrections Act corrections that (i) would ensure that charitable donors would not incur any estate or gift taxes as a result of any contribution of a fractional interest in tangible personal property, and (ii) grandfather gifts-in-progress, so that donors will receive the benefits of the law prior to the enactment of the PPA with respect to their additional contributions of such property. We also hope that other changes to Section 1218 will be considered by the 110th Congress that will restore incentives for charitable giving of works of art, while ensuring that those incentives are not abused.

We would be pleased to discuss these comments with you or members of your staff at any time. We appreciate your consideration of the needs of museums and the important benefits to the public that result from fractional interest gifts.

Sincerely yours,

Sara Geelan
Associate General Counsel

Los Angeles County Museum of Art
Los Angeles, California 90036
October 31, 2006

On behalf of the Los Angeles County Museum of Art ("LACMA"), I urge you to include in the Technical Corrections bill (S. 4026 and H.R. 6264) the following changes to the provisions on fractional gifts in the recently enacted Pension Protection Act of 2006 (Section 1218) (the "Act"). Without these technical corrections, the Act will have a substantial chilling effect on such fractional gifts, on which the LACMA and, indeed, all of our museums rely.

Here at LACMA, we regularly receive fractional interests in donated art works which in fact do become 100% acquisitions. In just the last three years, such fractional donations, now 100% owned by LACMA, include: 39 etchings by David Hockney, 6 paintings by other artists (Matt Mullican, Tim Ebner, Simon de Vlieger, Aelbert Cuyp, Jacob van Ruisdael, and Jan van Huysum); an assemblage by Franois Morellet;sculptures by Keith Haring and Allen Ruppersberg; 43 photographs by Robert Stivers and Garry Winogrand, prints by Sam Francis and Johann Friedrich Overbeck;and aJapanese screenof Kinoshita Itsuun (Shōsai). In addition, LACMA currently owns a fractional interest in well more than 100 significant works of art, under gift agreements entered into before HR 4 was enacted. Each of these agreements will be negatively impacted by the provisions of the Act, if it is permitted to apply retroactively.

Specifically, the following provisions on fractional interests in the Act would have a significant, unfavorable effect on LACMA's programs:

1. ***Estate and Gift Tax Consequence.*** If a donor were to initiate a fractional gift after the effective date of the Act, or if he or she were to donate additional fractions of gifts already in progress, each successive fraction would trigger either gift tax (during the donor's life) or estate tax consequences (after the donor's death), because of the difference between the deduction permitted under the Act and the actual fair-market value.

To correct the problem: **all fractions should be allowed at the fair-market value after a qualified appraisal.**

2. ***Transitional clarification.*** The new law should not apply to subsequent gifts of fractional interests in property if the donee institution already owns a fractional interest in such property. This would avoid disrupting pre-existing acquisition, program, and development plans by museums that were put in place in reliance on continuing acquisition of additional fractions of already partially-owned gifts. Because this clarification would apply only to works in which fractional interests were given prior to enactment, there is no risk that this change would give rise to a pre-effective date flurry of fractional gifts. Without this clarification, donors who have already made gifts of fractional interests in works will be unlikely to give additional interests out of fear of becoming subject to the new law's uncertainties and harsh penalties. Thus the next installment of fractional gifts already in process will most likely not come to the donee museum until the death of the donor.

To correct the problem: **only fractional gifts begun after the effective date should be subject to the new law.**

3. ***Eliminate the requirement for gifts to be given within 10 years or donor's death whichever is sooner.*** This provision would likely result in the postponement, and in some cases, outright elimination of some gifts of fractional gifts in artwork to LACMA. Rather than surrender a work in so short a time, a potential donor might well prefer to wait until later in life. The gift postponed could then become the gift denied, if plans change or if the donor dies before making the gift. It would be fairer and still encourage giving to require that the museum take actual possession for a period of time proportional to the fractional gift, rather than imposing an arbitrary maximum ten-year period on a donor and donee museum. We do agree that the donor should be required to provide for the gift of the remainder of the work at or prior to the date of death of the donor (or the donor's spouse), which is generally the practice of most museums.

To correct the problem: **allow donors to give the gift over the period of time that suits their needs.** To ensure the charitable disposition of fractional gifts and proper disclosure of such donations, the new law should require binding contracts with mandatory reporting and recapture of deductions plus interest. This would mark a significant change for some institutions and would ensure that any work for which a tax deduction is taken will ultimately go to the donee museum for the benefit of taxpayers. Such a contract should require:

a) A donor of an undivided fractional interest in a work of art to evidence his or her gift in writing and pledge the remainder of the work to the same donee on or before his or her death (or the later death of the donor's spouse);

b) Museums to give written acknowledgment of receipt of fractional interest gifts;

c) Museums, under penalty, to inform the IRS, similar to reporting required by IRS Form 8282, if donors fail to give a remaining fractional interest, fail to comply with the possession requirements detailed above, or fail to honor any other contract requirement;

d) The recapture of deductions plus interest for donors who fail to comply with the terms of fractional gift contracts.

4. ***To ensure accurate appraisals.*** The provision that the donor must use the original appraisal, if lower, for each fractional gift is simply unfair to the donor and thus a disincentive to giving, since donors would not be able to take the full measure of the value of an appreciated gift. The more rigorous rules for the appraisal of donated personal property should be sufficient to address any perceived abuses. In lieu of the punitive requirement that donors use the lower of the appraisal at the time of the initial fractional gift or any subsequent fractions of the gift, donors should be allowed to use a current, accurate, fair-market value appraisal, provided that appraisals for fractional gifts in which the value of the work as a whole exceeds $1 million automatically would be subject to review by the IRS Art Advisory Panel. The US Treasury has confirmed the reliability and efficacy of the IRS Art Advisory Panel. The technical correction could include a requirement directing the IRS to require taxpayers to identify such works by checking a box on the appropriate tax form.

To correct the problem: **submit all works the whole of which exceeds $1 million to the IRS Art Advisory Panel.**

5. ***Physical possession requirement and exceptions to create a safe harbor.*** Under the Act, the donee institution must take physical possession of the work of art for a substantial period within the 10-year period or before the fractional gift is complete. We don't disagree that some requirement of proportional possession be included prior to the time the gift is completed, but believe that (1) for purposes

of determining "physical possession," credit will be given for any exhibition of the work to the public at another institution; (2) the donee's possession should be proportional over the life of the loan (exercised, perhaps, within each 10 year period); and (3) in certain cases, physical possession may be waived if either:

a) The donee museum certifies that physical possession within a 10-year period would not be in the interest of the work of art, the museum or the public because either:

i) The museum's permanent collection, exhibition, planning, educational, or construction commitments would prevent showing the work to the public during the period, or

ii) Packing and transporting the work may damage the work because, for example, of its fragility; or cause a serious financial hardship to the museum because, for example of the cost of transporting and assembling an overly large work of art; or

b) The donor dies within a 10-year period before the donee has an opportunity to possess the work.

***To correct the problem:* create exceptions in the rare case a museum cannot accommodate a work or the work would risk damage or extraordinary costs to move.**

The mission of LACMA is to serve the public through the collection, conservation, exhibition and interpretation of significant works of art from a broad range of cultures and historical periods, and through the translation of these collections into meaningful educational, aesthetic, intellectual and cultural experiences for the widest array of audiences.

To carry out this mission, LACMA relies in substantial part on the generosity of donors to increase its permanent collection by the donation of works of art. In general, the tax code recognizes and supports this activity through its long-standing incentives fostering such private philanthropy. Unless these technical corrections are adopted, the Act's changes on fractional interests will discourage and place significant negative limits on donors wishing to so contribute. In turn, this could detrimentally impact LACMA's operations. To ensure that the Act does not harm legitimate charitable activity, it is important that the Technical Corrections bill eliminate altogether or at least modify these harmful provisions in the Act.

We would appreciate your attention to these suggested technical corrections and thank you for your consideration of this request and for supporting charitable organizations.

Yours truly,

Fred Goldstein
General Counsel

Joint Statement of Government Finance Officers Association, National Association of Counties, National Association of State Auditors, Comptrollers and Treasurers, and National League of Cities

U.S. Conference of Mayors
October 31, 2006

The Honorable Bill Thomas
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington D.C. 20515

Dear Chairman Thomas:

The Government Finance Officers Association; the National Association of Counties; National Association of State Auditors, Comptrollers and Treasurers; the National League of Cities; and the U.S. Conference of Mayors appreciate the opportunity to provide suggestions to H.R. 6264 the *Technical Corrections Act of 2006*, with regard to Section 512 of the *Tax Increase and Prevention Act of 2005* (*TIPRA*).

Section 512 of *TIPRA*, imposes an excise tax on financing transactions, such as sale-in-lease-out (SILOs) and lease-in-lease-out (LILOs), that state and local governments and their agencies entered into until the *American Jobs Creation Act* labeled them as "listed transactions" in 2004. Prior to the *JOBS Act* state and local governments, and especially transit authorities, had entered into these financings with the encouragement and approval of the U.S. Department of Transportation.

TIPRA allows for a retroactive application of an excise tax penalty on transactions that were completed years ago with the full knowledge of the Department of Transportation and Treasury Department. The retroactive imposition of a substantial excise tax could have substantial negative repercussions to many governments, and ultimately the citizens that they serve.

We believe that a remedy for this retroactive application in *TIPRA*, is a clear definition of the term "proceeds" and "net income." We are concerned that the Treasury and the IRS have insufficient guidance in defining these terms and may promulgate regulations with overly broad definitions that would be detrimental to governments and transit authorities. Therefore, we respectfully request that a provision be added to H.R. 6264 that would clarify the meaning of "proceeds," as well as "net income." This would allow guidance to be written which would provide for the allocation of both "net income" and "proceeds" to avoid substantial retroactive consequences.

Allowing for this technical correction, and subsequent regulations from the Department of the Treasury, these transactions would be in parity with the exact same type of transit agency SILO financing transactions that were "grandfathered" by both the *JOBS Act* and *TIPRA*. Under the current application of the law, the same type of SILO transaction receives potentially different treatment, solely due to the date when the transaction was pending approval by the Department of the Transportation. We believe that this is unfair and should be rectified so that all of the financings receive the same treatment as the grandfathered deals. As we have stated, this could be accomplished with a consistent application of the terms "proceeds" and "net income."

Another item worth noting is that Section 512 casts a shadow over all future financial transactions entered into by state and local governments. Because the legislation is written so broadly, the Treasury has the power at any time in the future to administratively impose an excise tax retroactively on state and local governments by designating a type of transaction as a "listed transaction." Thus, transactions that close today could be listed in the future, with no debate or public hearing, resulting in state and local governments incurring a tax liability with no means of challenging the determination. This allows the IRS to tax state and local governments without specific Congressional approval, and could adversely affect the tax-exempt bond marketplace. Although the IRS can already challenge the tax-exempt status of state and local bonds, the potential application of Section 4965 creates another avenue for the IRS to weaken the bond market, without the possibility of judicial review.

Mr. Chairman, we again very much appreciate the opportunity to comment on the *Technical Corrections Act of 2006*, and encourage inclusion of a provision to clarify the terms "proceeds" and "net income" with regard to Section 512 of *TIPRA*. A more detailed letter that was sent to Treasury by the GFOA regarding this provision is attached for your review.

If you have any questions about our comments, please contact Susan Gaffney, Director of GFOA's Federal Liaison Center at 202–393–8020 x209.

Sincerely,

Government Finance Officers Association
National Association of Counties
National Association of State Auditors, Comptrollers and Treasurers
National League of Cities
U.S. Conference of Mayors

Dear Sir or Madam:

On behalf of the 16,500 members of the Government Finance Officers Association (GFOA), we appreciate the opportunity to comment on the newly created IRC Section 4965 as requested under Treasury notice 2006–65. The GFOA is a professional association of state and local government finance officers dedicated to the sound management of government financial resources. Many of our members will be impacted by these regulations.

Based on our analysis, this provision would impose an excise tax on state and local governments and their agencies that have entered into many types of transactions such as Sale In/Lease Out or Lease In/Lease Out (SILOs or LILOs) transactions prior to the date of enactment of the *Tax Increase Prevention and Reconciliation Act of 2005* (*TIPRA*) (P.L.109–222). *TIPRA* also allows a retroactive excise tax to be applied to future state and local government and governmental agency financings if they become listed transactions by the U.S. Department of the Treasury and the Internal Revenue Service.

To combat tax shelter concerns with SILO and LILO transactions, both Congress and the IRS have acted to abolish these types of transactions from occurring. This includes the 2004 *American Jobs Creation Act* (*JOBS*), which eliminated the tax incentives for SILO and LILO transactions. Additionally, the U.S. Department of the Treasury issued two Revenue Rulings on this issue that curtailed these transactions—the 1999 IRS Revenue Ruling 1999–14 which disallowed the depreciation and interest deductions for LILOs and the 2002 IRS Revenue Ruling 2002–69 that listed LILO transactions as abusive tax shelters or transactions.

Despite complying with evolving standards on lease-related transactions, Section 4965 imposes a new punitive excise tax on state and local governments and their agencies that entered into these transactions in good faith before such transactions were prohibited. Additionally, many SILO and LILO transactions were entered into by transit authorities and municipalities with the *encouragement and approval* of the U.S. Department of Transportation. Depending on forthcoming regulatory guidance, many of the affected state and local governments and their agencies could face significant tax liabilities, in some cases in the millions of dollars, even though the proceeds of these transactions were typically invested in the capital and operating budgets of these public agencies long ago.

Beyond the retroactive application of Section 4965, we are also very concerned about its open-ended nature that will allow an excise tax to be applied to future transactions that may become listed by the Treasury and the IRS. This creates an ominous cloud over current state and local government and governmental agency financings by imposing great uncertainty regarding what could become a listed transaction in the future. While we believe Congress, the Treasury, and the IRS should do everything possible to rid the marketplace of abusive transactions, we are concerned that future application of this provision may cause unintended consequences, and disrupt the most commonly used market for the state and local government financing, the tax-exempt bond arena.

To deter unfair application of Section 4965 on state and local governments and their agencies, we would like to make the following suggestions with respect to forthcoming regulatory actions of the Department of the Treasury.

1. *Retroactive application of an excise tax on transactions that were completed prior to enactment of* TIPRA*, should not be imposed.* Due to the fact that most SILO/LILO transactions closed before the 2004 *JOBS Act*, and were done in good faith, generally adhering to U.S. Department of Transportation guidelines (*Innovative Financing Techniques for America's Transit Systems*—1998), and other accepted tax practices, Treasury should consider these transactions completed with no net income/proceeds outstanding. As was suggested at our meeting with Treasury and IRS officials on July 21, if net income and gross proceeds are defined consistently with existing Code, there is currently no project income to which the excise tax could apply. Alternatively, these transactions could simply be delisted, as is the case for nearly a dozen transactions noted in *TIPRA*. Those delisted transactions were originally grandfathered in the *JOBS Act*, due to the fact that they were awaiting approval from the Department of Transportation at the time the legislation was introduced in 2003. The types of grandfathered/delisted financings are no different than the types of transactions that occurred prior to 2003, thus none of the SILO/LILO transactions that were completed prior to 2004 should be penalized by an excise tax.

2. *Uniform definitions of net income and proceeds should be applied*. Treasury should seek to define 'net income' and 'gross proceeds' in a manner that is consistent with current IRS Code, and reflective of the true nature of SILO/LILO transactions. Below are some technical suggestions.

Net Income

- The IRS takes the position that lessors must be taxed in accordance with the substance of the LILO/SILO transaction and such substance is (i) an up-front payment by the lessor to the lessee and (ii) a loan by the lessor to the lessee (the "Deemed Loan") in the amount that the lessee sets aside to purchase highly-rated securities (the "Equity Collateral") that defease certain obligations of the lessee under the LILO/SILO or, alternatively, in the case of a LILO, a purchase of a future leasehold interest in the leased property. The IRS takes the position that cash flows in respect of the debt financing must be disregarded as circular because the lessee uses the debt proceeds to defease the debt-portion of its obligations with an entity related to the lender.
- The lessee would have income on receipt of the up front payment in the year the LILO/SILO closes and, in the case of a SILO, income in respect of earnings on the Equity Collateral that would be offset, in timing and amount, by interest deductions attributable to the Deemed Loan throughout the term of the transaction. In the case of a LILO, the lessee would have either on-going interest in-

come offset by an interest deduction, as is the case in SILO transactions, or, alternatively, income in the year of closing with respect to the sale of a future interest in the property. The only net income from the transaction is the Accommodation Fee received by the lessee on closing of the transaction, and under an alternative IRS argument with respect to LILOs, the payment for the future interest in the property. Under normal tax accounting rules, these up-front payments would be taken into income on closing of the transaction and would not be allocable to subsequent years. In the absence of legislative direction to apply different tax accounting principles, normal tax accounting rules should apply.

Proceeds

- Section 4965 and its legislative history are silent on how the "proceeds" of a transaction to which the excise tax applies are to be determined. The proper approach would be to treat the up front payment as the proceeds of the transaction. The up front payment represents the lessee's "free cash" from the transaction after payment of transaction costs and provision for the defeasance of the lessee's obligations and purchase option payment.
- Under the proceeds prong of the measure of the excise tax, the tax-exempt entity's tax for a particular year is measured by reference to "the proceeds received by the entity for the taxable year," and then only to the extent the proceeds received for that year are attributable to the transaction. The predicate to the proceeds prong is that an amount must be received by the tax-exempt entity for the year in question; if no amount is received by the tax-exempt for the year, the inquiry stops: no tax is imposed under the proceeds prong. In the context of LILO/SILO transactions, no amounts are received by the lessee for any year, other than the year the transactions closed.

Additionally, creating uniform definitions will also assist the Department of the Treasury with their workload by not having to produce new regulations every time a listed transaction is established.

3. *Future application of Section 4965 should only be applied prospectively*. Procedures should be developed regarding how the Section would apply to future transactions. This includes creating a procedure so that the excise tax is not automatically applied to newly listed transactions. Instead, penalties should only be applied prospectively to transactions or at the very least, state and local governments and their agencies should be able to provide comments on the newly listed transactions and then only in extreme circumstances have the excise tax apply to these transactions in a retroactive manner. An independent judicial review mechanism should also be sought.

4. *Section 4965 should not apply to tax-exempt bond transactions*. A regime for compliance in the tax-exempt bond marketplace currently exists at the IRS. This includes the relatively recently (1999) created "Tax-Exempt Bond Office" which focuses solely on tax-exempt bond transactions with an emphasis on abusive practices. It is unlikely that Congress intended the Section to apply to tax-exempt bond financings, and it unduly places the potential for substantially greater penalties to be imposed upon state and local governments than currently exist, or that are in line with possible purported abuses. State and local governments and their agencies have little recourse in the tax-exempt bond audit program, because of a lack of independent judicial review, which is a problem in and of itself, without the further added threat of an excise tax penalty regime being imposed upon the same transaction, again without an independent judicial review mechanism.

5. *Guidance is needed with respect to the disclosure requirements in Section 4965*. While the Section requires state and local governments and governmental agencies to disclose existing transactions, the legislative language does not provide for the specific timing and form such disclosure must be made ("in such form and manner and such time as determined by the Secretary."). Ample time and guidance should be provided for governments to fulfill this requirement, and Treasury should consider exempting the disclosure requirement from applying to transactions where there is no current income or proceeds subject to the excise tax.

Conclusion

We are very concerned with the application of Section 4965 on state and local governments and governmental authorities. This provision from *TIPRA* creates a turning point in long standing federal/state/local government relations, by having a federal excise tax imposed upon state and local governments in the manner of a penalty, specifically in a retroactive manner. Many governments entered into LILO and SILO transactions from the late 1990's through 2004, most with the approval of the U.S, Department of Transportation. Having these past transactions now taxed is an unfair application of the penalty, and could cost state and local governments and agencies millions of dollars even though the proceeds of these transactions were generally spent at the time the transactions were closed on public infrastructure and services. By creating an atmosphere where an excise tax can be applied to governments and agencies at any time in the future on transactions that occur in the past, the ability of governments to enter into financing transactions will be undermined and become more costly, as tax lawyers strive to protect the transactions from possible—and currently undefined—tax exposure. Clear guidance from Treasury is imperative in order for governments to continue to provide the essential infrastructure and services that the public demands.

Thank you for the opportunity to comment on the forthcoming guidance.

Sincerely,

Susan Gaffney
Director, Federal Liaison Center

Money Management International, Inc.
Houston, Texas 77096
October 31, 2006

The Hon. William M. Thomas, Chairman
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

Dear Chairman Thomas:

Money Management International, Inc. ("MMI") would like to thank you for the opportunity to submit comments on the recently enacted credit counseling provisions of the Pension Protection Act of 2006 (the "Pension Protection Act"), as requested pursuant to the recent introduction of House Rule 6264, the Tax Technical Corrections Act of 2006.

The Pension Protection Act of 2006 adopted a new section 501(q) of the Internal Revenue Code ("Code"), which establishes standards that a credit counseling organization must satisfy in order to qualify for exemption under Code Section 501(c)(3) or 501(c)(4). We believe that a number of technical corrections are necessary in order to make Congressional intent clear with respect to the important changes made concerning credit counseling organizations.

I. *Background.*

MMI is the largest, tax-exempt, non-profit credit counseling organization ("CCO") in the nation and operates six telephone contact centers and 135 in—person counseling offices in 22 states and the District of Columbia. MMI provides professional financial guidance, counseling, community-wide educational programs, and debt management assistance. We are licensed in all states that require it of CCOs and have been approved by the Executive Office for U.S. Trustees to provide both pre-filing bankruptcy counseling and pre-discharge bankruptcy education programs in all judicial districts. MMI has been reaccredited by the Council on Accreditation after an extensive self-study and onsite review process. MMI is a member of, and has taken leadership roles in, the two well-regarded and reputable industry trade associations, the National Foundation for Credit Counseling ("NFCC") and the Association of Independent Consumer Credit Counseling Agencies ("AICCCA"), both of which have strict standards of operation as a condition of membership. In the first nine months of 2006, nearly 500,000 consumers contacted MMI looking for financial education and guidance on a wide range of issues, including credit card debt, budgeting problems, debt prioritization, housing counseling, bankruptcy counseling, and pre-discharge bankruptcy education.

II. *Comments.*

Below are our specific comments on the provisions of the Pension Protection Act of 2006. In some instances, we propose new text that is indicated by double underlines and deletions are indicated using ~~strikethroughs~~.

A. *Prohibited "credit repair activities" section 1220(a) amendment to Code Section 501(q)(1)(A)(iii).*

We suggest section 1120(a) creating Code Section 501(q)(1)(A)(iii) be revised to state "provides services for the purpose of improving a consumer's credit record, credit history, or credit; provided, however, that if such services involve only educating a consumer as to how the consumer can improve the consumer's credit record, credit history, or credit rating, and not acting as an agent on behalf of the consumer to do so (such as the organization contacting credit bureaus to correct inaccurate items on a consumer's credit record), then such services shall be considered the provision of educational information within the definition of "credit counseling services" and not covered by the restrictions of Section 501(q)(1)(A)(iii) or (iv), and".

During the credit counseling process, consumers recognize the importance of their financial health, often for the first time, and numerous questions arise concerning the consumer's credit record, credit history and credit rating. While MMI counselors have the consumer's attention, it is important to educate them as much as possible on the financial issues affecting their lives. Although CCOs would like to be able to offer all education assistance free of charge, education related to credit history and credit reports is expensive to provide, as credit reports with credit scores are not provided to CCOs free of charge. With decreasing contributions from creditors and others which in the past have covered most of the agency's costs, CCOs should be able to offer services related to credit reports and credit scores, and collect modest fees to cover their costs, when appropriate.

It is important to note that it is not MMI's intention to offer "credit repair" advocacy services. By making the suggested changes to the Act, we only wish to be able to provide consumers the information needed to understand their credit report which will allow them to contest any inaccuracies themselves. The intent of our proposed change is to clearly distinguish between "credit repair" advocacy services and traditional credit counseling education services.

B. *Referrals section 1220(a) amendment to Code Section 501(q)(1)(F).*

Section 1220(a) of the Pension Protection Act amends Code Section 501 to require CCOs to adhere to a number of operating requirements, including that:

The organization receives no amount for providing referrals to others for debt management plan services, and pays no amount to others for obtaining referrals of consumers.

We believe Code Section 501(q)(1)(F) is unnecessarily restrictive. Moreover, the Internal Revenue Service has already published on its web site an FAQ that we believe incorrectly interprets this provision.[1] In doing so, the IRS appears to ignore that the referral prohibition applies to "debt management plan services" and not "credit counseling services." These terms are expressly defined in Code Section 501(q)(4).

We suggest Code Section 501(q)(1)(F) be revised to state:

The organization receives no amount for providing referrals to others for debt management plan services, and pays no amount to others for obtaining referrals of consumers for debt management services who do not consent to such referrals. For purposes of this provision, a referral shall not include when a consumer seeks debt management plan services from an organization that is connected to a credit counseling organization. If a credit counseling organization pays or receives a fee, for example, for using or maintaining a locator service for consumers to find a credit counseling organization, such a fee is not considered a referral under this provision. Further, nothing herein shall be construed to prohibit a credit counseling organization from paying fees for advertising and marketing services rendered.

