HOUSE RESEARCH

Bill Summary

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Subject: Restrictions on LILOs and SILOs

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Overview

This bill provides that for purposes of the Minnesota corporate franchise tax, losses from lease-in/lease-out (LILO) or sale-in/lease-out (SILO) tax shelter type transactions cannot be used to reduce a corporation's other income, such as its operating or investment income. These restrictions operate in a manner similar to the passive loss rules that have been used to restrict individual income tax shelters since passage of the Tax Reform Act of 1986.

These LILO or SILO arrangements typically involve simultaneous lease transactions (or sale and lease transactions) between a taxable entity and a tax exempt entity (such as a local transit system or city water system). The properties that are involved are already owned by the tax exempt entity and the legal and financial arrangements provide it will continue to operate and maintain the property as it has in the past for a substantial period of time. The taxable lessor typically takes on few, if any, real risks of equity ownership of the property. In return for engaging in the transaction, the tax exempt entity receives a fee that represents a small part of the financial benefits of the tax benefits to the private, taxable entities.

Section

1 **Corporation add-back.** Requires corporations to add to federal taxable income for corporate franchise tax purposes the excess of the deductions over income from lease-in/lease-out (LILO) or sale-in/lease-out (SILO) transactions.

Section

2 **Corporate subtraction.** Allows a carryover subtraction for disallowed deductions in prior years from LILO and SILO transactions to the extent the properties generate income for the taxpayer.

3 **Tax exempt property; limits on tax benefits.** Defines terms:

- **Tax exempt use property** means property that is subject to the special lease rules under the Internal Revenue Code (often referred to as the Pickle rules) where a tax exempt entity is the lessee, plus the exemptions from these rules for (1) foreign persons and (2) high technology equipment do not apply. Generally, this category includes property that is leased to a tax exempt entity (e.g., a political subdivision or a 501(c)(3) corporation) that doesn't pay tax and, therefore, cannot benefit from the depreciation or other tax benefits associated with the property.

- **Taxpayer** means a corporation subject to the Minnesota corporate franchise tax that is claiming the deduction on the federal income tax return and any member of its unitary group.

A taxpayer is required to add back the amount (for the taxable year) that its deductions from tax exempt use property exceed its income from tax exempt use properties (e.g., the payments under the lease). This approach, in essence, imposes a passive loss limitation type rule: for example, it would not allow a corporation to use depreciation deductions from property leased to a local government (that qualifies under the Pickle rules as tax exempt property) to reduce its operating income (e.g., the profit it makes from manufacturing and selling widgets).

These disallowed deductions are not "lost" but are carried over to later taxable years, when the corporation has sufficient income from tax exempt use property. However, if a property stops being tax exempt use property, the carryover deductions for that property are limited to the income from it (e.g., gain realized on the sale or other payments). Any amount that cannot be used is, then, lost (i.e., it cannot be used to offset income from other tax exempt use properties). In general, the taxpayer can use the carryover deductions to reduce the gain on the sale tax exempt use property.

Effective date: These changes are effective for tax year 2004 and apply to leases entered into after the February 5, 2004.