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IRS Issues Ruling on Tax-Exempt Bond Proceeds Allocated to Acquisition Costs and Related Issues

By Forrest David Milder; Brown, Rudnick, Freed & Gesmer

The Internal Revenue Service (IRS) gave its views on some important issues related to bond-financed Section 42 projects, in a private letter ruling dated May 30, 2000.

The May 30 ruling involved the acquisition and rehabilitation of a housing project. Financing came from the issuance of two series of bonds by the same issuer, a tax-exempt series that was used to finance the acquisition and a taxable series that was used to finance the rehabilitation.

The proceeds of the tax-exempt bonds provided more than 50 percent of the financing for the "land and building" that comprised the project. However, apparently, if the costs of certain related "Section 1245 property" are included in this computation, then less than 50 percent of the costs will be bond-financed. It is not clear whether the Section 1245 property was "personal property" in a traditional sense.

The May 30 ruling reaches a few significant conclusions:

IRS Treats Two Debt Instruments as a Single Financing. First, the ruling concludes that where tax-exempt bonds and taxable bonds close on the same date, as "one transaction" with one trustee, the language in the bond documents that would allocate the tax-exempt debt to an acquisition while allocating the taxable debt to a rehabilitation, will *not* enable the rehabilitation to qualify for 70 percent credits. Instead, the rehabilitation portion of the project is only eligible for 30 percent credits.

Some may think that in issuing this ruling, the IRS chose to not extend the favorable rule of legislative history which states that the continuation of "old and cold debt" in an acquisition will not affect the credits available for a rehabilitation. The legislative history provides:

> "For example, a federal loan or tax-exempt bond financing that is continued or assumed upon purchase of existing housing is disregarded for purposes of the credit on rehabilitation expenditures." (H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. 11-91 (1986), 1986-3 (Vol. 4) C.B. 91.)

However, saving language does appear in the ruling. It provides:

> "If the acquisition and rehabilitation financings are independent transactions, the taint of the tax-exempt acquisition financing will not extend to the rehabilitation."

(continued on page two)

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Bond Proceeds

(continued from page one)

Clearly, this sentence is creating a broader exemption than the "continuation or assumption" language of legislative history. Although the next sentence in the ruling states that the taint will be present where "the financings are part of one plan of financing," its further observation, "as we have here," suggests that the ruling should be confined to its facts.

Thus, the IRS does not seem to be saying that federally-subsidized financing must be "old and cold" in order not to taint the rehabilitation. Instead, it is ruling that the subsidized financing must be clearly severable from any "good" financing. In other words, the unfavorable result follows where there are simultaneous closings of loans from one lender with one trustee, etc., but not where there are merely different financings closings at or about the same time.

This analysis is open to different interpretations. For example, the Treasury's bond regulations, at Section 1.150-1(c)(1), provide that two or more bonds will be considered part of the same "issue" if all of the following requirements are met: (A) the bonds are sold at substantially the same time (typically less than 15 days apart); (B) the bonds are sold pursuant to the same plan of financing (e.g., the bonds finance a single facility or related facilities, provided that short-term bonds to finance working capital are not the same as long-term bonds to finance capital projects, nor are certificates of participation in a lease and general obligation bonds); and (C) the bonds are reasonably expected to be paid from substantially the same source of funds (determined without regard to unrelated guarantees). Still, it appears that this definition *cannot* be the one on which the IRS relied in issuing the May 30 ruling.

The Section 150 regulations specifically provide that "Taxable bonds and tax-exempt bonds are *not* part of the same issue." Section 1.150-1(c)(2). [emphasis added]. Moreover, Section 1.150-1(c)(3) of the regulations would permit issues to be treated as "separate" if the proceeds are allocated "between each of the separate issues using a reasonable, consistently applied allocation method," something that was apparently done by the taxpayer in the May 30 ruling.

The Real IRS Motivation. It should be noted that there was something of a "double-dip" here—the project was attempting to avoid an allocation of credits by instead passing the 50 percent bond-financed test of Section 42(h)(4)(B), and, at the same time, it was attempting to get 70 percent credits on its rehabilitation expenditures. Perhaps the IRS was attempting to impose a standard that it felt should have been included in the statutory language— i.e., that use of the 50 percent test and 70 percent credits should be mutually exclusive. As is sometimes the case in the tax field, we may have a "nuclear" IRS response to this perceived abuse.

Implications for Other Transactions. We should query whether this ruling has implications beyond its own facts. For example, what about two debt obligations to different lenders that close at about the same time as part of a single plan of financing? And what about other kinds of financing, for example, below-market HOME loans that are limited by their terms to only paying for expenditures eligible for the 30 percent credit? If the argument presented here is correct, then these kinds of

(continued on page three)

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Bond Proceeds

(continued from page two)

financing, applied to acquisition costs, should not taint the entire project, and 70 percent credits should still be available for a non-subsidized rehabilitation.

The Second Portion of the Ruling – Does "Building" Include Personal Property? In computing the 50 percent test, the ruling also concludes that "Building is not limited to Section 1250 property, but includes all property (including Section 1245 property and depreciable land improvements)."

Apparently, the IRS is relying on the wording in Section 1.103-8(b)(4)(i) of the tax-exempt bond regulations that refers to "any functionally related and subordinate facilities." As a result, it may be that personal property must be taken into account in analyzing the 50 percent test.

In some ways, this portion of the ruling is more remarkable than the first part—the Code plainly refers to "the aggregate basis of any building and the land ..." There is no reference whatsoever to personalty, or even subordinate facilities. However, if the term "Section 1245 property" is intended only to identify certain property that is not "Section 1250 property," and yet is truly part of a building (flooring, for example), then the holding of the ruling is far more sensible. Presumably, this was the IRS' intention, although this is not clear from the ruling.

Are the Acquisition and the Rehabilitation Separate Buildings Such That Each Must be 50 Percent Bond Financed in Order to Bypass Credit Allocations? Finally, the ruling also concludes that "a taxpayer cannot separately meet the 50 percent test in Section 42(h)(4)(B) for the acquisition and the rehabilitation."

Of course, this ruling was directed at a taxpayer who finances more than 50 percent of its *acquisition* with tax-exempt bonds and then claims that at least the acquisition portion of the project was eligible for credits without needing an allocation. The May 30 ruling seems to adopt the better view that, for this purpose, the term "building" has the common sense meaning and should not be divided into separate acquisition and rehabilitation parts.

Clearly, this third ruling comes on the heels of a non-common sense definition (described in the preceding section) that would include Section 1245 property within the definition of "building." It is also interesting to note that the first ruling would have been different if the IRS had instead required the 50 percent test to be separately passed with respect to each of the acquired and rehabilitated "buildings." In that case, it would have been necessary for tax-exempt bonds to finance a portion of the rehabilitation so that the rehabilitation could qualify for credits. Of course, this would have made 70 percent credits unavailable for the rehabilitation, and the first ruling would have been unnecessary. ❖

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