We believe it is reasonable to consider the referral prohibition as intended to prevent consumers from being diverted from one kind of service provider to another, without their consent, for a referral fee, bonus or commission and not to prohibit marketing and advertising. However, we believe that consumers should not be prevented from being connected to CCOs by a source that has their permission to do so.

We believe that Congress intended to adopt a narrow view of what constitutes a "referral." For example, the Joint Committee on Taxation made clear that the Code Section 501(q)(1)(F) referral prohibition should be interpreted as meaning that "If a credit counseling organization pays or receives a fee, for example, for using or maintaining a locator service for consumers to find a credit counseling organization; such a fee is not considered a referral."[2] To keep costs down for both the agency and consumers, CCOs often contract with other organizations that represent a pool

[1] An Internal Revenue Service FAQ states:

May I buy lists of potential customers from the Internet site that carries my ads? No. You cannot purchase leads of customers from third party vendors and you cannot sell the names of your customers to other providers.

Internal Revenue Service Web Site, available at http://www.irs.gov/charities/article/0,,id=163193,00.html (visited on Oct. 27, 2007). Notably, in this FAQ the question asked and the answer provided appears to address two different issues. The question asks about advertising initiated by the CCO while the question addresses whether a tax-exempt nonprofit CCO can purchase "leads" of customers from third party vendors.

[2] See Joint Committee on Taxation, Technical Explanation of H.R. 4, page 318, n.436.

of consumers (employers, employee assistance programs, creditors, etc.) who may need the CCO's services and may provide reimbursement to these organizations for their marketing and related costs of making the referral.

We believe CCOs should be able to participate in locator services provided by trade associations and other credit counseling industry servicing organizations since it clearly improves operating efficiencies when offering their services to consumers. These types of locator services connect consumers seeking credit counseling and financial education with CCOs. This type of service should be acceptable to the Congress. Without the continuation of this service, consumers may turn to predatory companies, those without strict operating standards, as well as companies engaged in unlawful practices and not operating in full compliance with applicable laws and regulations.

Finally, as with other organizations, CCOs often engage in advertising and marketing campaigns to keep consumers informed of the availability of financial counseling and education, the vast majority of which is offered at no cost to the consumer. Congress should make clear that the referral prohibition is not intended to prevent this practice.

C. *Internal Revenue Service Disclosures to Third Parties Section 1224(a) amendment to subsection (c) of Code Section 6104.*

We suggest section 1224(a) amendment to subsection (c) of Code Section 6104 be revised to add the following after paragraph (5):

"(6) NOTIFICATION OF DISCLOSURE.—If a State officer receives or seeks disclosures pursuant to these provisions (2), (3), (4) or (5), the organization shall be included in all correspondence between the Secretary and the State officer;

"(~~6~~7) DEFINITIONS.—"

In the same spirit of disclosure and openness, CCOs should be included in the correspondence surrounding the disclosures now authorized under the Act. Such notification of disclosure would provide CCOs the opportunity to open a dialogue with the States most concerned about the CCO industry so that services may be better improved for our consumers.

Please do not hesitate to let me know if you have any questions or would like to discuss the comments outlined above. Thank you for your consideration of these proposed technical corrections.

Sincerely,

Ivan L. Hand, Jr.
President and CEO

Alaska Ocean Seafood
Anacortes, Washington 98221
October 31, 2006

Dear Congressman:

I am writing to alert you to a pending tax law development that I believe will be detrimental to small and mid-sized exporters. While I am writing this letter on my Company's behalf, I believe many fellow exporters share my views on this subject.

The Technical Corrections Bill Increases the Foreign Trade Deficit. Section 7(b) of the Tax Technical Corrections Act prevents dividends received from an IC–DISC from obtaining the same maximum 15% federal tax rate as qualifying dividends from other types of corporations. Passage of the bill would cause the IC–DISC regime to revert to its status prior to 2003. Rapidly growing companies who needed capital to expand export operations often came to the conclusion that they could not use the IC–DISC structure because the deferral of tax wasn't worth the interest charge or the soft costs of implementing the structure. But when the tax rules changed in 2003 to allow IC–DISC dividends to enjoy a permanent tax savings that the exporter never had to pay back to the federal government, the IC–DISC structure came within the reach of many companies with export activities.

One-Time Dividends Received Deduction Did Not Help Most Privately-Held Companies. Various sources have quoted figures suggesting that small businesses represent the vast majority of new jobs created in the U.S. My view is that the one-time dividend received deduction available for most taxpayers in their 2005 tax year benefited those U.S. multinationals who had already exported jobs and who had already built up significant foreign infrastructures. There was no corresponding reward for those U.S. enterprises that built their businesses at home.

The Tax-Sophisticated Company Still Obtains Permanent Tax Benefits. The Technical Corrections Bill does not eliminate the availability of the 15% maximum federal rate on dividends from qualifying foreign corporations or qualifying corporations formed in possessions of the United States. Therefore, my competitors who happen to have operations in China or Switzerland or Puerto Rico or Guam who have hired tax advisors to help them manage their tax liabilities outside the U.S. can still benefit from the 15% tax rate after passage of the Technical Corrections Bill. This result seems unfair.

The "Foreign-Owned" Company Still Benefits. The Technical Corrections Bill does not address technical rules that continue to allow foreign corporate owners of an IC–DISC to obtain an effective U.S. tax rate of 15% or less on profits derived from exporting activities. It doesn't seem fair that Congress would enact a Technical Correction that seemingly aids the foreign-owned U.S. company at the expense of a U.S.-owned, U.S.-based company, both competing in the global marketplace.

WTO Accepts IC–DISC. Congress has sought over years to provide tax benefits to U.S. exporters. The original DISC provisions were replaced with FSC provisions, and those were eventually replaced with the Extraterritorial Income Exclusion (EIE). All have been met with various objections from the WTO and the EU. EIE finally phases out at the end of 2006, leaving no export incentive except the IC–DISC. This last incentive was addressed by the WTO and accepted as not being an unfair advantage to U.S. exporters. Now, instead, it is our own government that is threatening to take away the only export incentive accepted by our trading partners.

Conclusion:

- Section 7(b) the Technical Corrections Bill eliminates the ability of most privately-held U.S. companies to obtain a permanently reduced federal tax rate on profits attributable to export activities.
- Section 7(b) has a disproportionately negative effect upon small to mid-sized companies owned by U.S. individuals.
- Section 7(b) can be defeated by taxpayers who can afford sophisticated tax advice.

I therefore urge you to recommend removal of Section 7(b) from the pending Tax Technical Corrections Act of 2006. After years of promoting exports through DISC, FSC and then EIE legislation, it is difficult to accept that the IC–DISC structure that is finally acceptable to the WTO risks being struck down by our own government.

Thank you for your consideration of this letter. I appreciate your leadership on this important issue to all U.S.-owned exporters.

Very truly yours,

Jeff Hendricks
CEO

Air Tractor, Inc.
Olney, Texas
October 27, 2006

The Honorable Bill Thomas
Chairman
House Ways and Means Committee
1102 Longworth House Office Building
Washington, DC 20515

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

Dear Chairmen Thomas and Grassley:

Air Tractor, Inc. ("AT") is a small business located in Olney, TX. AT manufactures agriculture and forestry fire bombing airplanes and has been in business since 1972. We are a small business with employment of approximately 180 people. In addition to selling our products domestically, AT also sells aircraft internationally.

We urge the Committee to reconsider Sec. 7 of the proposed legislation, which addresses the tax treatment of IC–DISCs. This section as written would bring about substantive (and we believe negative) changes to the areas of small business, U.S.

trade policy, U.S. trade deficit, job creation and operates as a tax increase. In view of the wide spectrum of categories impacted, Sec. 7 as currently proposed is much more than a technical correction. Since we believe that Sec. 7 is much broader than a technical correction, we request that it be pulled from the technical corrections legislation. If consideration of this section is something that Congress desires to undertake, then we respectfully submit that this consideration should be careful and in-depth deliberation afforded new legislation, and that affected companies like ours be given more opportunity for input.

Our comments on the major issues that make this section much more than a technical correction are as follows:

—Small Business. Since many of the IC–DISC mechanisms operate through a Subchapter S corporation, by definition Sec. 7 is for the most part a small business issue. Exporting for small business is an important but expensive proposition. Sec. 7 would make this proposition more expensive.

—U.S. Trade Policy. Through WTO rulings, U.S. exporters have lost the availability of DISCs, FSCs, and ETI. The IC–DISC remains the lone mechanism that the WTO has not ruled against and in fact, has specifically let stand. Sec. 7 effectively neuters this remaining, approved WTO mechanism.

—U.S. Trade Deficit. In the month of August 2006, the U.S. Department of Commerce announced a record monthly trade deficit of $69.9 Billion (second straight monthly "record"). Our country is on target for an annual trade deficit in excess of $800 Billion—unfortunately another "record". The IC–DISC by definition applies to small-medium enterprises ("SME") that engage in exporting. Our country should be working hard to reduce the trade deficit. Enactment of Sec. 7 takes away another tool of the exporter and works counterproductive to trade deficit reduction.

—Job Creation. Research indicates that companies that began trading internationally between 1993 and 2001 had about five times the employment growthof other companies. Companies that stopped trading during this period actually lost jobs. Additionally, virtually all of the Fortune 1000 companies are active international traders already, but less than 10% of the nation's small companies export. With 96% of the world's consumers living outside of the U.S., with global communications rapidly shrinking the world community, and with trade deficits threatening our future economic stability, this disappointing overall export performance by smaller companies is something our nation can no longer afford. Sec. 7 is a negative impact on SMEs that are exporting or wish to export. Legislation should be enacted to stimulate job growth—not the opposite.

—Tax Increase. Sec. 7 does not appear to address any specific, perceived abuse or situation that would give rise to a need for a technical correction. Sec. 7 operates as a straight tax increase.

Sec. 7 negatively impacts the issues noted above. Each issue alone has substantive economic effects. Collectively, the economic effects are amplified (in a negative way). Sec. 7 of the bill addresses "technical corrections" to the Jobs and Growth Tax Relief Reconciliation Act of 2003. In that context it is instructive to examine the House committee reports for that 2003 legislation. House Committee Report (H.R. Rep. No. 108–94) as related to Code Sec. 1(h), Code Sec. 163(d), Code Sec. 854 and Code Sec. 85c states in the Reason For Change, "The Committee believes it is important that tax policy be conducive to economic growth. The Committee believes that reducing the individual tax on dividends lowers the cost of capital and will lead to economic growth and the creation of jobs."

Further in the Reasons For Change, the Committee reached the following conclusion, "It is through such investment that the United States' economy can increase output, employment, and productivity."

Sec. 7 of the current proposed legislation was classified as a technical correction. However, as noted above the enactment of Sec. 7 would have a negative impact across a broad economic range. The Reasons For Change of the legislation that Sec. 7 are proposing to "technically correct" is very clear that the 2003 Act was keyed to increasing economic growth and creation of jobs. This puts Sec. 7 directly opposed to the reasons for enactment of the 2003 and renders the term "technical correction" dubious relative to the original legislation.

In the Description of the Tax Technical Corrections Act of 2006 prepared by the staff of the JOINT COMMITTEE ON TAXATION (dated October 2, 2006, page 10), a justification for the proposed change is linked to IRC 246(d). Sec. 246(d) references "dividend from a corporation which is a DISC or former DISC . . ." Sec. 246(d) was added to the law in 1971. Much has changed in the economic and exporting landscape in the ensuing 35 years. As noted, the WTO recently ruled against DISCs, FSCs and ETI. The IC–DISC (which was created in 1984) is one of the few mechanisms to stimulate exporting left standing today. Fundamentally, the operation of today's IC–DISC (which was created 13 years after 246(d) was added) in the current economic environment is much different than the DISCs addressed in 1971. This further reinforces our assertion that today's Sec. 7 is much more than a technical correction. Sec. 7 has broad (and negative) impacts. We urge that Sec. 7 be eliminated from a technical corrections bill.

Thank you for your consideration.

Sincerely,

David Ickert
Vice President—Finance

Hunton & Williams LLP
Richmond, Virginia 23219
October 31, 2006

Dear Chairman Thomas and Ranking Member Rangel:

In response to Advisory Release No. FC–26 (Sept. 29, 2006), Hunton & Williams LLP is submitting this comment letter regarding TTCA 2006 on behalf of one of its clients. Specifically, our comments relate to Section 48A of the Internal Revenue Code ("Section 48A") as enacted by Section 1307 of the Energy Policy Act of 2005.

Section 48A provides a 20 percent investment tax credit for certified qualifying advanced coal projects using integrated gasification combined cycle technology ("IGCC") and a 15 percent investment tax credit for projects using an advanced coal-based generation technology other than IGCC. The Secretary of Treasury is authorized to allocate a maximum of $800 million in tax credits for IGCC projects under Section 48A ($267 million to projects using bituminous coal, $267 million to projects using subbituminous coal and $266 million to project using lignite) and a maximum of $500 million in tax credits for project using an advanced coal-based generation technology other than IGCC. In order to qualify, a project must (i) be certified by the Department of Energy ("DOE"), (ii) receive an allocation of tax credits from the Internal Revenue Service (the "IRS"), and (iii) meet certain requirements set forth in Section 48A. One such requirement is that the generating unit must be "designed to meet" certain emission performance requirements, including 99 percent removal of sulfur dioxide.

In order to be considered in the initial round of tax credit allocations, a taxpayer must have submitted an application for DOE certification to DOE by June 30, 2006. DOE was required to notify the IRS as to which projects received DOE certification by no later than October 1, 2006. Taxpayers were required to submit an application to the IRS for an allocation of Section 48A tax credits by no later than October 2, 2006. The IRS is expected to notify taxpayers by November 30, 2006 as to whether they received an allocation.

We understand that companion bills have been introduced in the House and the Senate (the "Bills") which would amend the sulfur dioxide requirement to provide that such requirement will be satisfied if the unit is designed to achieve either 99 percent sulfur dioxide removal *or* the achievement of an emission limit of 0.04 pounds of sulfur dioxide per million Btu, on a 30-day average. H.R. 6173 (Sept. 25, 2006); S. 3883 (Sept. 11, 2006). This revised requirement would be applicable to all Section 48A projects and take effect as if included in the Energy Policy Act of 2005. Although TTCA 2006 does not currently contain the amendment to Section 48A proposed by the Bills, if such amendment is included and enacted, it would result in an increase in sulfur dioxide emissions beyond those contemplated by Section 48A as originally enacted.

In addition, the deadlines for application for DOE certification and for application for a tax credit allocation from the IRS for the initial round of allocations has passed (June 30, 2006 and October 2, 2006, respectively). Because the amendments made by the Bills would take effect as if included in the Energy Policy Act of 2005, certain taxpayers may not have filed applications due to a belief that they did not meet the sulfur dioxide removal requirement as originally enacted. These taxpayers would be prejudiced by a retroactive amendment. Similarly, projects that meet the sulfur dioxide removal requirement as originally enacted may also be prejudiced by a retroactive amendment.

Accordingly, we respectfully request that the amendment to Section 48A provided in the Bills not be included in TTCA 2006 as it would increase sulfur dioxide emissions and prejudice certain taxpayers that did not meet the initial Section 48A deadlines and those that met the deadlines and the sulfur dioxide removal requirement as originally enacted. However, if the tax writing committees believe the amendment is appropriate to be included in TTCA 2006, we respectfully recommend that the amendment be effective on a prospective basis after the date of enactment.

Thus, projects that meet the new alternative sulfur dioxide removal requirement would be eligible to participate in subsequent tax credit allocation rounds.

Finally, we understand that the DOE did not certify any of the Section 48A IGCC projects using subbituminous coal based on an assumption that such projects could not meet the 99 percent sulfur dioxide removal requirement. This assumption is incorrect. Although subbituminous coal is a low-sulfur coal, 99 percent removal (or more) of sulfur dioxide is possible, for example, when additional processes are incorporated to further remove pollutants such as sulfur from the synthesis gas. Moreover, Section 48A(f)(1) of the Code provides that an electric generation unit uses "advanced coal-based generation technology" if the unit "*is designed to meet*" certain performance requirements including a "*design level* for the project" of 99 percent sulfur dioxide removal. Thus, if a taxpayer presented technical and engineering information demonstrating that the project was designed to meet this requirement, the project should be certified by DOE. If the project, when completed and operational, does not meet the performance characteristics, the IRS can appropriately address this issue on audit.

We would welcome the opportunity to discuss our comments with you in more detail. Please contact me at (804) 788–8746 if you have any questions or require further information.

Respectfully submitted,

Laura Ellen Jones

Cascade Fishing, Inc.
Seattle, Washington 98199
October 31, 2006

I am writing to you to express my concerns with Section 7 of the Technical Corrections Act of 2006 and specifically with the changes proposed to the treatment of dividends paid by an IC DISC corporation.

We oppose the proposed changes to the treatment of dividends paid by an IC DISC. First, this change does not seem fitting as a "technical correction". Rather it is a fundamental change in the treatment of dividends as paid by an IC DISC. We believe any such fundamental change in tax law should be addressed the same way in which any other fundamental changes in tax law are addressed, which is through the tax approval process and not as a technical correction.

Second, the suddenness of the enactment date of the proposed change undermines basic business planning. As a small business whose sales are substantially foreign, we rely on the values the current tax laws allow as an important part of our business success for the year. For the tax laws on which we rely to suddenly change undermines a good portion of our fiscal success. If it is the committee's belief that this major change in stance regarding the treatment of dividends is within the technical corrections process, we would respectfully request that such enactment date be effective December 31, 2006 so as to not undermine a planned portion of our business success. It is our understanding the IC DISC rules were put in place to help businesses like ours who provide U.S. based employment and who export to foreign countries. This sudden change in the tax law will have the opposite effect.

We are a small US based business providing jobs in the US. Where specifically provided by our tax code we plan for and rely on the benefits this code provides us. These benefits are an integral part of our success and the suddenness of changes like it proposed in this area of the technical corrections act undermines the basis for our planning and success.

We request you either eliminate this provision in the technical corrections act or change the enactment date of this provision to December 31, 2006.

Respectfully submitted,

Nancy Kercheval
President

City of Chicago
Chicago, Illinois 60602
October 31, 2006

The Honorable Bill Thomas
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington D.C. 20515

Dear Chairman Thomas:

On behalf of the City of Chicago, I welcome this opportunity to submit comments on H.R. 6264, the "Technical Tax Corrections Act of 2006". Our comments discuss issues relevant to the application to the City of a new excise tax enacted by Section 516 of the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"). I will first mention some general concerns about the excise tax and then suggest some technical corrections to Section 516 which would alleviate a portion of our concerns. We respectfully request that these corrections be included in H.R. 6264.

In general, the City is concerned that the excise tax enacted by Section 516 of TIPRA may be applied retroactively to transactions that were entered into prior to the Internal Revenue Service issuing any guidance or stating any concern that certain transactions may be tax shelters. Such retroactivity can be inherently unfair given that state and local governments have endeavored to enter into financial transactions in accordance with the law. Furthermore, the excise tax appears to be a way of taxing state and local government income, which is contrary to long-established practice and may invoke constitutional issues.

To turn to more technical concerns and some possible technical corrections, the Act and its legislative history do not provide a clear definition of "proceeds," on which the excise tax imposed under Section 516 of TIPRA is partly based. As a result, the City is concerned that the Treasury and the Internal Revenue Service have insufficient guidance in defining this term during the regulatory process and may promulgate regulations with an overly broad definition of this key term. Therefore, the City asks the Committee to focus on the economics of the transaction to the City and provide a technical clarification of the definition of proceeds that is consistent with the fact that the City's only economic benefit from the transaction is received on the closing date of the transaction. Similarly, the City requests that the Committee consider adding a provision to H.R. 6264 that would clarify the meanings of "net income" and "proceeds" as such terms are used in Section 516 of TIRPA, and would provide guidance on the allocation of both "net income" and "proceeds" that is consistent with the fact that the City's only economic benefit from the transaction is received on the closing date of the transaction.

Thank you for your consideration of our views. If you have any further questions, please feel free to contact me.

Sincerely,

Dana Levenson
Chief Financial Officer

Washington Metropolitan Area Transit Authority
October 31, 2006

The Honorable William M. Thomas
Chairman
Committee on Ways & Means
United States Senate
1102 Longworth House Office Building
Washington D.C. 20515

Dear Chairman Thomas:

The Washington Metropolitan Area Transit Authority (WMATA) is the largest public transportation provider in the Washington, D.C. metropolitan area and the second largest subway and fifth largest bus system nationally. On average, we provide 720,000 rail trips, 439,000 bus trips, and 4,400 paratransit trips every weekday, and almost half of Metrorail's peak period riders are federal employees. Pursuant to your request for written comments on September 29, 2006, WMATA is pleased to submit formal comments on H.R. 6264, the "Tax Technical Corrections Act of 2006." Specifically, our comments relate to the application of a new section

4965 of the Internal Revenue Code following the enactment of the Tax Increase Protection and Reconciliation Act (TIPRA) in May of 2006 (P.L. 109–222).

WMATA believes that neither TIPRA nor its legislative precedents provide a clear definition of the term "proceeds" and "net income," particularly for the application of Internal Revenue Code § 4965 (excise taxes). As a result, the U.S. Department of the Treasury and the Internal Revenue Service (IRS) may have insufficient guidance to define these terms during the regulatory process and could promulgate regulations with an overly broad definition of these key terms.

WMATA is deeply concerned that unless these terms are defined with more precision, the IRS may impose an excise tax on proceeds of Sale In/Lease Out (SILO) or Lease In/Lease Out (LILO) transactions completed by WMATA prior to the passage of TIPRA. Between 1998 and 2003, WMATA was the lessee in several LILO and SILO transactions. Consequently, if these terms are not clearly defined, the IRS could impose substantial excise tax on those transactions, which could have a material adverse impact on WMATA's ability to serve our riding public, including over 360,000 federal employees.

Therefore, WMATA respectfully requests that the Ways & Means Committee include in H.R. 6264 a technical clarification of the definitions of "proceeds" and "net income" that are also consistent with the position taken by the IRS in revenue rulings and court filings. Specifically, WMATA suggests that for purposes of assessing excise taxes, all proceeds and net income be considered to have been received at the closing of the transaction when the tax exempt entity received a cash payment.

Thank you for introducing H.R. 6264 and for allowing those affected by TIPRA to submit comments. If you or your staff have any further questions, please do not hesitate to contact me at 202–962–1003 or Mark R. Pohl, WMATA Associate General Counsel at 202–962–2541.

Sincerely,

Deborah S. Lipman
Director, Office of Policy and Government Relations

California Transit Agencies
October 24, 2006

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

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

The Honorable Bill Thomas
Chairman
House Ways and Means Committee
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Charles B. Rangel
Ranking Member
House Ways and Means Committee
1106 Longworth House Office Building
Washington, DC 20515

Dear Chairmen and Ranking Members:

On behalf of transit agencies around the country, California transit agencies appreciate your introduction of H.R. 6264, the Tax Technical Corrections Act of 2006. Enactment of this measure will resolve numerous ambiguities in the Tax Increase Prevention and Reconciliation Act (TIPRA), the American Jobs Creation Act of 2004 (Jobs Act) and other significant tax legislation, improving compliance while providing certainty.

Per the Committees' request for comments on the proposed legislation, we respectfully request that an additional technical correction relating to the treatment of Sale In/Lease Out transactions under Section 4965 be included in the enacted legislation.

The correction would clarify that TIPRA does not impose an excise tax on transit system transactions lawfully entered into before such transactions were prohibited under the Jobs Act.

Enactment of the Jobs Act effectively ended tax-advantaged leasing transactions, and none have been entered into since its effective date. However, for years prior to the enactment of the Jobs Act, the U.S. Department of Transportation (DOT) and its Federal Transit Administration (FTA) encouraged transit systems to employ innovative financing mechanisms as a means to raise revenue for public transit, and in fact heavily promoted the use of tax-advantaged leasing transactions to that end. This is evidenced in the 1998 FTA publication entitled "Innovative Financing Techniques for America's Transit Systems," which specifically encouraged the use of these transactions.

As such, public transit systems relying not only on DOT's encouragement but with the FTA's review and approval acted entirely in good faith when entering into these transactions. As intended, the proceeds earned under such transactions were long ago used to meet critical public transit needs.

Our concern is that, as currently written, IRC Section 4965 could be interpreted to impose an excise tax on transactions involving transit systems that were entered into in good faith long before the effective date of the Jobs Act. While we believe this interpretation to be wrong, it could mean a retroactive application of an excise tax to transactions that were not only lawfully entered into, but were recommended and approved by the federal government.

Such an application of Section 4965 would appear to be inconsistent with the approach to these leasing transactions taken under the Jobs Act. The language of the Jobs Act makes clear that Congress did not intend to target benefits received by state and local government entities. We believe this Congressional intent is further underscored by the Joint Committee on Taxation revenue estimate for TIPRA, which does not appear to anticipate taxation of these transactions. Rather, the JCT score shows an estimate which does not reflect collections from potentially affected transit entities.

Moreover, the transactions that were pending during consideration of the Jobs Act were specifically "grandfathered" and are not subject to the excise tax as per Section 4965. As a result applying Section 4965 to past leasing transactions would result in a 100 percent excise tax retroactively applied to older transactions, while more recent transactions are held harmless. This result would appear to be arbitrary and inequitable.

In light of the foregoing, we respectfully request that the technical correction clarify that the excise tax as enacted under TIPRA does not apply to transit agency transactions lawfully executed before the effective date of the Jobs Act.

Again, thank you for the opportunity to comment on H.R. 6264, the Tax Technical Corrections Act of 2006. We hope that this comment will help in clarifying the intent of Congress with respect to the applicability of Section 4965. We welcome the opportunity to answer any questions or discuss this issue further. Thank you for your consideration.

Sincerely,

Thomas E. Margro
General Manager
San Francisco Bay Area Rapid Transit District

Beverly A. Scott
General Manager
Sacramento Regional Transit District

Roger Snoble
Chief Executive Officer
Los Angeles County Metropolitan Transportation Authority

Nathaniel P. Ford Sr.
Executive Director/CEO
San Francisco MTA

Michael Scanlon
Executive Director
Peninsula Corridor Joint Powers Board (PCJPB) / Caltrain

Michael J. Burns
General Manager
Santa Clara Valley Transportation Authority

Metropolitan Atlanta Rapid Transit Authority
Atlanta, Georgia 30324
October 24, 2006

The Honorable Bill Thomas
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington D.C. 20515

Dear Chairman Thomas:

The Metropolitan Atlanta Rapid Transit Authority (MARTA) welcomes this opportunity to submit formal comments pursuant to your request for comments on September 29, 2006. Our comments discuss issues relevant to the application of a newly enacted section of the Internal Revenue Code to the Metropolitan Atlanta Rapid Transit Authority as a result of MARTA's role as a lessee in transactions commonly referred to as LILOs and SILOs.

MARTA is concerned that the excise tax (The Tax Increase Protection and Reconciliation Act, Section 516) may be applied retroactively to transactions that were entered into prior to the IRS issuing any guidance or stating any concern that certain transactions may be tax shelters. MARTA was the lessee in several LILO and SILO transactions involving assets with an appraised fair market value in excess of $2.2 billion. Retroactive imposition of a substantial excise tax could have a material adverse impact on MARTA's ability to serve our riding public.

The Tax Increase Protection and Reconciliation Act and its legislative history do not provide a clear definition of "proceeds." As a result, MARTA is also concerned that the Treasury and the IRS have insufficient guidance in defining this term during the regulatory process and may promulgate regulations with an overly broad definition of this key term. Therefore, MARTA asks the Committee to focus on the economics of the transaction and provide a technical clarification of the definition of proceeds that is also consistent with the position taken by the IRS in Revenue Rulings and court filings. Additionally, MARTA requests that the Chairman consider adding a provision to the recently introduced Tax Technical Correction bill (H.R. 6264) that would clarify the meaning of net income and proceeds and would provide guidance on the allocation of both net income and proceeds that is consistent with the treatment of net income and proceeds by the IRS.

Thank you for your consideration of our views. For a more detailed explanation of the issue, we have attached a copy of our comment letter to the Treasury Department and IRS. If you have any further questions, please contact me at 404–848–5377.

Sincerely,

Richard J. McCrillis
General Manager/CEO

S Corporation Association
October 24, 2006

The Honorable Bill Thomas
Chairman
House Ways and Means Committee
1102 Longworth House Office Building
Washington, DC 20515

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

Dear Chairmen Thomas and Grassley:

On behalf of the members of the S Corporation Association and the 3.2 million S corporations nationwide, we appreciate your introduction of H.R. 6264 and S 4026, the Tax Technical Corrections Act of 2006. Enactment of this measure will resolve numerous ambiguities in the Tax Code, improving compliance while providing certainty.

Per the Committee's request for comments, I would like to raise serious concerns regarding Section 7 of the Act which, if enacted, would significantly increase taxes on small and closely-held U.S. ***manufacturing*** exporters.

Since the 1970s, the EU has successfully challenged a number of U.S. tax provisions—DISC, FSC, and ETI—designed to mitigate the harm caused by their use of border-adjustable taxes and to assist U.S. exporters competing in the global marketplace. In each of these cases, the U.S. has been forced to comply with the EU challenge by eliminating the pro-export provision.

The IC–DISC (Interest Charge Domestic International Sales Corporation) was created in 1984 to allow the deferral of tax on IC–DISC income until it is repatriated as a dividend. The IC–DISC is different from DISC in that IC–DISC shareholders must pay interest on any deferred taxes. Because it requires shareholders to pay interest on any deferred tax liability, the EU has never challenged its legality under GATT or WTO.

Under the IC–DISC, a U.S. exporter pays the IC–DISC an annual "commission" equal to a percentage of its export income. This income accumulates untaxed within the IC–DISC. When the IC–DISC income is repatriated, it is distributed to the IC–DISC shareholders in the form of a dividend. Since the repeal of FSC/ETI and the reduction in the dividend tax rate to 15 percent, the IC–DISC has become a very popular tool for small and closely held manufacturers seeking to increase their exports.

Section 7 of the Tax Technical Corrections Act of 2006 would increase the tax on IC–DISC dividends by making these payments ineligible for the lower 15-percent tax rate for dividends. This change would apply to dividends paid after September 29, 2006. Our objections to this provision are two-fold.

First, we believe this provision does not qualify as a technical correction. It is substantive, controversial, and would significantly impact revenues. The question of whether IC–DISC dividends should be taxed at 15 or 35 percent is a policy matter for Congress to determine through the normal legislative process, not as part of a bill reserved for technical and non-controversial adjustments to the tax code.

Second, Congress should oppose raising taxes on domestic exporters. While U.S. exports are on the rise, particularly from smaller manufacturers, it is critical that this growth continue for the Untied States to continue making progress toward addressing our current trade imbalance. Following the repeal of the most recent RSC/ETI regime, the IC–DISC provisions are the sole remaining tax provisions targeted directly at U.S. exporters. Given the current size of the U.S. trade deficit, it makes little sense for Congress to act unilaterally to harm small and closely-held manufacturers and other exporters.

Based on these concerns, we urge you to support America's small and closely-held exporters and remove this provision from the Tax Technical Corrections Act.

Thank you for your consideration of our comments and we would be pleased to discuss this matter further with you as you work to complete this bill.

With best regards,

Tom McMahon
Vice President/Operations

Statement of Metropolitan Transportation Authority, New York, New York

The Metropolitan Transportation Authority ("MTA"), a public benefit corporation and public authority of the State of New York, welcomes this opportunity to submit formal comments pursuant to your request for comments to the Tax Technical Correction bill (H.R. 6264).

MTA is concerned that the newly created IRC section 4965 excise tax (The Tax Increase Protection and Reconciliation Act, Section 516) may be applied retroactively to transactions that were entered into prior to the IRS issuing any guidance or stating any concern that certain transactions may be tax shelters or enactment of any legislation effecting certain leasing transactions. Between 1997 and 2003, the MTA was the lessee in several LILO and SILO transactions involving assets with an appraised fair market value of approximately $2.9 billion. Retroactive imposition of a substantial excise tax could have a material adverse impact on MTA's ability to serve our riding public.

The Tax Increase Protection and Reconciliation Act and its legislative history does not provide a clear definition of "proceeds." As a result, MTA is also concerned that the Treasury and the IRS have insufficient guidance in defining this term during the regulatory process and may promulgate regulations with an overly broad definition of this key term. Therefore, MTA asks the Committee to focus on the economics of the transaction and include a provision that would provide a technical clarification of the definition of proceeds and would provide guidance on the allocation of both net income and proceeds that is also consistent with the position taken by the IRS in Revenue Rulings and court filings.

Thank you for your consideration of our views. For a more detailed explanation of the issue, we have attached a copy of our comment letter to the Treasury Department and IRS. If you have any further questions, please feel free to contact me.

Statement of RSM McGladrey

Introduction

RSM McGladrey is a leading professional services firm providing accounting, tax and business consulting to midsized companies. When considered together with McGladrey & Pullen (a partner-owned CPA firm), the two companies rank as the fifth largest accounting, tax and business consulting firm in the United States. Our client list represents some of the top names in manufacturing and distribution, construction, real estate, health care, financial services and the public sector. RSM McGladrey focuses on the middle market because it represents the heart of U.S. commerce and industry, with more than 500,000 businesses contributing more than 30 percent of the nation's gross domestic production and representing one third of all American workers. Companies in the middle market are a vital sector of our economy and we appreciate the opportunity to comment on legislation that affects them.

Overview

We applaud the efforts of the Committee to promote the pro-growth tax relief that is critical to the competitiveness of American exporters. Similarly, we appreciate the efforts of the Committee to advance legislation (H.R. 6264) that makes needed technical corrections to recent tax relief legislation.

In response to your request for comments on H.R. 6264, we are extremely concerned about how Section 7 will change the tax treatment of dividends paid from Interest-Charge Domestic International Sales Companies (IC–DISCs). If enacted, this provision would make a substantive change in the current tax code, resulting in a significant hidden retroactive tax increase on many privately-held manufacturing companies that export. As H.R. 6264 moves through the legislative process, we strongly urge you to drop Sec. 7 from the technical corrections bill.

Background

Continued export growth is critical to addressing our current trade deficit. While the U.S. trade deficit is large—on a seasonally adjusted basis, the August 2006 deficit in manufactured goods was at an annual rate of $536 billion—it has stayed at essentially the same range since January 2006. Export growth is stabilizing the balance. According to the Commerce Department, *August 2006 was the 10th month in a row in which manufactured goods exports rose more rapidly than imports.*

United States manufacturers play a major role in U.S. exports, exporting more than $60 billion in goods every month. In addition, exports from the United States have increased by 57 percent over the past ten years. *Nonetheless, in order for the* manufactured goods trade imbalance to shrink, i*t is critical that export growth continue since* import value is about 50 percent larger than manufactured goods exports value.

While manufacturers of all sizes are exporters, the increase in exports by midsized companies has increased significantly in recent years. According to the Commerce Department, 97 percent of all exporting manufacturers have fewer than 500 employees.

Potential Impact of Tax Law Change

If enacted, the proposed change in the tax treatment of IC–DISCs likely would have a negative impact on U.S. exports. Under current tax rules, privately-held companies that export can set up an IC–DISC that allows the deferral of taxes on certain income from export activities, as long as interest is paid on the deferred tax.

In addition, when the income is distributed to noncorporate shareholders as a dividend, it is taxed at a 15 percent rate. The amount of deferral is capped at gross annual export receipts of $10 million.

The proposed change in the IC–DISC rules would increase taxes for a number of midsized companies in the United States that export manufactured goods, making it more difficult for them to compete in the global marketplace. Over 90% of the businesses whom we represent have 1,000 or fewer employees. Most of our clients are privately held and a great many of these companies are exporters. A recent survey conducted by the National Association of Manufacturers is consistent with our experience serving midsized businesses. More than two thirds of privately, family or individually owned companies responding to the survey said that they export products.

Section 7 Is a Substantive Law Change

While the stated purpose of H.R. 6264 is to "make Congressional intent clear regarding crucial components of recent tax legislation," Section 7 of the bill goes well beyond a clarification. We believe the statutory language of the Jobs and Growth Tax Relief Reconciliation Act (2003 Act) is unambiguous as it applies to IC–DISCs. However, Section 7 would significantly increase the tax rate on dividends paid by IC–DISCs without any public debate or discussion of the policy ramifications, and with no public analysis on the proposal's impact to midsized businesses. For this reason we think it is not proper to attempt to enact such a change as a "technical correction."

We note that in 1984, and again in 2000 when the FSC regime was under challenge, the World Trade Organization (WTO) commented that the IC DISC was not to be viewed as an illegal export subsidy. Thus, we believe that a repeal of the IC–DISC regime would have been improper during consideration of the 2003 Act as this section wasn't one of the offending sections that the WTO had highlighted. Obviously, a repeal now based upon a "technical correction" to the 2003 Act makes no sense without a public debate on export tax policies impacting midsized businesses.

Many midsized businesses have made decisions to repatriate earnings or expand internationally based upon the laws in effect at the time. In addition, midsized businesses are currently making decisions to increase exports based upon tax laws applicable to such transactions. Changes to the IC–DISC regime need to be carefully considered because midsized businesses can't avail themselves of the variety of restructuring options available to larger businesses with more resources and larger scale. We respectfully believe such changes need to be done outside the "technical corrections" process.

Conclusion

The proposed change to the IC–DISC rules in H.R. 6264 represents a substantive change to current tax law that would have a negative impact on the ability of midsized businesses to export. Thank you in advance for considering our request to remove this anti-growth provision from the Technical Corrections Act of 2006.

If you have questions concerning these comments, please contact Bill Major, Managing Director, International Tax, RSM McGladrey, at 1.847.413.6236.

Sincerely,

Michael L. Metz
Executive Vice President, Tax Services

Federal Tax Committee of the Wisconsin Institute of Certified Public Accountants
Brookfield, Wisconsin 53005
October 23, 2006

The Honorable Senators Chuck Grassley and Max Baucus
U.S. Senate Committee On Finance
219 Dirksen Senate Office Building
Washington, DC 20515

The Honorable Bill Thomas, Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Gentlemen:

As an attorney for numerous small manufacturers and on behalf of the Federal Tax Committee of the Wisconsin Institute of Certified Public Accountants, I am responding to requests for comments to the Tax Technical Corrections Act of 2006 (H.R. 6264/S. 4026).

If signed into law, section 7 of the Tax Technical Corrections Act of 2006 would eliminate the incentive aspect of IC–DISCs for tens of thousands of closely-held manufacturers, a sector of the economy crucial to long-term growth and prosperity.

This comment explains why the proposed legislation is inappropriate and would go against the longstanding policy of aiding domestic manufacturers of exported goods.

1. *The Proposed Legislation Hurts U.S. Manufacturers of Exported Products.* Manufacturers are the bedrock of a prosperous economy. Manufacturing jobs generally pay higher wages and have more generous benefits than jobs in other sectors. Furthermore, manufacturing jobs are considered especially valuable because they import wealth from around the world. Through their interactions with others, manufacturers spur demand in the retail, service and not-for-profit sectors. Now, however, with manufacturers closing U.S. plants and moving production to less expensive foreign locations, this ripple effect is working in reverse, magnifying the economic disruption caused by manufacturer exodus. The proposed legislation would effectively eliminate a key export incentive that helps put domestic manufacturers in an economic position closer to that of their foreign counterparts. Eliminating the incentive aspect of IC–DISCs will negatively effect domestic manufacturers, leading to reduced exports, lower productivity and fewer jobs.

2. *The Proposed Legislation is Unnecessary.* More than merely providing a "technical correction," the proposed legislation would work a substantive change by eliminating an export benefit that has existed without question. Nothing in the text or legislative history of the Jobs and Growth Tax Relief Reconciliation Act of 2003 suggests that the current tax rate on dividends paid from an IC–DISC is something that requires correction.

Furthermore, the Joint Committee's description of the Tax Technical Corrections Act of 2006 tries to argue that the proposed legislation is similar to the denial of a dividends received deduction on dividends received from an IC–DISC found in Code section 246(d). That section does deny the dividends received deduction with respect to dividends received from IC–DISCs because those dividends have not yet been subject to corporate-level tax. Code section 246(d)'s sole purpose is to prevent corporate shareholders of IC–DISCs from avoiding corporate-level tax on IC–DISC dividends altogether. However, this problem does not exist with respect to non-corporate IC–DISC shareholders because there is no corporate-level tax to avoid.

3. *The Proposed Legislation Goes Against the Longstanding Policy of Aiding Domestic Manufacturers of Exported Goods.* A review of the history of export incentives shows that Congress has a longstanding policy of aiding domestic manufacturers of exported goods and has only abandoned this policy after significant pressure from our foreign trading partners. Our foreign trading partners have not objected to the rate of tax paid by individuals on dividends received from IC–DISCs, making abandonment of this policy through the proposed legislation inappropriate.

In 1971, Congress enacted the domestic international sales corporation ("DISC") regime in an attempt to stimulate U.S. exports. A DISC afforded U.S. exporters some relief from U.S. tax on a portion of their export profits by allocating those profits to a special type of domestic subsidiary known as a DISC. In the mid-1970s, foreign trading partners of the United States began complaining that the DISC regime was an illegal export subsidy in violation of the General Agreement on Tariffs and Trade ("GATT").

In 1984, Congress enacted the foreign sales corporation ("FSC") regime as a replacement for the DISC regime in response to the GATT controversy. The FSC regime required U.S. exporters to establish a foreign corporation that performs certain activities abroad in order to obtain a U.S. tax benefit. Rather than repeal the DISC regime, Congress modified it to include an interest charge component, making all DISCs from that point forward IC–DISCs. Manufacturers often did not take advantage of the IC–DISC because until recently other regimes, such as the FSC and ETI exclusion, were more attractive.

In 1998, the European Union filed a complaint with the World Trade Organization ("WTO") asserting that the FSC regime, similar to the original DISC regime that preceded it, was an illegal export subsidy in violation of the GATT. In 1999, the WTO released its report on the European Union's complaint, ruling that the FSC regime was an illegal export subsidy that should be eliminated by 2000.

In 2000, Congress responded to the WTO's ruling by enacting the FSC Repeal and Extraterritorial Income Exclusion Act of 2000. The new extraterritorial income ("ETI") exclusion afforded U.S. exporters essentially the same tax relief as the FSC regime. Consequently, the ETI exclusion did not end this trade controversy as the WTO subsequently ruled that the ETI exclusion was an illegal export subsidy that should be eliminated.

In 2004, Congress enacted the American Jobs Creation Act of 2004 ("2004 Act"), which phased out the ETI exclusion while phasing in a domestic production deduction ("DPD"). With the elimination of the ETI exclusion, the only remaining incentive for exports was the IC–DISC. Rather than encouraging exports, the DPD allows a deduction for certain domestic production activities. While exporting manufacturers may take advantage of the DPD, the tax relief (and concomitant incentive to export) of the DPD is far less than that afforded by the IC–DISC.

As the foregoing history shows, Congress has only removed export incentives under significant pressure from our foreign trading partners. As our foreign trading partners have not objected to the tax rate on dividends received from IC–DISCs, it is inappropriate for Congress to abandon its longstanding policy of aiding domestic manufacturers of exported goods.

4. *The Proposed Legislation Unfairly Impacts Exporters.* The proposed legislation unfairly impacts exporters who have relied on current law to arrange their affairs by applying retroactively to all dividends paid from IC–DISCs since the date of its introduction. Even in the face of challenges and discontent by the European Union, the transition periods for each of the FSC and ETI regimes began several months after the dates of their introduction and lasted at least two years.

Here in the Midwest, America's heartland, we are home to more than one-third of all manufacturing jobs in the United States and generate more than $100 billion in revenue from exports each year. The proposed legislation will harm tens of thousands of hard-working small businesses whose value to the economy cannot be overstated. Furthermore, the proposed legislation has no basis in the text or legislative history of the Jobs and Growth Tax Relief Reconciliation Act of 2003 and penalizes exporters who reasonably relied on the law. Accordingly, section 7 of the Tax Technical Corrections Act of 2006 should not be enacted into law.

Yours very truly,

Robert J. Misey, Jr., Esq.

Small Business Exporters Association
October 27, 2006

Hon. Bill Thomas
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Thomas,

On behalf of the more than 22,000 small and mid-sized exporting companies that belong to the Small Business Exporters Association of the United States and its affiliated nonprofit organization, the National Small Business association, SBEA would like to comment on H.R. 6424, the Tax Technical Corrections Act of 2006.

We appreciate the conscientious work that went into this legislation, as well as its companion bill S.4026, by the members and staff of the House Ways and Means Committee, the Senate Finance Committee, and the Joint Committee on Taxation. We know that many provisions of the bill will help clarify the tax code for taxpayers, tax practioners, and Congress itself.

However, we do wish to draw the attention of the Ways and Means Committee to one section of the bill that we believe requires a more extensive analysis and more public input than it is likely to receive in this bill.

Section 7 of the bill would significantly change the tax treatment of Interest Charge Domestic International Sales Corporations (IC–DISC's). We believe these changes would unnecessarily harm small U.S. exporters, notably those who manufacture their products.

Change would disrupt businesses. The IC–DISC form of business organization is best suited for privately-held companies with few shareholders, such as smaller C corporations and pass-through entities like S Corporations. Consequently, nearly all of the companies utilizing the IC–DISC are small. Our members who use IC–DISC's tell us that they spent tens of thousands of dollars, and considerable amounts of time, structuring their companies so as to utilize the IC–DISC format, on the basis of assurances from attorneys and CPA's that this form of organization was approved by Congress and the World Trade Organization.

Not only would a change in the tax treatment of IC–DISC's expose these companies to much greater than anticipated federal taxes, but it would require them to yet again restructure their companies, yet again spend tens of thousands of dollars on attorneys and accountants, and yet again divert precious management time to all of this.

For a larger company, spending tens of thousands of dollars and many hours of management time is not inconsequential, but it can at least be spread over tens or hundreds of millions of dollars in sales and dozens of managers. Not so a smaller company. For them, this would be a real blow.

The sudden decision by the tax-writing Committees, in the closing hours of the last session of Congress, to focus on this provision means that almost none of these affected companies are prepared for this change. Indeed, the American Institute of Certified Public Accountants has just finished holding two programs, in Chicago and San Francisco, advising accountants and companies on how to structure IC–DISC's. (Two more such programs are planned soon.)

Legal under the WTO. The IC–DISC is qualitatively different from other forms of business organization by exporters that have been invalidated by WTO decisions. In the first place, IC–DISC shareholders pay interest on any deferred taxes. Secondly, the type of taxation and the tax rates levied on IC–DISC income (dividend income taxation and rates) are available not only to exporters, but to a broad swath of U.S. taxpayers. Thus, the IC–DISC has never been challenged, and indeed the WTO has specifically exempted it from its earlier decisions affecting DISC's and FSC–ETI. So we see no external reason to tamper with it.

Would increase taxes. An upward revision in the tax rates on IC–DISC revenue would affect, at a bare minimum, many hundreds of companies and many millions of dollars in revenues. This is a tax increase; there is no other way to view it. Historically, and as a matter of fairness, Congress has allowed those affected by tax increases ample opportunity to express their views to their elected representatives. That process has included the commissioning of economic studies and the debating of alternatives. It has also included allowing ample lead time for those affected to plan and adapt.

None of that has occurred in this situation. With no advanced warning or publicity, a significant tax increase has been proposed for a whole swath of taxpayers—in the closing moments of a Congressional session just before an election. It is further proposed that Congress approve this tax increase a week or two after the election, in a "lame duck" session that may last only a few days. Most of those affected are small companies who aren't "plugged in" to Washington and have no idea what could be coming their way. This isn't right or fair.

A substantive change. Sometimes, what seems like a modest tweak to analysts who concentrate closely on the tax code will seem far more sweeping to those who experience the change. We can understand how the IC–DISC proposal might seem small to some, and therefore end up in a "Technical Corrections" bill. IC–DISC's have grown quietly over a period of years, and those outside the manufacturing and exporting communities are probably not that familiar with them. But perhaps more than any other provision in the "Tax Technical Corrections" bill, this one has far-reaching ramifications. It is truly a substantive change. It deserves careful deliberation. We ask the Committees to refrain from acting on this provision until that more careful deliberation has occurred.

Trade policy considerations. Changing IC–DISC's is not simply a matter of tax policy. It is also a matter of trade policy. How can the U.S. best deal with a trade deficit that is rapidly ascending to $1 trillion a year? What needs more emphasis—and less emphasis? Engaging American small and mid-sized enterprises in international trade would seem to be a crucial piece of the puzzle. Virtually all of our country's largest companies are fully globalized, but fewer than 10% of U.S. companies that have less than one hundred employees export. How can we address the cost of entry hurdles that keep smaller companies out of the international marketplace?

How, too, can we address the global price advantage that border-adjustable taxes give to countries that offer them? Shall we wait years or decades for an overhaul of the U.S. tax system—as trade deficits continue rising unimpeded—or shall we do something sooner?

SBEA urges the Committee to take the time to explore these issues before acting on the IC–DISC proposal.

Regards,

James Morrison
President

The Small Business Exporters Association of the United States

SBEA is the nation's oldest and largest nonprofit organization exclusively representing small and mid-size companies in international trade. SBEA is proud to serve as the international trade council of the National Small Business Association, the nation's oldest nonprofit advocacy organization for small business.

Statement of National Association of Manufacturers

Overview

The National Association of Manufacturers—the nation's largest industrial trade association—represents large, mid-size and small manufacturers in every industrial sector and in all 50 states. The NAM's mission is to enhance the competitiveness of manufacturers by shaping a legislative and regulatory environment conducive to U.S. economic growth and to increase understanding among policymakers, the media and the general public about the vital role of manufacturing to America's economic future and living standards.

NAM members applaud the efforts of the Committee to promote the pro-growth tax relief that is critical to the competitiveness of American manufacturers. Similarly, we appreciate the efforts of the Committee to advance legislation (H.R. 6264) that makes needed technical corrections to recent tax relief legislation.

In response to your request for comments on H.R. 6264, the NAM is extremely concerned about a provision (Section 7) included in the bill that would change the tax treatment of dividends paid from interest-charge Domestic International Sales Companies (IC DISCs). If enacted, this provision would make a substantive change in the current tax code, resulting in a tax increase on many privately-held manufacturing companies that export. As H.R. 6264 moves through the legislative process, we strongly urge you to drop Sec. 7 from the technical corrections bill.

Background

Continued export growth is critical to addressing our current trade deficit. While our trade deficit is large—on a seasonally adjusted basis, the August 2006 deficit in manufactured goods was at an annual rate of $536 billion—it has stayed at essentially the same range since January 2006. Export growth is stabilizing the balance. According to the Commerce Department, *August 2006 was the 10th month in a row in which manufactured goods exports rose more rapidly than imports.*

U.S. manufacturers play a major role in U.S. exports, exporting more than $60 billion in goods every month. In addition, exports from the United States have increased by 57 percent over the past ten years. *Nonetheless, in order for the manufactured goods trade imbalance to shrink, it is critical that export growth continue since* import value is about 50 percent larger than manufactured goods exports value.

While manufacturers of all sizes are exporters, the increase in exports by smaller companies has increased significantly in recent years. According to the Commerce Department, 97 percent of all exporting manufacturers have fewer than 500 employers. The NAM has tracked the exporting experience of smaller manufacturers for more than a decade. Based on a recent NAM survey, current export activity among smaller companies has doubled since 2001.

Potential Impact of Tax Law Change

If enacted, the proposed change in the tax treatment of IC–DISCs likely would have a negative impact on U.S. exports.

Under current tax rules, a U.S. manufacturing company that exports can set up a small IC–DISC that allows the deferral of taxes on certain income from export activities, as long as interest is paid on the deferred tax. In addition, when the income is distributed to noncorporate shareholders as a dividend, it is taxed at a 15 percent rate. The amount of deferral is capped at gross annual receipts of $10 million.

The proposed change in the IC–DISC rules would increase taxes for privately-held companies in the United States that export manufactured goods, making it more difficult for them to compete in the global marketplace. Roughly 90% of NAM's small and medium size companies (SMMs)—generally those with 1,000 or fewer employees—are privately held and many of these companies are exporters. In a recent survey of NAM's smaller members, more than two thirds of privately, family or individually owned companies responding to the survey said that they export products.

A Substantive Change

While the stated purpose of H.R. 6264 is to "make Congressional intent clear regarding crucial components of recent tax legislation, "Section 7 of the bill goes well beyond a clarification. Specifically Section 7 would significantly increase the tax rate on dividends paid by IC–DISCs, a substantive change to existing law, rather than a "technical correction."

Conclusion

In sum, the proposed changed to the IC–DISC rules in H.R. 6264 represents a substantive change to current tax law that would have a negative impact on the ability of some U.S. companies to export. Thank you in advance for considering our request to remove this anti-growth provision from the Technical Corrections Act of 2006. The NAM looks forward to continuing to work with Congress, the Administration and others to promote progrowth tax relief that encourages broad based economic growth and U.S. competitiveness.

Extended Stay, Inc.
October 31, 2006

The Honorable William M. Thomas
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Charles B. Rangel
Ranking Member
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Thomas and Ranking Member Rangel:

In response to the Committee's request, dated September 29, 2006, for comments on the Tax Technical Corrections Act of 2006 (H.R. 6264) and proposals for additional technical corrections, we respectfully request that you consider including in the bill a new provision that would clarify the application of the "transient basis" test that is used to define a "lodging facility" in section 856(d)(9)(D)(ii) for purposes of the real estate investment trust ("REIT") rules regarding taxable REIT subsidiaries ("TRS").[1]

We are submitting this request on behalf of Extended Stay, Inc. ("ESI"), which is a hospitality industry REIT with over 600 lodging properties located across the United States—approximately 550 of which are owned by ESI and leased to TRSs. As its name suggests, ESI specializes in a hospitality market segment that consists of longer term (but nevertheless temporary) occupancies. As discussed more fully below, a clarification of the TRS transient basis test would address an area of significant uncertainty for all hospitality industry REITs that utilize a TRS structure.

Background

To qualify as a REIT, an entity must derive at least 95 percent of its gross income from sources listed in section 856(c)(2) and at least 75 percent of its gross income from sources listed in section 856(c)(3). Although rents from real property generally are treated as qualifying income for purposes of these tests, income from providing hotel accommodations to guests is not treated as qualifying income due to the service element associated with providing hotel accommodations. However, the REIT rules provide that a REIT's gross income derived from a hotel property can be treated as qualifying income if the REIT leases the hotel property to a third party operator or a TRS (which, in turn, must contract with a third party to operate the property).

The lease payments from a TRS to the REIT under such an arrangement are treated as rents from real property (i.e., qualifying income under the REIT income tests), provided the leased property constitutes a "lodging facility" (among other requirements). Section 856(d)(9)(D)(ii) defines a "lodging facility" as a "hotel, motel, or other establishment more than one-half of the dwelling units in which are used on a transient basis." The term "transient basis" is not defined in section 856 or any regulations thereunder, notwithstanding the fact that a failure to satisfy the transient basis test could result in a loss of REIT status.

In the aftermath of Hurricanes Katrina and Rita last year, the hospitality industry provided (and continues to provide) lodging for evacuees, employees of displaced businesses, and relief workers for extended periods of time. To assist hospitality industry REITs in meeting these critical housing needs without impacting their compliance with the transient basis test, the Internal Revenue Service (the "IRS")

[1] Unless otherwise noted herein, all references to "section" are to the Internal Revenue Code of 1986, as amended (the "Code").

issued two notices providing a limited and temporary clarification of the transient basis test.

The IRS announced in Notice 2005–89, 2005–49 I.R.B. 1077, that, for purposes of the "lodging facility" definition under section 856(d)(9)(D)(ii), it would treat a dwelling unit within a property as being used on a transient basis if the unit was used to provide shelter to evacuees, displaced employees or relief workers during the 6-month period beginning on August 28, 2005 (the date of the President's first major disaster declaration resulting from Hurricane Katrina). Due to the magnitude of the damage resulting from Hurricanes Katrina and Rita, the IRS later extended and modified this guidance with the issuance of Notice 2006–58, 2006–28, I.R.B. 59. ***In both Notices, the IRS acknowledged that "Section 856 and the regulations thereunder do not define the term transient basis'."***

Permanent Clarification of the Transient Basis Test

While the IRS Notices provided welcome and needed clarification of the section 856(d)(9)(D)(ii) transient basis test under extenuating circumstances, this clarification is only temporary and limited to occupancies related to Hurricanes Katrina and Rita. As an addition to the pending technical corrections bill, we respectfully request that the application of the section 856(d)(9)(D)(ii) transient basis test be clarified permanently and generally, either by providing a 6-month quantitative standard for the test (Alternative #1) or by clarifying that the transient basis test does not apply to properties that are hotels or motels (Alternative #2).

Alternative #1—Clarify that the transient basis test is applied using a six (6)-month period.

While other Code sections employ variations of the transient basis test,[2] there is no consistent definition of what constitutes a transient basis. In fact, we are aware of only a few instances in which such a definition has been provided.[3]

The term "transient basis" is used in section 42(i)(3)(B)(i) which, for purposes of the low-income housing credit, defines a "low-income unit" as any unit that (among other things) is "used other than on a transient basis." As is the case with regard to section 856(d)(9)(D)(ii), neither section 42 nor the regulations thereunder define the term "transient basis". However, legislative history discussing the low-income housing credit indicates that transient basis use of a unit refers to occupancy periods of less than six months: "Generally, a unit is considered to be used on a non-transient basis if the initial lease term is six months or greater." H.R. Conf. Rep. No. 99–841, at 4183 (1986).

We believe that the uses of the term "transient basis" in the section 42 low-income housing credit and in the section 856 REIT TRS rules serve the same purpose. In both cases, the term is intended to distinguish between property which is used to provide temporary lodging for guests and property which is used to provide permanent housing for residents. Therefore, if a quantitative standard is used to clarify the application of the transient basis test in determining whether property constitutes a "lodging facility" under section 856(d)(9)(D)(ii), we would suggest using the same 6-month standard that is used in determining whether a unit is a low-income unit for purposes of the low-income housing credit. ***This clarification also would be consistent with the temporary and limited clarification that was provided in the IRS Notices relating to Hurricanes Katrina and Rita, which itself presumably found support from the low-income housing credit for using a 6-month period.***

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[2] For example, under the investment credit recapture rules of section 50(b)(2)(B), property used for lodging is not eligible for the credit except for "property used by a hotel or motel in connection with the trade or business of furnishing lodging where the predominant portion of the accommodations is used by transients." Another example of the transient basis test can be found in the accelerated cost recovery system depreciation rules of section 168. In distinguishing between an apartment lodging facility, which qualifies as residential rental property with a 27.5-year recovery period, and a hotel/motel, which does not qualify as residential rental property (and has a 39-year recovery period), section 168(e)(2)(A)(i) provides that the term "residential rental property" means any building or structure if 80 percent or more of the gross rental income from such building or structure for the taxable year is rental income from dwelling units. For this purpose, section 168(e)(2)(A)(ii)(I) provides that the term "dwelling unit" means a house or apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, or other establishment more than one-half of the units in which are used on a transient basis.

[3] See, e.g., former Treas. Reg. section 1.167(k)-3(c) and Treas. Reg. section 1.48–1(h)(2)(ii). These regulations provide (or provided) that a facility is treated as used on a transient basis if the facility is used more than 50 percent of the time for occupancies of less than 30 days. Although section 48 itself was repealed in 1990, the Treasury regulations under section 48 (including Treas. Reg. section 1.48–1(h)(2)(ii)) have never been removed.

Proposed language—Under Alternative #1, Section 856(d)(9)(D)(ii) would be amended to read to as follows:

"(ii) LODGING FACILITY.—The term lodging facility' means a hotel, motel, or other establishment more than one-half of the dwelling units in which are used by persons who occupy the unit for less than 6 months." [4]

Alternative #2—Clarify that the transient basis test applies only to establishments other than hotels and motels.

Beyond the absence of a definition of the term "transient basis", the scope of application of the transient basis test for purposes of section 856(d)(9)(D)(ii) is unclear with regard to whether the test even applies to properties that are hotels or motels. The relevant statutory language of section 856(d)(9)(D)(ii)—"hotel, motel, or other establishment more than one-half of the dwelling units in which are used on a transient basis"—could be interpreted as providing that the transient basis test only applies to "other establishment[s]" and not to hotels or motels, particularly since the terms "hotel" and "motel" would appear to be surplusage if, instead, the transient basis test applies to all properties without regard to whether they are "hotels", "motels" or "other establishment[s]".[5]

Such an interpretation does place some definitional pressure on the terms "hotel" and "motel". However, these terms are used in several other Code sections, often without any accompanying definitional detail.[6] With regard to whether a property constitutes a "lodging facility" under section 856(d)(9)(D)(ii), we believe that the plain meaning of these terms is sufficiently clear in the vast majority of circumstances without the need for further statutory definition. Even in the handful of cases in which there might be some factual question concerning whether a particular property constitutes a hotel or motel, there are certain distinctive features of hotels and motels that can be identified and an analysis of the property in question performed to determine whether the property possesses the requisite characteristics of a hotel or motel.

For example, hotels and motels may be subject to applicable local occupancy taxes that do not apply to residential property, and their sites generally are zoned specifically for use by a hotel or motel. In addition, the nature of the contractual relationship between the provider and occupant of the dwelling units in question (i.e., guest registration versus negotiated lease) may be determinative of this issue.

While there may be a few isolated situations in which the terms "hotel" and "motel" by themselves are somewhat ambiguous and pose some interpretive difficulty, the statutory language of section 856(d)(9)(D)(ii) at least should be more clear about whether properties that are hotels or motels also must satisfy the transient basis test. If hotels and motels are required to satisfy the transient basis test, then we believe that the transient basis test itself needs to be more clearly defined, as proposed by Alternative #1 above. If not, then we believe that section 856(d)(9)(D)(ii) needs to be restated to clarify that the transient basis test applies only to "other establishment[s]" and not to "hotels" or "motels". The proposed language below would accomplish this by simply dividing the clause into separate subclauses.

Proposed language—Section 856(d)(9)(D)(ii) would be amended to read as follows:

"(ii) LODGING FACILITY.—The term 'lodging facility' means—

(I) a hotel or motel, or

(II) any other establishment more than one-half of the dwelling units in which are used on a transient basis."

We appreciate your consideration of our request to clarify the section 856(d)(9)(D)(ii) transient basis test in the pending technical corrections legislation.

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[4] The proposed language eliminates any reference to the term "transient basis" because a quantitative standard would supplant the need to use the term, thereby avoiding any unintended interpretive consequences for other Code sections that use the term. A further refinement to the proposed language also might eliminate the terms "hotel" and "motel" as surplusage if the transient basis test applies to all "establishments" without regard to whether they are hotels or motels.

[5] See Lawrence Filson, The Legislative Drafter's Desk Reference, Congressional Quarterly, Inc. (1993), at 234 ("When setting forth a series of items in a sentence either in conjunctive or disjunctive form, the last two items in the series, like the earlier items, should be separated by a comma. . . . The omission of the final comma in the series—a common practice in expository writing—sometimes invites the misreading that the last item is part of the preceding one. . . .").

[6] See former section 48(a)(3)(B) and sections 50(b)(2)(B), 168(e)(2)(A)(ii)(I), 179D(f)(2)(C)(i), 280A(f)(1)(B), 1202(e)(3)(E), and 3121(d)(3)(D).

We would be happy to meet with you to discuss this issue further. Please feel free to contact us at (202) 344–4034 (Sam Olchyk) or (202) 344–4406 (Ray Beeman).

Sincerely yours,

Samuel Olchyk
E. Ray Beeman

U.S. Securities Markets Coalition
November 8, 2006

The Honorable William M. Thomas
Chairman
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Charles E. Grassley
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20515

The Honorable Charles B. Rangel
Ranking Member
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Max S. Baucus
Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20515

Gentlemen:

This letter and the attached memorandum set forth the comments of the U.S. Securities Markets Coalition (the "Coalition") regarding the Tax Technical Corrections Act of 2006 (H.R. 6264 and S. 4026) (the "Bill"). The members of the Coalition include the American Stock Exchange, the Boston Options Exchange, the Boston Stock Exchange, the Chicago Board Options Exchange, the Chicago Stock Exchange, Depository Trust & Clearing Corporation, the International Securities Exchange, the NASDAQ Stock Market, the National Stock Exchange, NYSE Arca, the Options Clearing Corporation, and the Philadelphia Stock Exchange. All trading in listed equity options in the United States takes place on exchanges that are members of the Coalition.

The Coalition's comments relate to section 6(c) of the Bill, which contains amendments to the "identified straddle" provisions of Code section 1092. Those provisions were substantially revised by the American Jobs Creation Act of 2004 ("AJCA"). The Coalition generally supports the approach reflected in the proposed amendments and believes that they will eliminate the uncertainty created by AJCA with respect to the treatment of losses on positions in identified straddles when there are no gains on offsetting positions.

There is, however, one aspect of the proposed changes that we believe warrants further consideration. As explained in the attached memorandum, the Bill would expand the requirements for making a proper identification of an identified straddle to include the requirement that the taxpayer identify which positions in the identified straddle are offsetting with respect to one another. Under the Bill, this change would apply retroactively to the effective date of the AJCA provisions. As explained in the attached memorandum, we question whether this additional requirement is necessary or appropriate and recommend that Congress leave to Treasury's regulatory authority the issue of whether and under what circumstances such additional information would be useful. In addition, taxpayers could not have known of this new requirement prior to the introduction of the Bill, and it is highly likely that many taxpayers, including individuals, did not immediately become aware of the expanded requirement upon introduction of the Bill. Accordingly, we suggest that if this amendment is preserved in the final version of the Bill, its effective date should be tied to the date the Bill is enacted.

Sincerely yours,

William M. Paul

Tax Technical Corrections Act of 2006 (H.R. 6264, S. 4026)

Expanded Identification Requirement for "Identified Straddles" Under Code section 1092(a)(2)

Code Section 1092(a)(2) provides special rules for identified straddles. These rules were substantially revised by the American Jobs Creation Act of 2004 ("AJCA"). In order for these special rules to apply, a taxpayer must identify the straddle as an identified straddle by the close of the day on which the straddle is acquired (or such earlier time as Treasury may specify by regulation). Treasury has authority to specify, by regulations or other guidance, the proper methods for clearly identifying a straddle as an identified straddle and for identifying the positions comprising such straddle.[1]

Section 6(c)(2) of the Tax Technical Corrections Act of 2006 (the "Bill") would expand the identification requirement by requiring taxpayers not only to identify the positions making up the identified straddle but also to identify "the positions in the straddle which are offsetting with respect [to] other positions in the straddle." The Joint Committee Staff's description of this provision states as follows:

"Under present law, a straddle is treated as an identified straddle only if, among other requirements, it is clearly identified on the taxpayer's records as an identified straddle before the earlier of (1) the close of the day on which the straddle is acquired, or (2) a time that the Secretary of the Treasury may prescribe by regulations. The provision clarifies that for purposes of this identification requirement, a straddle is clearly identified only if the identification includes an identification of the positions in the straddle that are offsetting with respect to other positions in the straddle. Consequently, taxpayers are required to identify not only the positions that make up an identified straddle but also which positions in that identified straddle are offsetting with respect to one another."[2]

This change, as well as the other changes that the Bill would make to Code section 1092(a)(2), would take effect as if included in AJCA.[3]

The U.S. Securities Markets Coalition (the "Coalition") questions whether this additional requirement is necessary or appropriate. In the vast majority of straddles, it will be evident which positions in the identified straddle are "long" positions and which positions are "short" positions. This will certainly be true for identified straddles that consist of stock and options with respect to such stock. For example, if a taxpayer identifies 1,000 shares of stock and put options on those shares as an identified straddle, it is perfectly clear that the put options are offsetting positions to the stock. Treating identification of such an identified straddle as invalid for failure to state expressly that the put options offset the stock will needlessly cause a taxpayer who inadvertently omits such a statement to be subject to the general loss deferral rule of section 1092(a)(1).[4] Accordingly, the Coalition recommends that any rules along these lines be left to Treasury regulations. Such regulations could, for example, describe some subset of identified straddles with respect to which imposing the additional requirement would result in providing the Internal Revenue Service with useful information.

We also note that the requirement that taxpayers identify which positions in the identified straddle are offsetting with respect to one another is a new requirement that taxpayers could not have been aware of or anticipated prior to the introduction of the Bill. While the introduction of the Bill may be viewed as putting taxpayers on notice of the new requirement, as a practical matter many taxpayers, including individuals, who are likely to avail themselves of the identified straddle rules would not immediately become aware of the requirement on September 29, 2006, the day the Bill was introduced. Accordingly, if the new requirement is retained in the final

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[1] See Code § 1092(a)(2)(C).

[2] Joint Committee on Taxation, Description of the Tax Technical Corrections Act of 2006 (JCX–48–06) at 9–10.

[3] See section 6(d) of the Bill.

[4] Alternatively, there may be uncertainty as to whether section 1092(a)(2) would nevertheless apply to such a straddle. Under section 1092(a)(2), Treasury has authority to specify the rules for applying section 1092 to taxpayers who fail to comply with the identification requirements. Until Treasury exercises that authority, taxpayers who fail to satisfy the proposed new requirement might be in a position to whipsaw the government.

version of the Bill, the Coalition recommends that it not apply with respect to identified straddles entered into before the date the Bill is enacted.

We recognize that technical corrections typically have the same effective date as the provisions they amend. However, that is not always the case. For example, section 7 of the Bill would amend the 2003 legislation relating to "qualified dividend income" eligible for the 15% rate by excluding certain dividends paid by a DISC or former DISC. This change would apply to dividends received on or after September 29, 2006, the date the Bill was introduced. In addition, the change made by section 5(d)(3) of the Bill, relating to certain 2005 amendments to the LUST tax provisions, would apply to fuel sold after the date the Bill is enacted. Similar examples of delayed effective dates for technical corrections can be found in prior technical corrections legislation.[5] Thus, while there is a presumption that the effective date of a technical correction should relate back to the effective date of the provision being amended, a later effective date may appropriately be adopted where, as here, there is reason to do so.

LI–COR, Inc.
October 31, 2006

To Whom It May Concern:

I am writing with respect to Section 7. of H.R. 6264 and companion S. 4026—Tax Technical Corrections Act of 2006.

I am VERY confused. After decades of doing continual battle with World Trade Organization accusations of unfair trade practices and multiple varieties of legislation (DISC, FSC, ETI, etc.) enacted in a conscientious effort to appease the WTO and yet encourage export activities, we have finally found a vehicle, the IC–DISC, which serves the purpose and is also apparently acceptable to the WTO. And what do we do? Potentially "shoot ourselves in the foot" by introducing the above referenced legislation!

At $35 million of Sales (70% export) and 230 employees, LI–COR is not a major player in world economic markets. But I do believe companies our size and legions of even smaller companies do collectively comprise an extremely large constituency for whom export tax incentives DO make a difference. We established a DISC back in the early 1980's and have taken advantage of this legislation and successors since that time. It has meant hundreds of thousands of "incremental" investment dollars available, by virtue of reduced taxes, that has financed the growth LI–COR has experienced and therefore has been plowed right back into our local and national economies. In the economic circle, this reinvestment of tax-saved dollars has, of course, resulted ultimately in substantially increased tax dollars coming back to numerous government units as a consequence of higher employment levels, goods and services purchased, etc. etc.

There are a variety of legislative measures Congress could consider to continue encouraging export activities. I'm sure the appropriate legislative parties are aware of all of them and I am confident they will all be given due consideration. At the same time and particularly since the impetuous behind the above referenced legislation did not come from external sources (i.e. the WTO), it seems perfectly reasonable that current law remain in effect as is, including the 15% tax rate on IC–DISC dividend distributions.

If this country is to remain competitive in the world marketplace, it is IMPERATIVE export incentives be preserved. And it is cumbersome and problematic in a variety of ways to us as "the players" to continually be changing the playing field. Fair and reasonable legislation needs to be in place and it needs to be consistent in application from year to year. Significant plans are built around existing tax legislation at any point in time, and it is one thing to "tweek' things but it is an entirely different matter to alter fundamental structure!

Thank you for your consideration, and I urge you in the STRONGEST terms to reconsider the ramifications of Section 7. of H.R. 6264 and companion S. 4026 as it currently stands. Please remove this "correction" from the Bill in its entirety so

[5] *See, e.g.,* Tax Technical Corrections Act of 2005, enacted as part of the Gulf Opportunity Zone Act of 2005, § 402(m)(3).

that the full ramifications of any potential changes can be properly and thoughtfully considered at a more appropriate and later date.

Respectfully,

Gordon Quitmeyer
Treasurer

Statement of Real Estate Roundtable

Section by Section Analysis

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

Bill Language

Section 470(e)(1)—

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

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

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

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

Section 470(e)(4)—

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

Commentary

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

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

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

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

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

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

Recommendation

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

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

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

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

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

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

Bill Language

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

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

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

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

Commentary

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

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

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

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

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

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

Recommendations

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

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

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

Bill Language

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

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

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

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

Commentary

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

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

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

Recommendations

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

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

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

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

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

Bill Language

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

Commentary

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

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

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

Recommendation

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

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

Bill Language

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

Commentary

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

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

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

Recommendations

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

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

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

Bill Language

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

Commentary

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

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

Recommendation

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

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

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

Proposed Language

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

Commentary

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

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

Recommendation

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

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

Bill Language

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

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

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

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

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

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

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

Commentary

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

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

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

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

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

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

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

Bill Language

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

Commentary

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

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

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

Recommendations:

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

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

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

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

Proposed Language

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

Commentary

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

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

Recommendation

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

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

Proposed Language

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

Commentary

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

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

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

Recommendation

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

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

10. Section 470(b)(C)(4)—Regulatory Catch All Authority

Proposed Language

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

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

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

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

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

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

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

Commentary

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

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

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

Recommendation

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

13. Effective Date

Proposed Language

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

Commentary

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

Recommendation

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

Rebar & Associates, PLLC
October 31, 2006

I am writing to you to express my concerns with Section 7 of the Technical Corrections Act of 2006 and specifically with the changes proposed to the treatment of dividends paid by an IC DISC.

We oppose the proposed changes to the treatment of dividends paid by an IC DISC. First, this change does not seem fitting as a "technical correction". Rather it is a fundamental change in the treatment of dividends as paid by an IC DISC. We believe any such fundamental change in tax law should be addressed the same way in which any other fundamental changes in tax law are addressed, which is through the tax approval process and not as a technical correction.

Second, the suddenness of the enactment date of the proposed change undermines basic business planning. We are a CPA firm who provides services to closely held businesses. These businesses for the most part are under $25mm in annual sales and owned by less than five people. All are US companies who provide US jobs and export their goods. These businesses plan annually and as a part of that planning take into consideration tax costs and benefits when making their decisions. Most all of the business that avail themselves of the treatment of IC DISC dividends make such payments at the end of the year. This is because most small businesses do not know where their profitability will come out until late in the year. To suddenly adversely change the tax law will have a very negative effect on many small business owners undermining solid business planning and harming the small business owner.

I respectfully request you eliminate this provision from the technical corrections act leaving it to be addressed through the tax writing process. If it is the committee's belief that this major change in tax treatment of dividends is within the technical corrections process, I respectfully request that such enactment date be effective December 31, 2006 so as to not damage small businesses that have planned for and relied upon this area of tax law. The IC DISC rules were put in place to help small businesses who provide U.S. based employment and who export to foreign countries. This sudden change in the tax law late in the year will have the opposite effect.

Respectfully submitted,

Robert J. Rebar
Managing Member

New York State Society of Certified Public Accountants
New York, New York 10016
October 31, 2006

House Ways and Means Committee
U.S. House of Representatives
1102 Longworth House Office Building
Washington D.C. 20515

Ladies and Gentlemen:

The New York State Society of Certified Public Accountants, representing 30,000 CPAs in public practice, industry, government and education, submits the following comments to you regarding the technical corrections bill captioned above.

The NYSSCPA thanks Ways and Means for the opportunity to comment on this proposed legislation.

The NYSSCPA International Taxation Committee deliberated the bill and prepared the attached comments. If you would like to discuss the comments further with the Committee, please contact Cristina N. Wolff, CPA, Chair, International Taxation Division Committee at 212–682–1600 or Ernest J. Markezin, CPA or William Lalli, CPA, NYSSCPA staff, at 212–719–8300.

Sincerely,

Thomas E. Riley, CPA
President

TAX TECHNICAL CORRECTIONS ACT OF 2006 HR6264—SECTION 7, AMENDMENT RELATED TO THE JOBS AND GROWTH TAX RELIEF RECONCILIATION ACT OF 2003 (REPEAL OF 15% IC–DISC)

Principal Drafter

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Paul Dailey
Steven Davis
Alan R. Deutsch
Thomas J. Flattery
Alfred Floramo
Melissa S. Gillespie
Kadir R. Karabay
Norman A. Levine
Antonio Malavasi
Richard W. Margaroli
Richard D. Nichols
Gerard P. O'Beirne
Lawrence A. Pollack
Monica A. Rannige

Donald Reisinger
Gentiana Shameti
Stanley G. Sherwood
Lawrence E. Shoenthal
Mitchell Sorkin
Jonathan Tierney
Philip Van Schuyler
Ann-Christine Westerlund
Paul Zambito

General Comments

The International Taxation Committee (the Committee) of the New York State Society of Certified Public Accountants has reviewed the above-referenced technical corrections bill and has the following comments:

If this legislation is passed, it may force taxpayers who have established Interest Charge-Domestic International Sales Corporations (IC–DISCs) to open up facilities abroad to avoid increased taxes which will ultimately cost the United States in jobs and growth.

As part of the Jobs and Growth Tax Relief Reconciliation Act of 2003, Congress introduced the 15% long-term capital gains tax along with the 15% rate on qualified dividends. The purpose of this change was to reduce income tax on investment income and provide an incentive for investing in corporate America.

The proposed section of the bill to exclude application of the lower 15% dividend rate to IC–DISC distributions appears not to be a technical correction, but rather a significant shift in policy with repercussions throughout the small and mid-sized business community, especially having a negative impact on the small domestic manufacturer who exports.

Many domestic manufacturers who export their goods have a difficult time competing in world markets where wages and related production costs are less expensive than they are in the U.S. Congress tried to redress this business segment by passing the Extraterritorial Income Exclusion Act in 2000. As a result of pressure from the European Union, Congress was forced to repeal this law with a phase out, but retained some grandfathering provisions that have now also been repealed. Congress then decided to pass the Domestic Production Activity Deduction that would help U.S. manufacturers and qualified industries. However, this law falls short compared to the earlier Extraterritorial Income Exclusion.

Many smaller companies have found some refuge in utilizing an IC–DISC to reduce their costs and stay competitive by taking advantage of distributions received from IC–DISCs that are taxed at the 15% rate.

Although the use of IC–DISCs was no longer beneficial to large American corporations due to the inability to defer the tax on the income attributed to sales in excess of the $10 million threshold (the gross income limitation) and the interest charge relating to the deferral below this threshold, many smaller manufacturers saw opportunities to reduce their operating costs and compete more effectively abroad when the 15% rate for dividends came into effect.

Arguably, individuals, not necessarily businesses, were meant to be the primary beneficiaries of the 15% dividend rate. Nevertheless, a 15% rate for IC–DISC dividends is in correlation to that principle since IC–DISCs are utilized by small businesses that are owned by individuals or by pass through entities in which individuals are the stakeholders, as opposed to publicly traded companies.

Under the present law, smaller exporting companies are able to receive distributions from their IC–DISCs, pay their applicable taxes and reinvest the after-tax proceeds into the economy. This translates into more jobs, more production, and ultimately more revenue for the Government.

In summary, the Committee considers that this proposed section of the bill seems less a technical correction and more a policy shift, which might have an adverse impact on taxes, U.S. competitiveness, U.S. jobs and the U.S. economy, and, therefore, should not be included in the bill.

Northwest Horticultural Council
Yakima, Washington, 98901
October 27, 2006

The Honorable Bill Thomas, Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth Office Bldg.
Washington, DC 20515

Dear Chairman Thomas:

We oppose a provision—Section 7—in the "Tax Technical Corrections Act of 2006" (TTCA) that if approved by Congress would counteract efforts ongoing for over two years in the Pacific Northwest's tree fruit industry to utilize an important tax savings tool created by the "Jobs and Growth Tax Relief Reconciliation Act of 2003" (JGTRRA).

The Northwest Horticultural Council is a trade association, located in Yakima, Washington, representing the policy interests of growers and shippers of such deciduous tree fruits as apples, pears, and cherries. Our membership covers the states of Idaho, Oregon, and Washington.

Competing with foreign producers of fruits, such as fresh apples, in key export markets has been a difficult one in recent years for the small privately-held companies that comprise our industry. Determinations of the World Trade Organization have resulted in the repeal of two important tax incentives for these exporters: Foreign Sales Corporations (repealed in 2000 by P.L. 106–519) and Extraterritorial Income (repealed in 2004 by P.L. 108–357). As of January 1, 2007, Export DISCs will represent the sole remaining tax savings vehicle for small business exporters to utilize as a means of approaching parity with foreign trade competitors who enjoy a competitive advantage over U.S. producers due to direct government subsidization, lower production cost structures (especially wages), and, in the case of the People's Republic of China, these and soaring production increases. (China now grows more apples than any other country.) This lone remaining export incentive will be nearly useless to our industry if Congress approves Section 7 of the TTCA.

Section 7 of the TTCA is a significant policy change inappropriately and unfairly characterized as a simple and routine corrective measure. It arbitrarily disqualifies dividends received from an Export DISC for the 15% tax rate established under § 303 of the JGTRRA. Those harmed by this arbitrary change are not large corporations but shareholders of small companies fighting an uphill battle to compete in increasingly competitive export markets.

Further contributing to the unfairness and arbitrary nature of Section 7 of H.R. 6264 and S. 4026 is the proposed date of the change. The repeals of Foreign Sales Corporations and Extraterritorial Income were accompanied by either multi-year transition periods or an immediate and effective successor benefit. This legislation establishes the effective date as the date the bill was introduced to Congress (September 29, 2006) and offers no successor proposal or remedy. The effective date as proposed pays no regard to the substantial investments made by our small business exporters to establish Export DISCs and comply with requirements of their administration for the current tax year. This is a very real expense that has been incurred in good faith.

We respectfully ask that the Committee remove Section 7 of the TTCA. Its excision will not provide a permanent benefit—it will only maintain the current benefit through its scheduled expiration in 2010. Eliminating Section 7 will grant our small business exporters an appropriate amount of time to plan for the phase-out of the current tax benefit. At worst, the fate of Section 7 should be set aside for further hearings in the next Congress to give ample time for this serious policy proposal by the Committee to be thoroughly debated. This would allow for the possibility of a more targeted corrective action next year alleviating any actual problem (now unknown to us) with this particular tax provision.

We would be happy to provide additional information on the impact of this legislation to our industry upon your request. Thank you for this opportunity to provide comment.

Sincerely yours,

Christian Schlect
President

Statement of Carol Schreckhise, Moore Fans, LLC, Marceline, Missouri

We are a small business in Missouri and are writing to ask you to vote against HR6264 AND COMPANION S4026 that were introduced on September 29, 2006. These bills deal with the taxation of dividends from Domestic International Sales Corporatons (DISCs).

According to the Jobs and Growth Tax Relief Reconciliation Act of 2003, these dividends were taxed at the 15% Federal income tax rate in the same manner as capital gains. To be more competitive in the global marketplace, our company has undertaken to make use of this incentive at considerable time and expense.

HR6264 AND COMPANION S4026, if approved, would make these dividends taxable at ordinary Federal income tax rates. This will raise the tax rates for the individuals who own shares in DISCs making them a less attractive investment and eventually costing Missouri jobs due to a decrease in products exported outside the United States.

The use of DISCs will increase the volume of exports from Missouri. It is also the only export incentive that has not been attacked by the World Trade Organization.

Not only do HR6264 AND COMPANION S4026 take away the tax benefit, they also backdate the date of the tax increase to the date the bill was introduced on September 29, 2006.

Thank you for allowing us to express our concerns and we hope you will examine HR6264 AND COMPANION S4026 and decide not to vote in favor of their passage.

If you wish to discuss this further, I can be reached at my work number or by E–Mail.

American Bar Association Section of Taxation
October 31, 2006

The Honorable Charles E. Grassley
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Bldg.
Washington, DC 20510

The Honorable Max S. Baucus
Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Bldg.
Washington, DC 20510

The Honorable William M. Thomas
Chairman
House Committee on Ways and Means
1102 Longworth House Office Bldg.
Washington, DC 20515

The Honorable Charles B. Rangel
Ranking Member
House Committee on Ways and Means
1106 Longworth House Office Bldg.
Washington, DC 20515

Dear Gentlemen:

Enclosed are comments on the proposals included in H.R. 6264 and S.4026 related to the application of Code section 470 to partnerships and proposed clarification of the term "separate affiliated group" in section 355(b)(3). These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Susan P. Serota
Chair, Section of Taxation

EXECUTIVE SUMMARY

I. Comments on Proposed Technical Corrections to Code Section 470

The Tax Technical Corrections Act of 2006 ("Technical Corrections Act") would amend section 470 [1] to provide rules regarding the application of section 470 to partnerships. As is explained below, we commend the drafters of the Technical Corrections Act for excluding some legitimate partnerships that are not engaged in the abuses that Congress intended to prevent from the application of section 470. We also commend the drafters for recognizing the need to exclude non-depreciable partnership property. Importantly, however, we believe that the legislation does not go far enough in excluding legitimate arrangements that have nothing to do with SILO transactions from being subject to the loss deferral regime. We also believe that the approach taken by the legislation will engender substantial uncertainty regarding whether and to what extent common business arrangements are subject to section 470, in contravention of sound tax policy. As is explained in more detail below:

- We believe that the legislation's retroactive expansion of the portion of a pass-thru entity's property that can be subject to the loss deferral rules is inappropriate and inconsistent with sound tax policy.
- The legislation provides an exception for partnerships that meet certain objective requirements (relating to funds not being set aside or subject to certain arrangements and to the lack of certain types of options). Because the economic arrangements that exist with respect to partnerships are so diverse, we believe that focusing on the economic relationship of the partners, partnership, and lenders in the manner specified will apply the loss deferral rules to far more partnerships than can be justified on policy grounds. Accordingly, we believe that, if this approach is pursued, an additional exception should be provided for property that is not subject to "use" or "control" by a tax-exempt partner and that "qualified allocations" should be determined by reference to section 514(c)(9)(E), rather than section 168(h)(6)(B). We also believe that consideration should be given to a more general anti-abuse rule for the application of section 470 to partnerships and to providing anexception when all taxable partners satisfy a threshold projected variance in their investment return with respect to the partnership. We also have highlighted significant problems with, and made suggestions regarding, the arrangement, set aside, and options rules.
- Numerous practical and technical issues exist that are fundamental to whether and how section 470 applies with regard to tiered partnerships. Given the large number of tiered arrangements, we believe it is inappropriate to leave resolution of these issues to regulations.
- We believe that the broad regulatory authority to expand the scope of section 470 with respect to partnerships should be narrowed significantly so as to potentially capture only those situations where the arrangement truly resembles a SILO.
- We believe that certain additional exceptions and definitions need to be provided.
- Given the inability of taxpayers to have predicted the details of the technical correction, we believe that consideration should be given to applying section 470 only to partnership property acquired after the date the Technical Corrections Act was introduced (in non-leasing situations) and to providing appropriate transition relief for arrangements entered into before the Technical Corrections Act was introduced that may be difficult or impossible to modify.

If appropriate legislation cannot be enacted expeditiously, we strongly believe that the existing moratoria should be extended to taxable years beginning before January 1, 2007.

II. Comments on Proposed Technical Corrections to Code Section 355

The Tax Increase Prevention and Reconciliation Act of 2005 amended the active trade or business requirement of section 355(b) by adding paragraph (3), providing that all members of a corporation's "separate affiliated group" ("SAG") are treated as one corporation for purposes of the active trade or business requirement. In the Technical Corrections Act, Congress has proposed to clarify that the term SAG would not include any corporation that became an otherwise qualifying member of the SAG within the five-year period ending on the date of the distribution by reason of one or more transactions in which gain or loss was recognized in whole or in part.

[1] Except to the extent specified otherwise, all section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury regulations promulgated thereunder.

This proposed change would undermine the so-called "expansion" doctrine embodied in Treasury Regulation § 1.355–3(b)(3)(ii) that permits a corporation to acquire a business in a taxable acquisition during the five-year period, provided that the business is an expansion of a pre-existing active business. The expansion doctrine is regularly relied upon by taxpayers to satisfy the active business requirement of section 355.

We recommend that the proposed technical correction not be enacted without modification to make clear that any such change will not interfere with the law that has developed to allow an expansion of a historic business. This could be accomplished by making clear that the expansion doctrine will be applied on an affiliated group basis, without regard to the SAG membership and providing examples to illustrate the principle.

ABA SECTION OF TAXATION

COMMENTS ON H.R. 6264 AND S.4026: THE TAX TECHNICAL CORRECTIONS ACT OF 2006

I. Comments on Proposed Technical Corrections to Code Section 470

A. Introduction

Section 6 of the Technical Corrections Act would amend the "anti-SILO" rules of section 470 of the Internal Revenue Code to provide rules regarding the application of section 470 to partnerships. The amendment would expand the portion of a partnership's losses and deductions that could be deferred, but would provide new exceptions for (1) non-depreciable property and (2) certain property that meets two specific requirements that are based on certain leasing rules contained in section 470(d). The amendment also would provide the Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") with extremely broad regulatory authority based on certain vague concepts to subject partnerships to section 470, even if those entities would otherwise be excepted from the application of section 470. The amendment would apply retroactively to property acquired after March 12, 2004.

The application of section 470 to pass-thru entities is a critical issue to thousands of taxpayers in a variety of industries, as well as to those practitioners who advise pass-thru entities and their owners regarding compliance with the tax laws. We commend the drafters of the Technical Corrections Act for their efforts in attempting to limit the application of section 470 in the context of partnerships that are not engaged in "SILO" transactions and for recognizing the need to exclude non-depreciable partnership property. As is explained in more detail below, however, we have significant concerns regarding both the general direction and the particular details of the amendment contained in the Technical Corrections Act.

Very generally, we are concerned that, notwithstanding the provisions of the Technical Corrections Act, many partnerships will be subject to section 470 even though they are not engaged in, or being used to replicate, the kinds of transactions that Congress intended to subject to section 470. We also are concerned that the amendment will engender considerable uncertainty regarding how, whether, and to what extent section 470 applies to many common business arrangements. We also have concerns with respect to other compliance and policy issues, including effective date concerns.

Before elaborating upon our concerns regarding the amendment, we believe it is useful to provide some brief background regarding current law and the comments we previously submitted regarding the application of section 470 to pass-thru entities.

B. Background Regarding Current Law

Section 470 is a loss deferral provision that was enacted as part of the American Jobs Creation Act of 2004 (P.L. 108–357, the "2004 Act"). Section 470 was primarily designed to address concerns with certain SILO (*i.e.,* sale-in, lease-out) transactions the Government considers abusive. These transactions typically involved a sale of property (such as a subway system) by a tax-exempt entity (such as a municipal transit authority) to a taxable entity that, in turn, leased the property back to the tax-exempt entity. The taxable entity benefited from the cost recovery deductions associated with the property, while the tax-exempt entity typically received an implicit fee for participating in the arrangement and continued to control the operation of the property.

Section 470 suspends the deduction of losses related to "tax-exempt use property" in excess of the income or gain from that property. Tax-exempt use property includes property that is leased to a tax-exempt entity. Importantly, however, as a result of the application of section 168(h)(6), tax-exempt use property also includes property (whether or not leased) owned by a partnership that (1) has as partners both taxable and tax-exempt entities (including foreign persons) and (2) makes allocations to the tax-exempt partners that are not "qualified." As a result, a partnership that has a combination of taxable and tax-exempt (including foreign) partners and that makes nonqualified allocations is potentially subject to section 470, even if the partnership does not lease any property and even if the partnership is not engaged in a SILO-like transaction.

In the pass-thru context, section 470 applies to property acquired after March 12, 2004. The IRS and Treasury, however, have indicated that, for tax years beginning before January 1, 2006, the IRS will not apply section 470 to disallow losses associated with property that is treated as tax-exempt use property solely as a result of the application of section 168(h)(6).[2]

C. Previous Submission by the Tax Section

In June 7, 2005, the Tax Section of the American Bar Association submitted a letter to the distinguished Chairs and Ranking Members of the House Committee on Ways and Means and the Senate Finance Committee expressing concerns regarding the application of section 470 to pass-thru entities.

In our previous submission, we expressed our strong concern that section 470 applied in the partnership context far more broadly than necessary to achieve the Government's "anti-SILO" objective. Our previous submission provided support for why we did not believe Congress intended section 470 to apply so broadly, as well as examples of the kinds of common business arrangements that could be inappropriately subject to the loss deferral regime.

In our previous submission, we made a number of recommendations that were intended both (1) to protect the Government's interest in preventing the "next generation" of SILO transactions through partnerships and (2) to allow taxable and tax-exempt parties to continue to undertake legitimate business transactions through partnerships without inappropriately being subject to the loss deferral rules of section 470. Although there were numerous aspects to the recommendations, the core recommendation focused on excluding partnerships from the application of section 470 where a tax-exempt partner did not "use" or "control" the property following acquisition of the property by the partnership. While we recognize that there are difficulties in applying the concepts of "use" and "control" in the context of certain limited types of properties, we continue to believe that this basic approach is most effective in distinguishing legitimate arrangements from those that resemble SILOs. Further, from a tax policy perspective, it provides an objective standard that, in most cases, can easily be administered.

D. Section 6 of the Technical Corrections Act

Section 6 of the Technical Corrections Act takes a different approach to addressing how section 470 applies to pass-thru entities that are not engaged in covered leasing transactions. This approach would exclude some legitimate business arrangements from the application of the loss deferral regime. In this regard, we commend the drafters for recognizing the need to narrow the application of section 470. Nonetheless, we are very concerned that the Technical Corrections Act does not go far enough in excluding those entities that are not engaged in the kinds of SILO transactions Congress considers to be abusive. We also are concerned that the approach reflected in the Technical Corrections Act will engender tremendous uncertainty as to both the scope and operation of section 470 in the pass-thru context, in contravention of sound tax policy. Thus, we respectfully encourage the drafters to reconsider the suggested approach that we described in our previous submission.

We appreciate, however, the interest in securing expeditiously a legislative solution to the problems associated with the application of section 470 to pass-thru entities. We also understand that the drafters of the Technical Corrections Act would like this solution to "mirror" the exceptions contained in section 470(d) for "legitimate" leases to the extent possible and are appreciative of the opportunity to provide comments on the Technical Corrections Act before it moves further in the legislative process. Thus, while the discussion below summarizes significant problems with the approach reflected in the Technical Corrections Act, it also contains suggestions as to how that approach could be modified so as to protect the Government's interests in deterring "synthetic" SILOs, while not inappropriately subjecting a large number of legitimate arrangements to the loss deferral rules.

1. Scope of Loss Deferral

The Technical Corrections Act would amend section 470 to expand the portion of a pass-thru entity's property that can be subject to the loss deferral rules. Section

[2] See Notice 2006–2, 2006–2 I.R.B. 278, and Notice 2005–29, 2005–1 C.B. 796.

168(h)(6) treats only the tax-exempt entity's "proportionate share" of the entity's property as tax-exempt use property. The Technical Corrections Act would eliminate the "proportionate share" rule and treat all property of a pass-thru entity (not otherwise excepted from section 470) as tax-exempt use property for purposes of section 470 if any portion is treated as tax-exempt use property for purposes of section 168(h)(6). This approach has the practical effect of causing all of the losses with respect to a particular property to be deferred, even if the tax-exempt partner's share of partnership items with respect to such property is extremely small. This result is unduly harsh, particularly to the extent that section 470 continues to apply to many legitimate pass-thru entities that are not involved in SILO arrangements. Further, expanding the scope of the disallowance retroactively (as the Technical Corrections Act proposes to do) would be inconsistent with sound tax policy. Thus, we recommend that only the tax-exempt entity's share of property be treated as tax-exempt use property.

2. *Exception for Non-Depreciable Property*

The Technical Corrections Act also provides two new exceptions to the definition of tax-exempt use property in situations in which property would otherwise be considered tax-exempt use property solely by reason of section 168(h)(6). One of these exceptions is for property that is not of a character subject to the allowance for depreciation. We strongly support this exception for the reasons set forth in our previous submission. We note, however, that the Joint Committee on Taxation's description of the Technical Corrections Act (JCX–48–06) (the "JCT Description") indicates that, to qualify for the exception, property must be both non-depreciable and non-amortizable. Presumably, the reference to property that is subject to amortization is intended to capture amortizable section 197 intangibles, which is consistent with the inclusion of such property in section 470(c)(2)(B)(ii). This reference, however, also raises questions with respect to other property that may be subject to amortization, such as bonds with amortizable bond premium under section 171. Bonds with amortizable bond premium generally are not thought to be of a character subject to the allowance for depreciation and should not be subject to section 470. For this reason, clarification as to the scope of the reference to "amortizable property" in the JCT Description would be helpful.

3. Exception Based Upon the Economic Characteristics of the Partnership

The second new exception (the "Two-Part Exception") is for partnerships that meet both of two fairly complex requirements—the "no set aside" requirement and the "no option to purchase at other than value" requirement—with respect to the property for the taxable year. The Two-Part Exception is the exception upon which many thousands of legitimate pass-thru entities that hold depreciable property would have to rely in order to escape the application of the anti-SILO loss deferral rules.

a. General Concerns

As is explained below, the Two-Part Exception focuses on the economic characteristics of the arrangements among partnerships, partners, lenders, and potentially others. As the Government has previously recognized in another context, "[s]ubchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax."[3] This statement gives explicit recognition to the flexibility of the partnership entity and the fact that taxpayers may engage in a myriad of diverse economic arrangements through partnerships. We cannot emphasize enough the difficulty in anticipating the economic terms that taxpayers may enter into, or may have entered into, in advancing legitimate business interests in connection with a partnership. Thus, any rule that focuses exclusively on the economic characteristics of partnership arrangements, such as the Two-Part Exception, will inevitably capture many legitimate partnerships that have nothing to do with SILOs. For this reason, we believe that, if such an approach is employed, it needs to be combined with a consideration of other characteristics of the arrangement. Otherwise, numerous legitimate taxpayers will be subject to loss deferral rules that Congress intended to apply only to abusive arrangements. We discuss alternative approaches and rules for consideration after the discussion of issues arising in connection with the Two-Part Exception.

[3] Treas. Reg. § 1.701–2(a).

b. Particular Concerns Regarding the "No Set Aside" Requirement

The "no set aside" requirement focuses on whether, at any time during a taxable year with respect to any property owned by the partnership, funds are (1) subject to certain arrangements (such as a defeasance arrangement, a letter of credit collateralized with cash or cash equivalents, or a loan by a tax-exempt partner or the partnership to any taxable partner, the partnership, or any lender, among others) or (2) set aside or expected to be set aside, to or for the benefit of a taxable partner or any lender, or to or for the benefit of any tax-exempt partner to satisfy any obligation of the tax-exempt partner to the partnership, any taxable partner, or any lender. In the case of funds outside of the partnership (i.e., funds held by a party other than the partnership that are set aside to satisfy an obligation described in the prior sentence), the "no set aside" requirement requires that no amount be subject to an arrangement or set aside in this manner at any time during a taxable year. With respect to funds held by the partnership, it would be permissible for funds to be subject to an arrangement or set aside (or expected to be set aside) by the partnership to or for the benefit of a partner or lenderas of any date during the year in an amount equal to the greater of:

(1) 20 percent of the "aggregate debt of the partnership" (which term is not defined); or

(2) the sum of (a) 20 percent of the taxable partners' capital accounts determined under the rules of section 704(b) and (b) 20 percent of the taxable partners' share of the recourse liabilities of the partnership determined under section 752.

The Technical Corrections Act provides that funds that are set aside for less than 12 months would not be taken into account in determining whether the "no set aside" requirement is met. It further provides that funds would not be treated as "set aside" if such funds "(I) bear no connection to the economic relationships among the partners, and (II) bear no connection to the economic relationships among the partners and the partnership."

The "no set aside" requirement appears designed to mirror the "no defeasance" rule set forth in section 470(d) with respect to leases. Section 470(d) provides that a lease that has certain characteristics is not subject to the loss deferral rules, presumably because those characteristics are inconsistent with SILO transactions. One of these characteristics is that the tax-exempt lessee has not monetized more than an allowable amount of its lease obligation (including any purchase option) pursuant to an arrangement, set aside, or expected set aside that is to or for the benefit of the taxpayer or any lender, or is to or for the benefit of the tax-exempt lessee. While looking to a lack of defeasance may make sense in distinguishing a "good" leasing arrangement from a SILO leasing arrangement, such an approach is inherently difficult to apply in the partnership context and cannot be structured in such a manner so as to accurately separate legitimate pass-thru entities from those that might be structured in the future as synthetic SILOs.[4] Specific concerns and suggestions with regard to this requirement include the following:

- The exception establishes a "reasonable person" standard for determining when funds are set aside or expected to be "set aside for the benefit" of one of the relevant parties. In the context of leases, money set aside for the benefit of the lessor must be "targeted" towards the lessor in some way in order for a reasonable person to determine that the funds are impermissibly set aside. By contrast, all partnership funds are held for the eventual benefit of those with an economic stake in the partnership—including partners and lenders. Thus, in undertaking the required analysis for funds held by the partnership, the "for the benefit of" portion of the test does not meaningfully affect the inquiry. Instead, the primary question will relate to what it means for funds to be "set aside." Given that partnerships may hold significant cash for many purposes, it is imperative that taxpayers have detailed guidance allowing them to determine when funds are considered to be set aside in a manner that violates the "no set aside" requirement. Presumably, the "no set aside" requirement, as applied to funds held by a partnership, is intended to capture only funds that have been isolated, such that they will not be available for use in connection with the business of the partnership, and that are earmarked either for distribution to partners or payment to creditors.[5] Clarifying the meaning of the requirement

[4] As was indicated in our previous submission, we are not aware of any pass-thru entities that have been used to replicate the economics of a SILO transaction.

[5] As is discussed below, we similarly believe that, if the reference to "lenders" is retained in section 470(e)(2), the statute should apply only with respect to "arrangements" and "set asides" where the loan serves to support repayment of the investment of the taxable partner. Also, sinking funds to redeem partners are common business structures used in many legitimate arrange-

would help both the taxpayers and the IRS apply this provision. In fact, given the stakes of loss deferral for all partners, pass-thru entities need immediate clarity as to how they can establish with certainty that funds are not considered to be set aside for an impermissible purpose.

- Establishing the purpose for which particular funds are set aside raises tracing and fungibility concerns and could impose tremendous administrative burdens on both taxpayers and the Government.
- The blanket inclusion of partnership lenders as parties for whom "arrangements" and "set asides" are prohibited sweeps in numerous legitimate partnership arrangements.

We assume that lender arrangements are included to address two primary situations. In one situation, a taxable partner would contribute significant cash to the partnership and simultaneously would borrow a like amount of funds. The tax-exempt partner would bear the risk with respect to the debt, either by lending the funds directly to the taxable partner or by guaranteeing debt advanced to the taxable partner by a third-party lender. Repayment of the debt by the taxable partner would be contingent on the taxable partner receiving back its investment in the partnership.[6] In a second situation, the taxable partner may advance minimal funds to a partnership, with the majority of the acquisition proceeds for the property being borrowed by the partnership from an unrelated lender. In order to accrue significant deductions in this situation, the taxable partner would be required to enter into a guarantee or some similar arrangement with respect to the debt. To counteract the risk associated with the guarantee, however, the partnership would set aside significant funds for repayment of the debt so as to ensure that the taxable partner is never called upon to satisfy its guarantee obligation.

As an initial matter, we do not think that the second situation should create any concern for the Government. Treas. Reg. § 1.752–2(j)(3) provides that "[a]n obligation of a partner to make a payment is not recognized if the facts and circumstances evidence a plan to circumvent or avoid the obligation." It is hard to see how a scenario that satisfies the "set aside" requirement in section 470(e)(2) would not run afoul of this provision.[7]

We also believe that existing authority provides the Government with significant weapons to attack the first situation. Depending on the facts, the lending arrangement may be disregarded altogether, so that the tax-exempt party would be treated as the person contributing the funds.[8] Of equal or greater significance, the regula-

ments. Thus, the existence of a sinking fund should not necessarily be viewed as determinative of a SILO arrangement. Nonetheless, we understand that the presence of a sinking fund, in conjunction with other factors, could be troubling to the Government. This illustrates the problems with subjecting a partnership with depreciable property to section 470 merely because it fails the "no set aside" requirement, without examining the totality of the arrangement.

[6] In the third-party lender situation, the tax-exempt partner would repay the debt pursuant to the guarantee.

[7] As a result, the taxable partner would not have sufficient adjusted basis under section 705 to take into account significant losses, as section 704(d) would limit the allowance of such losses. Similarly, with minimal capital invested by the taxable partner, and presumably significant capital being contributed by the tax-exempt partner to provide for the funds that would be set aside and that would secure the partnership debt, it would not seem possible to allocate significant losses to that taxable partner under section 704(b). First, the taxable partner would not have contributed significant capital to justify the allocation of losses. Similarly, it would not seem possible to generate nonrecourse deductions under Treas. Reg. § 1.704–2(c) that might be allocated to the taxable partner in this situation. If both the property and the funds secured the debt, the total basis (or book value) of all property securing the debt would not fall below the amount of the debt (i.e., because the funds would retain their basis (or book value)). Thus, no nonrecourse deductions would result from depreciation of the property. See Treas. Reg. § 1.704–2(b)(2) ("partnership minimum gain" is the amount by which a nonrecourse liability exceeds the adjusted basis (or book value) of partnership property that the debt encumbers); Treas. Reg. § 1.704–2(c) ("nonrecourse deductions" must be attributable to a net increase in partnership minimum gain during the year).

[8] See Rev. Rul. 72–135, 1972–1 C.B. 200 (nonrecourse loan by general partner to limited partner for limited partner to purchase partnership interest recast as a contribution to capital by general partner). Cf. Knetsch v. U.S., 364 U.S. 361 (1960) (no valid indebtedness in deferred annuity savings investment where annual borrowings kept net cash value at a *de minimis* amount; lending was, in substance, a rebate of a substantial part of the interest payments); Bussing v. Commissioner, 88 T.C. 449 (1987) (loan disregarded in sham leasing arrangement where note payments and rental obligation offset each other), supplemental opinion, 89 T.C. 1050 (1987); HGA Cinema Trust v. Commissioner, 950 F.2d 1357 (7th Cir. 1991) (same), cert. denied, 505 U.S. 1205 (1992); Compare VanRoekel v. Commissioner, T.C. Memo 1989–74 (note in sale-leaseback transaction determined to be valid where debtor was unconditionally liable for pay-

Continued

tions under section 704(b) would certainly take such an arrangement into account in determining the allocation of losses under the partnership agreement. We think it is highly unlikely that section 704(b) would permit a partner to be allocated losses where the partner is protected from loss as a result of a lender arrangement.[9]

Given the means already available to the Government to deal with lender arrangements and set asides, the inclusion of such arrangements seems unnecessary. Further weighing against the inclusion of these lender arrangements and set asides is the multitude of legitimate lender arrangements that occur everyday in the partnership context which would unfairly subject a partnership to loss deferral under section 470. For instance, many loans that are subject to securitization may not be prepaid.[10] The only way to effectively pre-pay such a loan is to defease the obligation. It appears, however, that if a partnership utilizes "in substance" defeasance or "legal" defeasance, the partnership will fail section 470 unless it can satisfy one of the 20-percent safe harbors for "inside" defeasance.[11] As another example, where a partner guarantees debt of a partnership, it is not at all unusual for the lender to require that the guarantor post some amount of collateral to secure its guarantee obligations. This often will take the form of a letter of credit or some other arrangement that would be impermissible under the terms of the amendment. Because this arrangement would relate to funds held outside the partnership, the 20-percent safe harbor would not be available. The universe of analogous arrangements that raise troubles in this regard is too numerous to catalogue.

Because the references to "lenders" sweeps in numerous legitimate transactions in situations where the Government's interest already is significantly protected by existing rules and authority, we believe that the references to "lenders" in section 470(e)(2) should be eliminated. If these references are not eliminated, we believe that the situations in which lender arrangements are considered should be significantly limited so as to refer only to situations where the principle purpose of the loan is to support repayment, directly or indirectly, of the investment of the taxable partner.

- "Arrangement" includes a loan by a tax-exempt partner or the partnership to any taxable partner, the partnership, or any lender. These kinds of arrangements are very common. For example, if a partnership is having financial difficulty, partners often will fund operations through debt rather than equity so

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ments and the form was respected in early years of the arrangement; court noted this was a "close case").

[9] Treas. Reg. § 1.704–1(b)(2)(ii)(f) states that, for purposes of section 704(b), the partnership agreement includes all agreements among the partners, or between one or more partners and the partnership, concerning the affairs of the partnership and responsibility of partners, whether oral or written, and whether or not embodied in a document referred to by the partners as the partnership agreement. Thus, in determining whether distributions are required in all cases to be made in accordance with the partners' positive capital account balances . . ., and in determining the extent to which a partner is obligated to restore a deficit balance in his capital account . . ., all arrangements among partners, or between one or more partners and the partnership relating to the partnership, direct and indirect, including puts, options and other buy-sell agreements, and any other 'stop-loss' arrangement, are considered to be part of the partnership agreement. (Thus, for example, if one partner who assumes a liability of the partnership is indemnified by another partner for a portion of such liability, the indemnifying partner (depending on the particular facts) may be viewed as in effect having a partial deficit makeup obligation as a result of such indemnity agreement.)

Under Treas Reg. § 1.704–1(b)(2)(ii)(a), in order for an allocation to be respected as having economic effect, "it must be consistent with the underlying economic arrangement of the partners." In other words, any economic benefit or economic burden that corresponds to an allocation must inure to the benefit or detriment of the partner to whom the allocation is made. If the lender arrangement is taken into account as part of the partnership agreement, so that the taxable partner is considered to be protected from loss with respect to its investment for purposes of analyzing allocations, the section 704(b) regulations would not permit an allocation of losses to the taxable partner. We note that, in *Van Roekel v. Commissioner*, T.C. Memo 1989–74 (discussed *supra* note 8), the court found that, although the indebtedness in that case would be respected for federal tax purposes, the taxpayer would be viewed as protected from loss with respect to such indebtedness.

[10] See B. Rubin, A. Whiteway, and J. Finkelstein, Tax Planning for Conduit Loan Defeasance Transactions, Including Like Kind Exchanges, 9 J. of Passthrough Entities 15 (2006).

[11] Significantly, even though the partnership would no longer be treated as the borrower for federal tax purposes with respect to debt that it legally defeases, section 470 may nevertheless be applicable. This is because the reference to "lender" in the amendment does not refer only to a lender of the partnership, as determined for federal tax purposes. Instead, the provision literally seems to apply where the partnership provides for the defeasance of an obligation of anyborrower to any lender. As is discussed below, proposed new section 470(e)(2)(D)(ii) provides the only limitation on arrangements with respect to lenders; under this provision, such arrangements are ignored only if the funds bear no connection to the economic relationship (1) of the partners or (2) among the partners and the partnership. See infra text accompanying note 12.

as to preserve claims for repayment in bankruptcy or other collection actions. Partners (including tax-exempt partners) also may lend funds to employees or service providers of a partnership in order to allow such persons to acquire interests in partnerships and thereby "incentivize" such persons to contribute to the success of the business. Loans by partnerships to partners also are extremely common. (Indeed, the Treasury regulations contain specific rules to address such loans.[12]) Further, where one partner fails to fund a capital call, it is very common for another partner to contribute funds for that partner, with the operative documents treating the advance as a loan between the partners. Where the partner making the advance is a tax-exempt partner and the partner who failed to make the advance is taxable, presumably the arrangement would constitute impermissible "outside" defeasance, thereby subjecting the partnership to section 470. Consistent with our recommendation above, we believe that, if loans continue to be treated as "arrangements," such treatment should follow only where the principal purpose of the loan is to support repayment, directly or indirectly, of the investment of the taxable partner.

- Where a partnership sells property and does not instantaneously distribute such amounts, the sales proceeds seemingly would be treated as set aside for the benefit of the partners (including taxable partners). The amendment includes a 12-month safe harbor rule to help alleviate this problem. This rule, however, may not apply when a partnership repeatedly sells assets. In this situation, the "set aside" amount may never fall to zero in a 12-month period because, by the time that the proceeds from one sale are distributed, the proceeds from the next sale have already been received.[13] This is of particular concern where a partnership is in the process of winding up its affairs and liquidating. Thus, consideration should be given to deeming a partnership to satisfy the "no set aside" requirement if it has adopted a plan of liquidation and distributes all of its assets within a few years of adopting such plan.[14] A partnership that is near the end of its life would not be an attractive vehicle for a SILO, given the limited period during which deductions would be generated. Nonetheless, even with such an exception, it is important to recognize that entities that frequently sell assets but that are not in the process of winding down still could be inappropriately subject to the loss deferral regime.
- At a minimum, the "20-percent" allowable partnership amount should be increased to a much higher percentage. Much larger amounts (approaching 100 percent) were "defeased" in the SILO transactions with which Congress was concerned in enacting section 470 because substantial defeasance was necessary in order to make the transactions attractive. It is hard for us to point to a specific benchmark for what would be a reasonable allowable partnership amount. The fact that a partnership has a significant amount of liquid assets is in no way determinative that it is being used to replicate a SILO; indeed, many current joint ventures and other pass-thru entities have significant funds on hands for a variety of reasons, yet we are not aware of any such entities that have been used to replicate a SILO arrangement.

Given the extremely broad parameters for what is caught by the amendment, we view the allowable partnership amount as a "rough justice" provision designed to give a chance to those innocent parties who, for legitimate reasons, enter into (or have entered into) an otherwise impermissible arrangement or set aside. Whether a situation falls below or above any allowable partnership amount necessarily will be "luck of the draw," depending on the characteristics of the partners and the part-

[12] See, e.g., Treas. Reg. § 1.752–2(c)(1) (partner generally bears "economic risk of loss" with respect to loans made by such partner or related person); Treas. Reg. § 1.752–2(d) (de minimis exception applicable to loans made or guaranteed by a partner or related person); and Treas. Reg. § 1.704–2(i) (providing that "partner nonrecourse deduction," i.e., deductions arising from otherwise nonrecourse loans made by partners or related persons, must be allocated to the partner that bears the economic risk of loss with respect to such loans).

[13] In order to qualify for the safe harbor, funds cannot be set aside, or subject to an arrangement, for 12 months or more. Thus, questions are raised as to the availability of the safe harbor when a partnership sells multiple properties over a period of time; even though the partnership may distribute funds from each property sale within a relatively short period of time following the sale, it may have a positive amount "set aside" for a period of more than 12 months.

[14] Cf. section 332(b)(3) (permitting a corporate shareholder to receive assets from a subsidiary corporation tax free in connection with the liquidation of the subsidiary if, among other things, the subsidiary distributes all of its assets within 3 years of the close of the taxable year during which the first liquidating distribution is made).

nership.[15] Given the extremely broad parameters of what constitutes an impermissible arrangement or set aside and the numerous legitimate partnerships that will fall within these parameters, we strongly urge the Government to consider how high this threshold could go before the Government's interests are realistically compromised. Similar thought should be given in the context of outside defeasance, as the provisions defining what constitutes outside defeasance also are so broad as to encompass many very common partnership arrangements. In many situations, the allowable partnership amount will serve as the only way for legitimate partnerships to avoid loss disallowance under section 470.

- The meaning of the rule that provides that funds would not be treated as "set aside" if they bear no connection to the economic relationships among the partners or to the economic relationships among the partners and the partnership is unclear. We understand that this rule is viewed as necessary due to the lack of any designation as to who can hold funds pursuant to an arrangement or set aside for the benefit of (1) a taxable partner, the partnership, or any lender or (2) a tax-exempt partner to satisfy any obligation of such tax-exempt partner to the partnership, any taxable partner, or any lender. For example, without this rule, a partnership could become subject to section 470 by virtue of an unrelated third party taking out a letter of credit to secure a loan to a taxable partner of the partnership, even though the loan has absolutely nothing to do with the partnership.

The "no connection to economic relationships" language obviously is very restrictive and seemingly would not apply in situations in which a party may have a very tangential connection to the economic relationship among the partners or the partners and the partnership. In addition, the language would not appear to apply to an arrangement or set aside that has a connection to the economic relationship among the partners, but in a context that is wholly unrelated to the partnership. In today's investment world, investors may come together in numerous transactions and in a multitude of circumstances. For example, a taxable party and a tax-exempt pension fund may come together as partners in one deal, while, in another deal, the taxable party (or an affiliate) may undertake syndicated financing for a project where the same tax-exempt pension fund participates as a lender. The loan has nothing to do with the joint investment of the parties in the partnership, but the loan does bear a clear connection to the economic relationship of the taxable party and tax-exempt pension fund. There are an endless number of similar scenarios that have nothing to do with SILOs.

In order to prevent such arrangements from causing legitimate partnerships to be subject to loss deferral under section 470, it is necessary to more specifically define the arrangements and set asides that do not, in a real and substantial way, implicate the relationships among the relevant parties "in a capacity" that relates to the partnership.

- In addition, the rule relating to arrangements and set asides contemplates relationships with lenders, although the exclusion gives no indication as to how lenders are taken into account. Presumably, arrangements or set asides with respect to lenders are only taken into account where such arrangements affect the economic relationships among the partners or among the partners and the partnership.[16] Nonetheless, the existing rule engenders significant uncertainty and confusion. For instance, suppose that a tax-exempt partner owes significant funds to a bank, and a taxable partner in the same partnership owns a small number of shares of that bank. The bank requires that collateral be set aside for the loan. The loan is of such a size that, if it were to become uncollectible, it could affect the price of the bank's stock, thereby indirectly affecting the economic well-being of the taxable partner. Without further guidance, this arrangement could be viewed as having some (albeit *de minimis*) effect on the economic

[15] Because, under one test, the "allowable partnership amount" is measured by reference to taxable partners' capital accounts and their share of recourse debt, the test may not assist legitimate partnerships from escaping the inappropriate application of section 470 when there are insignificant taxable partners participating. Similarly, because, under the other test, the "allowable partnership amount" is measured by reference to partnership debt, partnerships that are not highly leveraged would have little leeway accorded by this test. Separately, defeasance of a loan relating to a single property in a large multi-property partnership may not create problems under the 20-percent safe harbor, whereas defeasance of a loan relating to a single property in a single-property partnership is much more likely to give rise to an arrangement that falls outside of the 20-percent safe harbor.

[16] See supra note 11.

relationship of the partners (assuming that the parties could even detect that this arrangement exists).

- Finally, the amendment operates with respect to "funds" that are subject to an "arrangement" or that are "set aside." We note, however, that the amendment does not define "funds" for purposes of this provision. While "funds" would seem to denote cash, we anticipate that the drafters may also intend that marketable securities fall within the definition of "funds." The inclusion of marketable securities could create problems in a number of situations that in no way implicate the concerns present with respect to SILOs.

One situation in particular exists with respect to REITs and their "umbrella" partnerships ("UPREIT partnerships").[17] Most REITs hold their property through an UPREIT partnership that has unrelated third-party partners. The partners may be either taxable or tax-exempt. An outside investor in an UPREIT partnership generally is entitled to have its partnership interest redeemed either for cash or stock of the REIT that is equal to the fair market value of the partnership interest. The REIT generally will stand ready to issue stock to satisfy the redemption obligation. A REIT obviously has a virtually unlimited ability to issue its own stock, so it is quite easy to see how the Government might argue that the arrangement with respect to UPREIT partners gives rise to an impermissible "set aside." Nonetheless, such arrangements in no way create concerns implicated by SILOs.[18]

c. Particular Concerns Regarding the "No Option to Purchase at Other Than Value" Requirement

In order to meet the "no option to purchase at other than value" requirement, no tax-exempt partner can have, at any time during a taxable year, an option to purchase (or to compel distribution of) partnership property or a direct or indirect interest in the partnership other than at the fair market value of such property or interest at the time of the purchase or distribution. In addition, the partnership and the taxable partners cannot have an option to sell (or to compel distribution of) partnership property or a partnership interest to any tax-exempt partner at any time other than at the fair market value of such property or interest as determined at the time of the sale or distribution. Treasury would have the authority to issue regulations allowing the fair market value of partnership property or a partnership interest to be determined by formula "when the value is determined based on objective criteria that are reasonably designed to approximate the fair market value of such property at the time of the purchase, sale, or distribution."

The "no option to purchase at other than value" requirement appears to be based upon concerns that, in the typical SILO transaction, a tax-exempt lessee is assured that it can purchase the property it previously had sold for a predetermined amount at the end of the lease term. Although looking to a tax-exempt entity's ability to purchase property for an amount other than value may make sense in attempting to distinguish a "good" leasing arrangement from a SILO leasing arrangement, such an approach is more problematic in the pass-thru entity context, given that pass-thru entities utilize different kinds of option arrangements for a variety of different business reasons. Further, it may be very difficult, if not impossible, for pass-thru entities to restructure existing options, puts, and other similar agreements, given that this involves renegotiating and modifying the economic agreement among the parties. Specific concerns and suggestions with regard to the "no option to purchase other than at value" requirement include the following:

- Many options determine the fair market value of property at the time of exercise based upon formulae. Further, there are many different kinds of formulae that are used. Although the Technical Corrections Act provides Treasury with authority to "allow" the use of formula options, it is unclear at this point what kinds of formulae will be acceptable. Clear rules as to what kinds of formula options satisfy the "no option to purchase at other than value" need to be provided before section 470 is applied to any pass-thru entity that is not engaged in a covered leasing transaction. Deferring resolution of this issue until such time as regulations may be issued will create considerable uncertainty as to

[17] Also, analogous structures (typically referred to as "Public LLCs" or "Pubco" structures) have become increasingly commonplace in corporate America, with a number of companies having gone public in the last year using this structure.

[18] We note that there also could be significant problems presented where a partnership holds, along with property that is subject to an allowance for depreciation, stock in a corporation whose stock becomes publicly traded. If a partnership decides that it will not immediately distribute such publicly-traded stock to the partners (possibly because it is prohibited from doing so for regulatory reasons), but also determines that it will ultimately distribute, rather than sell, the stock, this action seemingly could create an impermissible "set aside."

what extent taxpayers are subject to section 470, will engender significant compliance concerns, and is inconsistent with the sound administration of the tax laws.

- The application of the fair market value analysis is unclear in many contexts relating to partnerships. The amendment makes reference to fair market value only in the context of the property being acquired from the partnership or the partnership interest being acquired from another partner. The analysis, however, in the partnership context is more complicated than this. Unlike in the leasing context, where the consideration that will be conveyed in exercising the option almost always will be cash, for partnerships, a partner often will transfer its partnership interest in exchange for property received in redemption. In this situation, the Government presumably will want to ensure that (1) the amount of property being distributed is determined by reference to fair market value, and (2) the credit given to the partner for the partnership interest being redeemed similarly is fair market value. Manipulation of either side of the equation could upset the protection that the Government is looking to obtain. This raises the very difficult question, however, as to how one determines the fair market value of a partnership interest. That is, does one look to what a willing buyer would pay to a willing seller when bargaining at arm's length, or does one instead look to the liquidation value of the interest that is being redeemed? The Government has previously struggled with this analysis, and, in one context, has given taxpayers the ability to choose either method.[19] While "liquidation value" often (although not always) is used to measure economic entitlement in a liquidating distribution,[20] this amount rarely will reflect the fair market value that parties would derive where a willing buyer and seller are negotiating for the sale of a partnership interest, as these parties will consider factors like voting control, liquidity of the investment, etc., and the Government has recognized this fact.[21] Would this dichotomy result in taxpayers being required to undertake a different fair market value analysis for the partnership interest depending on how the interest is transferred? Such an analysis would seem to undercut the conclusion that taxpayers really can determine the "fair market value" of a partnership interest. Guidance with respect to this issue obviously would be of great importance in applying section 470.
- Problems also could arise in the context of preferred partnership interests that are not redeemable for a period of time without payment of a penalty. Suppose that a foreign (i.e., tax-exempt) partner is the general partner of a partnership. Taxable partners hold nine-percent cumulative preferred partnership interests that are mandatorily redeemable in ten years. The partnership, which is managed by the foreign general partner, may redeem the preferred interests earlier by paying a penalty equal to an additional one-percent percent cumulative return to the partners determined through the redemption date. Would the payment of the penalty cause the foreign partner to be treated as acquiring an indirect interest in the partnership at other than fair market value (i.e., the value of a nine percent preferred partnership interest) or is the penalty provision taken into account in determining the value of the partnership interest? One would hope that the answer is the latter, given that the penalty provision is an inherent feature of the partnership interest, but this answer is by no means clear under the statute.[22]
- It is common for a partnership or partner promoting a partnership to reacquire a partnership interest from a service provider partner when the service provider ceases to provide services for the partnership. The acquisition price may be the

[19] Prop. Reg. § 1.83–3(l); Notice 2005–43, 2005–24 I.R.B. 1221.

[20] In determining whether a partnership's allocations have economic effect, the regulations generally require that liquidating distributions with respect to a partner must be in accordance with that partners' positive capital accounts. Treas. Reg. § 1.704–1(b)(2)(ii)(b)(2). This requirement, however, is not violated if "all or part of the partnership interest of one or more partners is purchased (other than in connection with the liquidation of the partnership) by the partnership or by one or more partners... pursuant to an agreement negotiated at arm's length by persons who at the time such agreement is entered into have materially adverse interests and if a principal purpose of such purchase and sale is not to avoid" the principle that partners must receive the economic benefit and bear the economic burden relating to allocations. Treas. Reg. § 1.704–1(b)(2)(ii)(b) (flush language).

[21] See supra note 19.

[22] Note that this question also raises issues that relate to the discussion immediately above. That is, from a willing buyer/willing seller valuation perspective, some discount for the penalty provision likely would be taken given the probability that the interest will not be redeemed prior to the end of ten years. Presumably, no such discount would be applied once it became clear that the redemption option would be exercised early, so that penalty provision clearly would apply. Issues such as this, however, create significant confusion.

amount the service provider paid for its interest, book value, or some other amount that does not reflect the fair market value of the interest. The service provider partner does not receive the full fair market value simply because the arrangement was structured so as to deter the service provider partner from terminating the employment relationship. Although this kind of arrangement does not present SILO concerns, it arguably violates the fair market value option requirement because a tax-exempt partner's indirect interest (or direct, where a tax-exempt partner acquires directly the interest) may be increased as a result of the exercise of the option to reacquire the partnership interest from the service provider.

- The fair market value option requirement also provides the potential for partners to use section 470 to their benefit. For instance, assume that two small partners, one taxable and one tax-exempt, are bargaining to have their partnership interests redeemed. In order to inflate the redemption price, the taxable partner threatens to issue a non-fair market value option to the tax-exempt partner to acquire the taxable partner's interest. Such an option could cause the partnership to become subject to loss deferral under section 470, which would adversely affect all of the taxable partners. This possibility could force the partnership to succumb to the economic blackmail of the partners who are bargaining for redemption, such that the partnership would pay those partners an inflated amount for their partnership interests. This result obviously is not one that the tax system should encourage.

4. Issues Regarding Tiered Partnerships

The amendment grants regulatory authority to "provide for the application of [section 470] to tiered and other related partnerships." The issues regarding the application of section 470 in the tiered partnership context are so significant that we believe that the provision literally will be impossible to apply in many, if not most, situations involving partnerships with taxable and tax-exempt partners.

A very significant portion of the universe of partnerships with taxable and tax-exempt partners involves investment partnerships where the tax-exempts are merely passive financial investors in a "fund" partnership that is managed by a third-party promoter. The "fund" partnership often will invest in the underlying property or business that is the subject of its investment through one or more tiers of partnerships.[23] It is not unusual for one fund to joint venture with another fund with respect to a particular investment. This may occur from the inception of an investment or during the life of an investment, where the original fund wants to diversify its risk or capture part of its return with respect to the investment. Also, many times, one fund will actually invest as a partner in another fund. There often will be different properties and partners involved at each tier in the investment structure.

Numerous additional reasons exist for tiered partnerships, including a desire to isolate certain properties in a portfolio for partial investment by a different group of investors, structural, as opposed to legal, subordination in lending and equity arrangements, regulatory reasons, and state and foreign tax planning, just to name a few. Given the frequency with which taxable and tax-exempt partners join together in tiered partnership arrangements, it is absolutely imperative that parties have clear guidance in any enacted legislation as to how the rules of section 470 should apply in this context. Some of the problems arising in the tiered context—for both taxpayers and the Government—are as follows:

- It is not clear how a lower-tier partnership will obtain the information necessary to determine whether and how section 470 applies. Under the amendment, section 470 applies on a property-by-property basis, so the partnership that holds the direct interest in the property will have to determine the extent of loss disallowance. Often, this partnership will have no access to information regarding the ultimate partners, whether there is a non-fair market value option at any level in the tiered partnerships, whether an arrangement or set aside exists at any level in the tiered partnerships, and whether non-qualified allocations exist at any level in the tiered partnerships. Lower-tier partnerships could take the conservative position that section 470 applies to all property and include information on the Schedule K–1s to this effect. This obviously would be a reporting nightmare. Similarly, if there are multiple chains of partnerships flowing from the ultimate properties, and section 470 applies because of a viola-

[23] The exception in the Technical Corrections Act for nondepreciable property will not remove the partnership from the application of section 470 to the extent (as is common) the fund invests in non-corporate entities that hold operating businesses or other property (such as real estate) that is subject to the allowance for depreciation.

tion in one of the chains, how will partners in another chain know to apply section 470 where all parties in that chain have arranged their affairs so as to comply with section 470?

- It is not clear how the no "arrangement" or "set aside" requirements apply in a tiered partnership structure. For instance, is the 20-percent safe harbor available in a tiered arrangement where funds may be set aside for distribution or for the benefit of a lender in one or more upper-tier partnerships? The 20-percent safe harbor is not available in "outside defeasance arrangements" where the funds set aside are not "partnership property." Does "partnership property" refer only to funds held by the partnership where the property that potentially is subject to 470 resides, or does it refer to property anywhere in the chain between the property and the ultimate partners? If the 20-percent safe harbor cannot apply in this situation, the safe harbor will be of very little use in escaping the inappropriate application of section 470, particularly where "arrangements" and "set asides" with respect to lenders must be considered. If the safe harbor can apply, how does one accomplish the 20-percent calculations where there is a different mix of partners, properties, and creditors at each tier in the structure?

The Joint Committee Description contemplates that regulations "may permit or require the aggregation of tiered or related partnerships for purposes of any or all determinations required under section 470." Obviously, one can reach very different results depending on whether aggregation applies. Until regulations are promulgated, are taxpayers left to apply section 470 on both an aggregate and tier-by-tier basis, taking the worst of the two results? Similarly, if aggregation applies, how would it apply where there are different properties at each tier? If one were allowed to aggregate all properties and partnerships, it is possible to see how a SILO-replicating arrangement could "slip through the cracks." That is, suppose that a SILO-replicating arrangement is created between a taxable and tax-exempt partner in a lower-tier partnership, but the parties bring into that partnership for a small interest an upper-tier partnership that, itself, holds significant property and has significant taxable partners or debt. By bringing in the upper-tier partnership, the base against which the 20-percent safe harbor is applied would grow to a level that could permit complete defeasance of the taxable investor's investment at the lower-tier partnership.

Assuming that more limited aggregation must apply to prevent such arrangements, how would it apply? In order to prevent parties from "growing the base" against which the 20-percent safe harbor applies, would the parties have to apply the 20-percent safe harbor on a property-by-property basis? Seemingly, such an analysis would require that the parties determine the ultimate proportionate ownership of each property by each partner and then take a proportionate amount of each partner's section 704(b) capital account and recourse debt, allocating such debt and capital to such portion of the property. This amount then would be combined for every taxable partner with respect to every property. Obviously, with different partners at each tier, economic sharing ratios that vary for partners at each tier, and different loans in place at each tier, this analysis would be inordinately complex, even assuming that perfect information were available.

Similarly complicated questions arise in trying to apply the "20 percent of partnership debt" prong of the "allowable partnership amount" test, given that debt with respect to partnership property may be incurred at different levels in the structure. Presumably this analysis would require an analysis of the test again on a property-by-property basis and would require liability tracing rules akin to those used for purposes of section 163 or 265.

- Similar complications arise with respect to options in tiered partnership arrangements. The options rules contained in the amendment essentially operate with respect to arrangements whereby the tax-exempt can purchase, or can be forced to purchase, partnership property or interests for an amount other than fair market value. Questions arise in determining how the rules apply where options exist between tiers of partnerships or between a partner and a middle-tier partnership. Apart from the issue as to how the lowest tier partnership would know that such options even exist, an issue arises as to how such options fit into the scheme of section 470. Such options are not actually putting a direct interest in the property or partnership interest in the hands of a tax-exempt partner. However, such options may be increasing one or more tax-exempt partners' indirect interests in partnership property. On the other hand, depending on the mix of partners in the various tiers, the options may operate so as to decrease indirect tax-exempt ownership in the property. Or, the calculus may change from year to year based upon transfers of partnership interests among taxable and tax-exempt partners in upper-tier partnerships. Again, even with perfect information, making this determination would be extremely time consuming and difficult. It may be that the Government would decide that any option at other than fair market value anywhere within the tiers would give rise to loss deferral under section 470. Such a result, however, would unfairly subject many legitimate arrangements to a loss deferral regime that Congress intended to apply only to SILO-replicating partnership structures.

5. Need for Other Exceptions/Rules

As was indicated above, we believe that, under the Technical Corrections Act, many legitimate pass-thru entities would not be able to consistently satisfy both parts of the Two-Part Test and would be subject to section 470, even though they are not engaged in the kinds of activities with which Congress was concerned in enacting that section. Therefore, we continue to believe, as stated in our prior submission, that section 470 should not apply to the pass-thru entity's property if no tax-exempt partner has significant operational control over the property or uses the property to a significant extent.[24] In addition, as explained in our prior report, we believe that partnerships satisfying the allocation rules in section 514(c)(9)(E) (i.e., the "fractions rule") should be excluded from section 470. The "qualified allocation" rules in section 168(h)(6) are so restrictive as to be virtually useless in sophisticated partnerships like those that typically have tax-exempt partners, and there would be no potential for undertaking a SILO-like arrangement where the partnership's allocations comply with section 514(c)(9)(E).[25]

Alternatively, we believe that a more general anti-abuse rule for the application of section 470 to partnerships, which incorporates an analysis of taxpayer intent and the facts and circumstances taken as a whole, warrants consideration, in lieu of an approach that, in effect, broadly sweeps legitimate partnerships "into" section 470 and then relies on specific exceptions to attempt to remove legitimate arrangements. We generally have not favored such a subjective analysis, given the problems inherent in planning in the face of uncertain standards. Nonetheless, if the law (or legislative history) contains appropriate specificity regarding the characteristics of the SILO transactions with which Congress is concerned, we think that such an approach could distinguish abusive transactions from those that are legitimate business transactions in a manner that is more accurate than the standards contained in the Two-Part Exception.

Nonetheless, if the drafters remain committed to an approach that relies primarily on identifying economic aspects of a partnership arrangement that bear some relationship to a SILO, we believe it imperative that an additional, mutually exclusive, economic factor be adopted that would allow many legitimate partnerships to escape loss deferral under section 470. As one option, a factor could be adopted that would except from section 470 partnerships where all taxable partners satisfy a threshold projected variance in their investment return with respect to the partnership. Given that one of the hallmarks of a SILO transaction is that the taxable purchaser of the property undertakes no meaningful risk and has no meaningful upside with respect to the property, it seems that the Government could safely assume that a partner whose return is projected to vary by some reasonable amount is not engaging in a SILO-like transaction. Taxable partners with pure preferred interests (i.e., interests that accrue only a fixed return and that are allocated losses only after partners of all other classes have depleted their capital) would have to be excluded from the analysis, but, being in a last-loss position, such partners would not represent candidates for replicating a SILO transaction.

We do not believe that this factor is an ideal means of excluding legitimate partnerships from the reach of section 470, as there are difficult issues of proof in showing variability in projected returns, and issues relating to the exclusion of partners with pure preferred interests in tiered partnership arrangements would be difficult. Nonetheless, this exception would be generally consistent with the approach taken in the Two-Part Exception and would offer an additional way out of section 470 for

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[24] As was explained in depth in our previous submission, the tax-exempt partner's continued control over, or use of, the property is a critical ingredient in a SILO transaction. Also, note that this approach has the added benefit in the tiered partnership context of being capable of analysis by the partnership that holds the property that could be subject to section 470. By permitting analysis with respect to the property itself, the partnership that is required to report under section 470 could more easily determine whether section 470 applies to property that it holds.

[25] We recognize that the fractions rule has been criticized in the past and that there may be some hesitancy to reference a rule that ultimately may be modified. Nonetheless, if the fractions rule is modified in the future, consideration could be given at that time to whether and how such modification would (or would not) apply in the context of section 470.

the many legitimate partnerships that would be unable to satisfy the Two-Part Exception.

6. Concerns Regarding Regulatory Authority

Even if a partnership's property falls outside the scope of section 470 by virtue of the exceptions currently included in the Technical Corrections Act, the bill would provide the Government with broad authority to issue regulations treating partnership property as tax-exempt use property "if such property is used in an arrangement which is inconsistent with the purposes" of section 470, determined by reference to certain factors. These factors include that:

(1) a tax-exempt partner maintains physical possession or control, or holds the benefits and burdens of ownership, with respect to such property;

(2) there is "insignificant" equity investment in such property by any taxable partner (with the term "insignificant" not being defined);

(3) the transfer of property to the partnership does not result in a change in use of such property;

(4) the deductions for depreciation with respect to such property are allocated disproportionately to one or more taxable partners relative to such partner's "risk of loss" with respect to such property or to such partner's allocation of other partnership items; and

(5) such "other factors as the Secretary may determine."

We are very concerned with this extremely broad grant of regulatory authority and the vagueness of certain of the factors described above, particularly given the possibility that the IRS might attempt to issue regulations with retroactive application. Although we agree that the IRS should have the authority to issue regulations to subject those pass-thru entities that truly are being utilized to replicate SILO arrangements to section 470, we are concerned that the IRS might utilize this regulatory authority to challenge allocations and other arrangements that have nothing to do with the SILO-concerns Congress was trying to address in enacting section 470. This is particularly likely given the vagueness of certain of the factors and the lack of clear definition, in the statute and the JCT Description, of the particular kind of transaction with which Congress was concerned in enacting section 470.

Thus, we strongly recommend that this broad grant of regulatory authority be narrowed to delete factors 2, 4, and 5, above; that factor 1 be modified so as to allow *de minimis*use by a tax-exempt partner; and that the parameters of a SILO-transaction and the purposes of section 470 be defined more objectively (in the legislative history if not in the statute).[26] Such modifications would provide more certainty for both the Government and taxpayers as to whether various arrangements are subject to section 470, while ensuring that any regulations that ultimately may be issued are appropriately focused upon the abuses with which Congress was concerned in enacting section 470.

We also are very concerned that the Technical Corrections Act seemingly would not provide the IRS with authority to exclude from the scope of section 470 those partnerships that fail to qualify for one of the objective exceptions, but that are not being used to replicate SILO transactions. Although we believe that the drafters of the Technical Corrections Act can significantly reduce the number of legitimate arrangements that would be inappropriately subject to section 470 by adopting appropriate standards, there still likely will be some legitimate arrangements that fail to fall within an exception as a result of a "foot-fault." Such regulatory authority is even more critical if the additional exceptions we suggested are not added, given that more legitimate arrangements will be exposed to the application of section 470.

7. Other Technical Issues

The definition of "tax-exempt partner" in the Technical Corrections Act still encompasses tax-exempt controlled entities. For the reasons set forth in our previous submission, we believe that taxable corporations and foreign persons that are taxed adequately in foreign jurisdictions should not be treated as tax-exempt entities for purposes of section 470.

Section 470 generally applies on a property-by-property basis. The JCT Description provides that regulations "may permit or require the aggregation of partnership property." As was indicated in our previous submission, we believe the property-by-

[26] Among other things, we note that, relying on factors 2 and 4, the IRS and Treasury seemingly could, in effect, eliminate the exception under section 465(b)(6) of the "at risk" rules for qualified nonrecourse financing without obtaining legislative approval. We respectfully question whether Congress intended such a result in enacting legislation aimed at eliminating SILO transactions.

property application presents a host of problems. Thus, we support the ability to aggregate property in appropriate cases.

For the reasons set forth in our previous submission, RICs, REITs, and S corporations are not suitable vehicles for SILOs. Therefore, we suggest that it be clarified that none of these entities is treated as a pass-thru entity for purposes of applying section 470.[27]

8. Concerns Regarding Effective Date

Section 6 of the Technical Corrections Act appears to apply to property acquired after March 12, 2004. As was indicated above, the IRS and Treasury have indicated that the IRS will not apply section 470 to disallow losses associated with property that is treated as tax-exempt use property solely as a result of the application of section 168(h)(6) in tax years beginning before 2006. The JCT Description indicates that the technical correction is not intended to supersede the rules set forth in the two regulatory moratoria that previously have been issued. Nonetheless, this concept is not reflected in the bill language. In addition:

- Given that the Technical Corrections Act was introduced in October of 2006, pass-thru entities would not have been able to even attempt to comply with the Two-Part Test for their 2006 tax years.
- Taxpayers may not be able to restructure arrangements that were put in place after March 12, 2004, in order to comply with the Two-Part Test in future years.
- As was indicated above, we believe it is inappropriate for the Technical Corrections Act to expand the portion of property with respect to which losses are disallowed retroactively.

To this end, we recommend that section 470 not be applied by reason of section 168(h)(6) to any property of a pass-thru entity acquired before the date the Technical Corrections Act was introduced. The amendments to section 470 similarly should apply only to property acquired on or after the date the Technical Corrections Act was introduced.[28] Nonetheless, even this effective date will produce an inequitable result where property is acquired after such date by partnerships that have an existing "arrangement" or "set aside" or an option at other than fair market value that cannot be modified or eliminated. Thus, we respectfully submit that "arrangements" or "set asides" or options at other than fair market value that are in place as of the effective date should be grandfathered, such that they do not cause a partnership to fail the Two-Part Exception.

We do not believe that such modifications present an opportunity for abuse (or should cause the legislation to lose revenue) insofar as we are not aware of any partnerships that have been structured to replicate the economics of a SILO arrangement. Indeed, the enactment of section 470 in the 2004 Act should have deterred the promotion of any such partnership arrangements.

V. Extension of Moratorium

As explained above, Congress intended for section 470 to apply only to those pass-thru entities that are engaged in, or being used to replicate, SILO transactions. As noted, we are not aware of any pass-thru entities that, in fact, have been structured or utilized so as to replicate SILO transactions. Nonetheless, a large number of pass-thru entities in a variety of different industries are potentially subject to the loss deferral rules merely because of the characteristics of their partners and their allocations. While section 6 of the Technical Corrections Act is a step in the right direction, it does not go far enough in exempting from the application of section 470 those entities that are not engaged in the abuses Congress intended to prevent. Further, given the vagaries of the legislative process, it is unclear whether technical corrections legislation will be enacted this year.

Therefore, if appropriate legislation is not enacted this year that removes legitimate arrangements from the application of section 470, we strongly encourage the

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[27] See C. Kulish, J. Sowell, and P. Browne, Section 470 and Pass-thru Entities: A Problem in Need of a Solution, 7 Bus. Entities 12, 25–26 (2005) (discussing why a REIT should not be treated as pass-thru entity for purposes of section 470).

[28] We recognize that the effective date of a technical correction traditionally is the same as the effective date of the legislation to which the technical correction relates. We note, however, that section 7 of the Technical Corrections Act, relating to dividends received by a corporation that is a DISC or former DISC, breaks from this tradition and applies only to dividends received on or after September 26, 2006 (the date that the Technical Corrections Act was introduced), in taxable years ending after such date. We respectfully submit that the tax policy concerns justifying such a delayed effective date are extremely compelling in the context of section 470, such that the effective date of section 470 and the amendment thereto similarly should be adjusted.

Government to extend the moratorium on the application of section 470 to pass-thru entities that are not engaged in covered leasing transactions to tax years beginning before 2007. Failing to extend the moratorium in this situation not only would subject a large number of legitimate taxpayers to a loss deferral regime in contravention of Congressional intent, but also would create a compliance nightmare for both the Government and taxpayers given the lack of operating rules for the application of section 470 to partnerships. Further, extending the moratorium in late 2006 would not open the door for synthetic SILOs to be implemented in 2006 given both that most of 2006 already has transpired and that legislation is pending that would subject any synthetic SILOs structured in late 2006 to the loss deferral rules.

II. Comments on Proposed Technical Corrections to Code Section 355

A. Current Law

The Tax Increase Prevention and Reconciliation Act of 2005 amended the active trade or business requirement of section 355(b) by adding paragraph (3). Under section 355(b)(3), all members of a corporation's "separate affiliated group" (determined under section 1504(a) and without regard to section 1504(b)) ("SAG") are treated as one corporation for purposes of the active trade or business requirement. Section 355(b)(3) applies to distributions made after May 17, 2006, and on or before December 31, 2010.

B. Proposed Technical Correction

In the Tax Technical Corrections Act of 2006 (the "Act"), Congress has proposed to clarify that the term "separate affiliated group" in section 355(b)(3) would not include any corporation that became an otherwise qualifying member of the SAG (or of any SAG to which the active business rule of the provision applies for the same distribution) within the five-year period ending on the date of the distribution by reason of one or more transactions in which gain or loss was recognized in whole or in part. Additionally, the Act would provide that a business conducted by the corporation at the time it became a qualifying member will not be included. The Act also would clarify that Treasury shall prescribe regulations that provide for proper application of section 355(b)(2)(B), (C), and (D) to distributions to which section 355(b)(3) applies.

The Joint Committee on Taxation's description of the Act illustrates the proposed amendment as follows: Distributing spins off Controlled. Within the five-year period ending on the date of the spin-off, Distributing acquires, in a transaction in which gain or loss was recognized, stock ownership of Corporation such that Corporation would otherwise qualify as a member of Distributing's SAG. Corporation will not be considered a member of the SAG of Distributing if it is retained by Distributing in the spin-off. Moreover, if Distributing transfers the stock of Corporation to Controlled prior to the distribution, Corporation will not be considered a member of the SAG of Controlled. Likewise, a business conducted by Corporation will not be includable in either relevant SAG, regardless of whether such business is held by another corporation that otherwise is included in either relevant SAG.

C. Analysis of Proposed Technical Correction

Historically, the requirements for section 355 treatment were based on the definition of ownership as provided in section 368(c) (at least 80 percent of the voting stock and at least 80 percent of all other classes of stock). For example, section 355(b)(2)(D) provides that if control of a corporation, as defined in section 368(c), is acquired in a transaction in which gain or loss is recognized, the business of that corporation may not be relied upon to satisfy the active trade or business requirement of section 355(b). New section 355(b)(3), however, is based on the definition of ownership contained in section 1504(a) without regard to section 1504(b) (at least 80 percent of the voting power and value of all stock). Section 355(b)(3) as enacted by TIPRA did not address the interaction of the affiliated group test of section 355(b)(3) and the control test of section 368(b)(2)(D), creating certain anomalies.

In one such anomalous example, which may have been the impetus for the proposed technical correction, it seems possible to satisfy the section 355(b)(3) active trade or business requirement in contravention of the policy (but not the language) of section 355(b)(2)(D) by acquiring stock of a corporation that satisfies the section 1504 ownership requirement, but not the section 368(c) ownership requirement. For example, if Distributing has an active business but Controlled does not, Controlled could purchase the common stock of Corporation, that represents 80 percent of the voting power and value of Corporation, but not acquire any of Corporation's nonvoting preferred stock. As a technical matter, Controlled would satisfy the active business requirement of section 355(b)(3) because Corporation would be a member of Controlled's SAG. The proposed technical correction would provide that Corporation could not be treated as part of Controlled's SAG because it was purchased within the last five years. It seems appropriate to ensure that the principle of section 355(b)(2)(D) should continue to apply to members of a corporation's SAG that were acquired in a transaction in which gain or loss was recognized.

The proposed technical correction seems to go further, though. Excluding Corporation from the SAG seems to indicate that the "expansion" doctrine would not apply to an acquisition of stock in a transaction in which gain or loss is recognized. Treasury Regulation § 1.355–3(b)(3)(ii) permits a corporation to acquire a business in a taxable acquisition during the five-year period, provided that the business is an expansion of a pre-existing active business (i.e., a business that qualifies as an active business under section 355(b)(2)). An expansion requires that the acquired business is in the same line of business as the old-and-cold business. It is wholly consistent with the operation and policy of section 355(b)(3), providing that all members of a corporation's separate affiliated group are treated as one corporation, that a taxable acquisition of a business by any member of the separate affiliated group potentially could qualify as an expansion regardless of whether by stock or asset acquisition. In fact, even without the enactment of section 355(b)(3), the Internal Revenue Service had determined that it was possible to rely on the expansion doctrine for a business acquired in a taxable acquisition of stock.

D. Recommendation

The American Bar Association Section on Taxation strongly recommends that the proposed technical correction not be enacted without modification to make clear that any such change will not interfere with the law that has developed to allow an expansion of a historic business. This could be accomplished by making clear that the expansion doctrine will be applied on an affiliated group basis, without regard to the SAG membership and providing examples to illustrate the principle.

We note that there are other anomalies created by the disparate ownership definitions that could be addressed by modifications to section 355. For example, assume Controlled (with no business of its own) historically has owned all of the voting common stock of Corporation representing 80 percent of the value of Corporation, but does not own the nonvoting preferred stock, Corporation is part of Controlled's SAG and thus satisfies section 355(b)(3). If Controlled then purchases Corporation's nonvoting preferred stock prior to the spin-off, section 355(b)(2)(D) technically would apply. Presumably, Controlled should still be treated as satisfying the affiliated group test of section 355(b)(3), but it is unclear how to reconcile the two provisions and whether satisfying section 355(b)(3) would be dependent on arguing that the purchase is an expansion of a pre-existing business in Controlled or the Corporation itself (which does not seem sensible). Clarification on this interaction would be welcome.

Williams & Jensen, P.C.
on behalf of Church Alliance
October 27, 2006

Chairman William Thomas
Ranking Member Charles Rangel
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Thomas and Ranking Member Rangel:

On behalf of the Church Alliance, an organization representing the church benefits programs of a wide variety of denominations, I am submitting the attached proposed technical correction to the Pension Protection Act of 2006, for consideration to be included in the Tax Technical Corrections Act of 2006.

Thank you for the opportunity to comment.

Sincerely,

David Starr
Counsel

Technical Correction for PPA, Section 867

Providing Relief on Section 415 Percentage Limits for Lower Paid Participants of Church Plans

Certain defined benefit church plans provide benefit formulas that favor certain lower-paid employees/ministers. For example, some plans provide that benefits are calculated using a denomination's average wage for those who earn less than the average amount. These plans are finding that they are exceeding the tax law limitation under section 415(b) that prohibits paying benefits that exceed the average of the highest three years of compensation. The Pension Protection Act of 2006 (H.R. 4, P.L. 109–280) addresses this issue in section 867 for certain non-highly compensated participants in church plans. The enacted language of the law reads as follows:

"SEC. 867. CHURCH PLAN RULE.

(a) In General—Paragraph (11) of section 415(b) of the Internal Revenue Code of 1986 is amended by adding at the end the following:

"Subparagraph (B) of paragraph (1) shall not apply to a ***plan maintained by an organization described in section 3121(w)(3)(A)*** except with respect to highly compensated benefits. For purposes of this paragraph, the term highly compensated benefits' means any benefits accrued for an employee in any year on or after the first year in which such employee is a highly compensated employee (as defined in section 414(q)) of the organization described in ***section 3121(w)(3)(A).*** For purposes of applying paragraph (1)(B) to highly compensated benefits, all benefits of the employee otherwise taken into account (without regard to this paragraph) shall be taken into account."

(b) Effective Date—The amendment made by this section shall apply to years beginning after December 31, 2006." [emphasis added]

The JCT technical description of H.R. 4 (JCX–38–06) explains that "[t]he provision provides that the 100 percent of compensation limit does not apply to a plan ***maintained by a church or qualified church controlled organization*** defined in ***section 3121(w)(3)(A)*** except with respect to highly compensated benefits'" [emphasis added].

The Church Alliance believes the Code citation that is highlighted in the text of the PPA is contrary to the JCT description and is a technical drafting error, for the following reasons:

1. The language in the bill does not reflect the description contained in the Joint Committee description. The description provides that Qualified Church Controlled Organizations (QCCOs) were intended to be covered under the provision. The actual citation to Code section 3121(w)(3)(A) omits QCCOs.
2. The language creates a distinction between churches and certain Qualified Church Controlled Organizations (QCCOs) that exists nowhere else in the pension provisions of the Code to our knowledge. Non-QCCOs were intentionally excluded from the provision (for example, church controlled hospitals). Distinctions between churches and QCCOs on the one hand, and non-QCCOs on the other hand, have been made for church plans in several cases in the Code. However, there is no policy reason for protecting the pension benefits of lower-paid workers in a church, but not the pensions of lower-paid workers of a qualified church controlled organization (e.g., charity, church camp, mission, etc.).

We believe that the source of the technical error was that in the final drafting process for H.R. 4, Congress used language originally included in H.R. 1776 (Portman-Cardin) as introduced in the 108th Congress. Section 906 of that bill included the § 415 change, but mistakenly limited it only to churches as described in the Code section 3121(w)(3)(A). That mistake was subsequently corrected when Rep. Portman reintroduced his next version of the bill in the 109th Congress (H.R. 1960, sec. 405). Moreover, the language was also correct in S. 2193 introduced this year by Senator Hutchison.

On behalf of the Church Alliance, we urge Congress to correct this technical error in the language of section 867.

Proposed Language:

Section 867(a) of the Pension Protection Act of 2006 (P.L. 109–280) is amended by striking 'section 3121(w)(3)(A)' wherever it appears and inserting 'section 3121(w)(3)'.

October 31, 2006

The Honorable Bill Thomas
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

The Honorable Charles Grassley
Chairman
Committee on Finance
U.S. Senate
Washington, DC 20510

Chairman Thomas and Chairman Grassley:

I am writing to convey the interests of small business advocacy organizations that have contacted me regarding H.R. 6264 and its Senate counterpart S. 2026, the Technical Corrections Act of 2006. Specifically, trade and membership organizations that represent small businesses have expressed concern with how Section 7 may impact their operations.

Congress established the Office of Advocacy at the U.S. Small Business Administration (SBA) to represent the views of small businesses before Federal agencies and Congress. Public Law 94–305 requires that the Office of Advocacy, "determine the impact of the tax structure on small businesses and make legislative and other proposals for altering the tax structure to enable all small business to realize their potential for contributing to the improvement of the Nation's economic well-being."[1]

The Office of Advocacy is an independent office within the U.S. Small Business Administration, so the views expressed in this letter do not necessarily reflect the views of the SBA or the Administration. This letter was not circulated to the Office of Management and Budget for comment prior to its submittal to Congress.

First, I must commend the Committee for soliciting review and comment, for working in consultation with the Joint Committee on Taxation, and for working with the U.S. Department of the Treasury prior to finalizing technical corrections. The technical corrections legislation will be better written due to your inclusiveness and your commitment to make comments publicly available after the comment period has ended.

I feel that it is my responsibility to convey that some small business groups have concerns with Section 7. The small business groups that have contacted me believe Section 7 will prevent Interest Charge Domestic International Sales Corporation (IC–DISC) dividends from being taxed at the lower 15-percent tax rate.

I pointed out the positive impact that recent tax legislation has had on small business when I testified before the Small Business Committee in the House of Representatives in 2003.[2] More recently, dynamic analysis conducted by the U.S. Department of Treasury, documents the economic benefits of lower tax rates on dividends for small business and the economy in general.[3] The tax relief legislation drafted by your Committee and enacted in 2001 and 2003 demonstrates an appreciation for how legislative changes to the tax code impact small business. I would like to work with the Committee to ensure that small business views are fully vetted prior to finalizing the Tax Technical Corrections Act of 2006 so that small business can continue to benefit from tax relief passed by the 108th and 109th Congresses.

If you have questions about the content of this letter, please do not hesitate to contact me or my office's tax counsel, Candace Ewell.

Sincerely,

Thomas M. Sullivan
Chief Counsel for Advocacy

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[1] 15 U.S.C. Sec. 634(b)(4).

[2] Testimony of Thomas M. Sullivan, Chief Counsel for Advocacy, U.S. Small Business Administration before the Committee on Small Business, U.S. House of Representatives, Assisting Small Business Through the Tax Code—Recent Gains and What Needs to be Done (July 23, 2003), http://www.sba.gov/advo/laws/test03_0723.html

[3] U.S. Department of the Treasury, Office of Tax Analysis, A Dynamic Analysis of Permanent Extension of the President's Tax Relief (July 25, 2006), http://www.ustreas.gov/press/releases/reports/treasurydynamicanalysisreporjjuly252006.pdf

NH Research
Irvine, California 92606
October 31, 2006

The Honorable Bill Thomas
Chairman, Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Congressman Thomas,

NH Research is a privately-owned, $8-million-per-year manufacturer of automated test equipment for electronic power supplies. Approximately 1/3 of our business is international. This percentage, however, is growing rapidly due to the mass exodus of domestic electronics manufacturing to lower-cost Asian countries. In order to compete for business abroad we must invest heavily in local sales and service offices. For example, we have had to established offices in Shenzhen and Suzhou, China, where 70% of the world's electronic power supplies are now manufactured.

NH Research has only been able to accomplish this through the benefits afforded by the IC–DISC, which we have had in place since 1986.

To suddenly repeal this benefit is both unfair and hardship to our export sales efforts. In addition, it is disruptive to our 2006 year-end tax planning. Small private companies like us need all help they can get to compete in the global marketplace.

We urge you to delay enactment of this "technical correction" until more discussion is held about the unintended consequences on small manufacturers increasingly dependent on export sales.

Thank you for considering our comments.

Sincerely,

Peter Swartz
President

Stoughton Trailers
Stoughton, Wisconsin 53589
October 30, 2006

Hon. Bill Thomas Chairman House Ways and Means Committee

Dear Hon. Thomas and Committee:

We are a truck trailer, container and chassis manufacturer employing 1,300 people in Stoughton Wisconsin, Evansville Wisconsin and Brodhead Wisconsin. This year, within a six-month period, the Chinese have put our Evansville facility out of business. The Evansville facility was dedicated to manufacturing domestic containers and chassis. We have employed approximately 300 people there since 1991. This year the Chinese have put U.S. manufacturers out of business, including Hyundai, Inc., a manufacturer of the same product in Tijuana, Mexico. The Chinese are importing both the chassis and the container to the West Coast cheaper than we can buy the materials for. Even Hyundai, Inc. of Tijuana, Mexico with their $7/hour labor fully burdened cannot compete. They are already making inroads into the U.S. over-the-road freight trailer market. I can foresee that within a few years they will import the bulk of truck trailers manufactured in this country. We also manufacture a large amount of trailers for export to Canada. I want to bring your attention to another pending disadvantage we will have if a Tax Technical Correction is enacted.

This letter is to alert you to a pending tax law development that we believe will be very harmful to U.S. based small and mid-sized manufacturers. The proposed change will increase taxes on U.S. manufacturers, making it even harder to compete against manufacturers located in other countries that offer incentives (i.e. China manufacturing tax holidays or India software exportation holidays.)

The Technical Corrections Bill introduces a Policy Change. Section 7 of the Tax Technical Corrections Act of 2006 prevents dividends received form an IC–DISC from obtaining the same maximum 15% federal tax rate as qualifying dividends from other types of corporations. Such a substantial change in tax law would seem to merit open consideration by House members and the public.

The One-Time Dividends Received Deduction Did Not Help Most Privately-Held Manufacturers. Various sources have quoted figures suggesting that small businesses represent the vast majority of new jobs created in the U.S. But, the one-time dividend received deduction available last year mostly benefited those

U.S. multinationals who had already exported jobs and who had already built up significant foreign infrastructures. There was no corresponding reward for those U.S. enterprises that built and maintained their businesses at home.

The Tax-Sophisticated Manufacturer Still Obtains Offshore Tax Benefits. The Technical Corrections Bill does not eliminate the availability of the 15% maximum federal rate on dividends from qualifying foreign corporations or qualifying corporations formed in possessions of the United States. Therefore, competitors who choose to locate operations outside of the U.S. can still benefit from the 15% tax rate after passage of the Technical Corrections Bill. This result seems unfair.

The Foreign-Owned Manufacturer Still Obtains Export Benefits. The Technical Corrections Bill applies only to U.S. non-corporate taxpayers. It doesn't seem fair that Congress would enact a Technical Correction that appears to aid the foreign-owned U.S.-owned, U.S.-based manufacturer, both of whom are competing in the global marketplace.

Thank you for your consideration of this letter. I appreciate your leadership on this important issue to U.S.-owned manufacturers.

Very truly yours,

Donald D. Wahlin
CEO

Software and Information Industry Association
October 31, 2006

The Honorable Charles Grassley
Chairman
Committee on Finance
U.S. Senate
Washington, DC 20510

The Honorable Bill Thomas
Chairman
House Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Chairmen Thomas and Grassley,

On behalf of the Software & Information Industry Association (SIIA), I appreciate the opportunity to provide feedback on the Tax Technical Corrections Act of 2006. As a representative of many small and medium-sized technology companies, I am concerned about the potential effects of the amendments related to dividends from IC–DISCs, specifically, the amendments to Sec. 302 of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA).

SIIA appreciates the efforts that you have taken in drafting the tax technical corrections legislation to ensure that the effects of Section 302 are not retroactive to the date of enactment of the JGTRRA. However, because a clear, simple reading of JGTRRA could have led many companies to utilize the IC–DISC for obvious reasons, we are concerned that any effective date of Section 302 other than a prospective date would present harmful consequences for many companies utilizing IC–DISCS—consequences that we believe are unintended and unjustified by this legislation.

Companies, in creating an IC–DISC, have a choice about when to structure the commission payment and resulting dividend. Some taxpayers choose to do this monthly, some quarterly, some semi-annually. Many choose to declare the commission and the dividend annually—at the end of the year—to minimize administration and financial charges that result from the transaction. As the amendment to Section 302 is proposed, these companies would be prohibited from engaging in an IC–DISC transaction for calendar year 2006. Effectively, the retroactive nature of this proposed amendment punishes these taxpayers for creating a transaction that was perfectly lawful. Furthermore, the retroactive amendment treats similarly situation taxpayers differently for no other reason than the choice of administrative mechanics, and it does so without notice or a chance to make other decisions before the rules would be amended.

In light of the unintended consequences of choosing September 29, 2006 as the effective date, I respectfully request that the drafters change the effective date so that all similarly situated taxpayers are treated similarly. Thus, we would urge the drafters to choose tax years beginning after December 31, 2006 as a more equitable effective date.

Sincerely,

Ken Wasch
President

KPMG LLC
October 25, 2006

Hon. Bill Thomas, Chairman
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington D.C. 20515

Dear Chairman Thomas,

This letter is being submitted in response to your September 29, 2006 request for comments regarding the "Tax Technical Corrections Act of 2006," introduced on September 29, 2006, in the House of Representatives as H.R. 6264 (the "Act"). *See* Committee on Ways & Means, Press Release, September 29, 2006. In particular, this letter requests that the Committee expressly confirm the intent of the proposed clarification of the active trade or business definition of section 355 by section 2(b) of the Act, particularly as discussed in the related Joint Committee on Taxation report. *See* Joint Committee on Taxation, *Description of the Tax Technical Corrections Act of 2006,* p. 3 (JCX–48–06), October 2, 2006 (the "JCT Report").

As I understand it, the proposed clarification is intended to ensure that a taxable stock acquisition does not result in section 355(b) being satisfied if it would not have resulted in section 355(b) being satisfied prior to the enactment of section 355(b)(3). It is my further understanding that the proposed clarification, however, is not intended to limit the Department of the Treasury or the Internal Revenue Service from interpreting the application of section 355(b)(2) in the context of stock acquisitions as they had prior to the legislative enactment of section 355(b)(3) or, as appropriate, from altering such interpretations.

For example, the otherwise qualifying active trade or business conducted by a corporation acquired in a taxable stock acquisition from an affiliate within the five-year period prior to the distribution may continue to satisfy section 355(b)(2)(D) in circumstances in which the "purchase" basis is eliminated. *See* Treas. Reg. Sec. 1.355–3(b)(4) (applicable to acquisitions prior to the Revenue Act of 1987 and Technical and Miscellaneous Revenue Act of 1988) and related private letter rulings; *see also* Treas. Reg. Sec. 1.355–6(b)(2)(iii)(A)–(C). Similarly, to the extent the "business expansion" doctrine, as reflected in Treas. Reg. Sec. 1.355–3(b)(3)(ii) and the related legislative history (*see* Conf. Rep. No. 2543, at 38 (1954)), sanctioned a taxable stock acquisition prior to the enactment of section 355(b)(3), such acquisition may continue to be sanctioned. *See* PLR 200545001 (March 10, 2005).

If this understanding of the intent of Section 2(b) of the Act is correct, it is respectfully requested that the Committee include language confirming such understanding in any Committee Report that may accompany the Act's enactment. For that purpose, included below for your reference is proposed clarifying language for the JCT Report which is marked to show the proposed revisions ("Appendix A").

Respectfully submitted,

Thomas F. Wessel
Principal

Appendix A—Proposed Clarifying Language Highlighted

DESCRIPTION OF THE TAX TECHNICAL CORRECTIONS ACT OF 2006

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

OCTOBER 2, 2006

JCX–48–06

INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the Tax Technical Corrections Act of 2006, as introduced on September 29, 2006, in the House of Representatives as H.R. 6264, and in the Senate as S. 4026.

I. TAX TECHNICAL CORRECTIONS

[p. 2] The bill includes technical corrections to recently enacted tax legislation. Except as otherwise provided, the amendments made by the technical corrections contained in the bill take effect as if included in the original legislation to which each amendment relates.

Amendments Related to the Tax Increase Prevention and Reconciliation Act of 2005

[. . .] [p. 3] **Modification of active business definition under section 355 (Act sec. 202).**—The provision clarifies that, for purposes of the special rule in section 355(b)(3) relating to the active business requirement, the term "separate affiliated group" does not include any corporation that became an otherwise qualifying member of such separate affiliated group (or of any other separate affiliated group to which the active business rule of the provision applies with respect to the same distribution) within the 5-year period ending on the date of the distribution by reason of one or more transactions in which gain or loss was recognized in whole or in part*., or in part, if such transaction(s) would have precluded such corporation from qualifying as being engaged in the active conduct of a trade or business prior to the enactment of section 355(b)(3).* Also, a business conducted by such a corporation at the time it became such an otherwise qualifying member shall not be included. Thus *in determining the satisfaction of the active business requirement if, prior to the enactment of section 355(b)(3), it could not have been so included.*

Therefore, as one example, if a parent corporation spins off a subsidiary and, within the 5-year period ending on the date of the spin-off the parent corporation had acquired, in a transaction in which gain or loss was recognized, stock ownership of a third corporation such that the third corporation would otherwise qualify as a member of a separate affiliated group in the spin-off, then that third corporation shall not be considered a member of the separate affiliated group of the parent corporation if it is retained by the parent corporation in the spin-off. Also, that third corporation shall not be considered a member of the separate affiliated group of the spun-off subsidiary, even if the parent corporation has dropped the stock of that third corporation down to the subsidiary in a tax-free transaction prior to the spin-off. Similarly, a business conducted by the acquired third corporation at the time that corporation would otherwise have qualified as a member of a relevant separate affiliated group (but for the transaction in which gain or loss was recognized) also will not be includable in either relevant separate affiliated group, regardless of whether such business is held by another corporation that otherwise is included in either relevant separate affiliated group.

The conclusions in the foregoing examples that the acquired corporation and its business are not included in the relevant separate affiliated group are based on an assumption that such corporation or business could not have been relied upon to satisfy section 355(b) prior to the enactment of section 355(b)(3). Thus, for example, no implication is intended as to whether section 355(b) is satisfied in the case of a corporation whose stock was acquired in a taxable transaction from (i) an affiliate after

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the Tax Technical Corrections Act of 2006* (JCX–48–06), October 2, 2006.

the Revenue Act of 1987 and the Miscellaneous Revenue Act of 1988 (see Treas. Reg. section 1.355–3(b)(4)), or (ii) a non-affiliate where a direct taxable asset acquisition could satisfy such requirement under the "business expansion" doctrine.

The provision also clarifies that the Treasury Department shall*, as appropriate,* prescribe regulations that *or otherwise interpret section 355(b)(3) to* provide for the proper application of sections 355(b)(2)(B), (C) and (D) to distributions to which the provision applies.

Statement of Williams & Jensen PLLC, on behalf of Houston Firefighters' Relief and Retirement Fund

The Pension Protection Act, Section 828

SEC. 828. WAIVER OF 10 PERCENT EARLY WITHDRAWAL POENALTY TAX ON CERTAIN DISTRIBUTIONS OF PENSION PLANS FOR PUBLIC SAFETY EMPLOYEES.

(a) In General.—Section 72(t) of the Internal Revenue Code of 1986 (relating to subsection not to apply to certain distributions) is amended by adding at the end the following new paragraph:

"(10) Distributions to qualified public safety employees in governmental plans.—

"(A) In general.—In the case of a distribution to a qualified public safety employee from a governmental plan (within the meaning of section 414(d)) which is a defined benefit plan, paragraph (2)(A)(v) shall be applied by substituting 'age 50' for 'age 55'.

"(B) Qualified public safety employee.—For purposes of this paragraph, the term qualified public safety employee' means any employee of a State or political subdivision of a State who provides police protection, fire-fighting services, or emergency medical services for any area within the jurisdiction of such State or political subdivision.".

(b) Effective Date.—The amendment made by this section shall apply to distributions after the date of the enactment of this Act.

Explanation of Section 828

According to the Joint Committee on Taxation's Technical Explanation of the Pension Protection Act (JCX–38–06, p. 177), Section 828 provides that "the 10-percent early withdrawal tax does not apply to distributions from a governmental defined benefit pension plan to a qualified public safety employee when separated from service after age 50."

Questions Following Enactment

(1) Whether the Section 72(t)(4) recapture tax would apply if a qualified public safety employee began a series of substantially equal periodic payments before or after enactment of Section 828 and then changed the series to utilize the new Section 828 exception?

(2) Whether a qualified public safety employee who begins a series of substantially equal periodic payments before or after enactment of Section 828 is precluded from utilizing the new exception provided under Section 828?

Discussion of Questions

Question 1—Prior to or following enactment of Section 828 some qualified public safety employees reached age 50, separated from service, and began taking a series of substantially equal periodic payments. These payments may have been necessitated by their children's education expenses or their own health expenses. Meanwhile, other public safety employees reached age 50, separated from service, but were in a financial situation that allowed them to defer distributions.

While the latter group may begin taking penalty-free distributions following enactment of Section 828, the former group cannot change its series of substantially equal period payments without triggering the recapture tax under Section 72(t)(4). The former group finds itself disadvantaged under the revised statute.

The final months or years of a public safety employee's life may be ones of catastrophic illness brought about by the on-the-job hazards they faced for years while protecting the public. Through enactment of Section 828 Congress demonstrated its belief that public safety employees who have reached age 50 should be given the flexibility to receive pension distributions without being penalized. Unfortunately, a small class of public safety employees stand to be denied this tax relief because they began a series of periodic payments.

The ***first sentence*** of the proposed technical correction language below provides that those qualified public safety employees who find themselves caught between the recapture tax and the new Section 828 exception will not be subject to the additional tax.

Question 2—*A question has been raised within the governmental plan community over whether a qualified public safety employee who began a series of substantially equal periodic payments would be precluded from taking advantage of the new Section 828. The* ***second sentence*** *of the language below provides that commencing a series of substantially equal periodic payments does not preclude a qualified public safety employee from subsequently taking a penalty-free distribution under Section 828.*

Proposed Technical Correction Language

Section 72(t)(10) is amended by adding a new subparagraph:

"(C) APPLICATION TO SERIES OF SUBSTANTIALLY EQUAL PERIODIC PAYMENTS.—Section 72(t)(4) shall not apply if a change in a series of substantially equal periodic payments is made after the date of enactment of this paragraph to a qualified public safety employee, provided the qualified public safety employee met the requirements of subparagraph (A) at the time the substantially equal periodic payments commenced. Additional tax under this section is waived as to distributions to which subparagraph (A) applies, regardless of whether prior distributions were made pursuant to section 72(t)(2)(A)(iv). "

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