Private Letter Ruling 8943074

Sec. 48 Investment Credit: Eligible property and special rules; Rehabilitation expenditures; Rehabilitation credit passthroughs

This is in response to a letter dated January 31, 1989, and subsequent letters, submitted on behalf of Limited Partnership and Lessee (the "Parties") by your authorized representatives. In the letters, rulings are requested concerning the availability of the rehabilitation credit percentage under former section 46(b)(4)(A) of the Internal Revenue Code, and whether the rehabilitation credit may be passed through from Limited Partnership to Lessee under section 48(d)(2). Additional rulings are requested on related matters. The represented facts as they pertain to the request for rulings are set forth below.

Limited Partnership is a State Y limited partnership that was formed on *** Lessee is a State Y corporation that is a wholly owned subsidiary of Parent, and is included in the consolidated federal income tax return of Parent. The tax year of Lessee and Parent is the calendar year. Limited Partnership and Parent are under the examination jurisdiction for the District Director's Office located in City X.

Limited Partnership was formed for the purpose of developing the Project and adjacent land located in City X. The Project was previously used by the Business as its main office in City X, and consisted of *** floors and a basement. According to the Parties, the Project is classified as a certified historic structure under section 48(g)(3) of the Code. On ***, Limited Partnership and the Business entered into a *** year lease for the Project and adjacent land. On *** the lease was revised to bifurcate the original lease into *** separate leases, *** for the land adjacent to the Project, and *** for the Project and underlying land. The revised lease for the land underlying the Project is referred to as the "Ground Lease." Under Section *** of the Ground Lease, all improvements to the Project constructed by Limited Partnership are owned by Limited Partnership.

According to the Parties, various documents executed by Limited Partnership, the Business and the Redevelopment Agency of City X (the "Redevelopment Agency") granted Limited Partnership the right to develop the Project and adjacent land, subject to various requirements imposed by the Business and the Redevelopment Agency, including that the Project be renovated in accordance with the requirements imposed by the United States Department of the Interior for rehabilitation of certified historic structures. Consistent with such requirements, Limited Partnership prepared and filed parts 1 and 2 of a Historic Preservation Certification application with the Department of the Interior on ***.

On *** Limited Partnership executed a construction contract (the "Construction Contract"), with Contractor, for the renovation of the Project, the addition of *** floors to the Project (the "Addition") and the construction of certain improvements on the land adjacent to the Project. Under the Construction Contract, Contractor was obligated to complete the rehabilitation of the Project. Rehabilitation of the Project commenced in ***.

According to the Parties, the rehabilitation of the Project has been completed in stages, with portions of floors first being made available in a finished condition or in a condition or state of readiness and availability for rental on *** and continuing to be made available in such condition through *** As of *** Limited Partnership's renovation of the Project and construction of the Addition was complete, except for certain tenant improvements to space not subject to the Lessee's leases.

The net rentable square footage of each floor of the Project and the Addition, known together as the Center, is as follows:

Net Rentable
Floor Square Footage
----- ---------------
Basement (parking)
and storage -- Project)
(retail -- Project) \
(office -- Project) \
(office -- Project) \
Subtotal -- Project \
(office -- Addition)
(office -- Addition) \
Subtotal -- Addition \
Total – Center

The Parties represent that primarily all of the expenditures incurred by Limited Partnership in rehabilitating the Project constitute "qualified rehabilitation expenditures" under section 48(g)(1) of the Code.

On *** Limited Partnership, as lessor, executed a lease with Lessee for space in the Center. A first amendment to the lease was executed on *** to clarify that the space subject to the lease consisted of *** net rentable square feet of office space on the *** floor of the Project, . . . square feet of storage space in the basement of the Center, and all of the *** net rentable square feet of office space in the Addition. The lease, as amended by the first amendment, is referred to as the "First Lessee Lease". The First Lessee Lease is for an initial term of *** years, and commenced on ***, the day that Lessee first occupied a portion of the space subject to the First Lessee Lease. Lessee occupied the space in the Center subject to the First Lessee Lease in stages as tenant improvements were completed. As of *** Lessee had occupied all the space subject to the First Lessee Lease. Under the First Lessee Lease, Lessee was originally obligated beginning in *** to pay all increases in operating expenses over the base year operating expenses.

On *** Limited Partnership, as lessor, executed another lease with Lessee, for *** of additional rentable square feet of office space on the *** floor of the Project. This lease is referred to as the "Second Lessee Lease". The Second Lessee Lease is for an initial term of years, and commenced on *** the day that Lessee first occupied a portion of the space subject to the Second Lessee Lease. Lessee occupied the space in the Center subject to the Second Lessee Lease in stages as tenant improvements were completed. As of *** Lessee had occupied all the space subject to the

Second Lessee Lease. Under the Second Lessee Lease, Lessee is obligated to pay operating expenses incurred by Limited Partnership in connection with the space subject to the Second Lessee Lease.

On *** Limited Partnership and Lessee executed amendments to the First and Second Lessee Leases, which amendments were amended and restated in their entirety on *** (the “Lessee Leases”). The amended and restated amendments, provide for the following provisions:

1. The pass-through to Lessee of all rehabilitation credits attributable to the space in the Project subject to the Lessee Leases, pursuant to the provisions of section 48(d) of the Code;
2. Lessee's payment of additional rent in consideration of Limited Partnership's pass-through of the rehabilitation credits (the “ITC Rent”); and
3. Lessee's payment of operating expenses incurred by Limited Partnership in connection with the space subject to the First Lessee Lease, commencing with the *** initial term of the First Lessee Lease.

The obligations of Lessee pertaining to the payment of ITC Rent under the Lessee Leases and the payment of operating expenses during the *** year are contingent upon Limited Partnership obtaining a private letter ruling from the Service on a number of legal issues, including that the amount of rehabilitation credits that may be passed through to Lessee is not subject to limitation under section 48(d)(2) of the Code. Under the Lessee Leases, ITC Rent is allocated to that portion of the space in the Center subject to the Lessee Leases that consists of qualified rehabilitation expenditures. In addition, if there is a disallowance of all or a portion of the rehabilitation credits passed through to Lessee under the Lessee Leases, then (i) Limited Partnership will refund with interest a corresponding amount of any ITC Rent paid by Lessee, (ii) Limited Partnership will pay to Lessee any penalties incurred by Lessee under the Code in connection with the disallowance of credits, and (iii) any subsequent payments of ITC Rent will be reduced in proportion to the percentage of rehabilitation credits disallowed.

On *** Corporation, a State Z corporation, pursuant to an Agreement of Sale by and between Corporation and Limited Partnership, purchased all of Limited Partnership's interest in the Project and the Addition, which consisted of the following items:

1. The improvements constructed by Limited Partnership;
2. Limited Partnership's leasehold interest under the terms of the Ground Lease in the Project shell and underlying land;
3. All tenant leases;
4. All equipment, fixtures and other personal property; and
5. All contracts, licenses, plans, drawings, surveys, and other intangible property.

The total purchase price paid by Corporation for these items was *** . The purchase price consisted of (a) *** in cash, (b) *** in assumption of an existing liability to Bank, and (c) *** in purchase money financing provided by Limited Partnership pursuant to a note bearing interest at the fixed rate of *** percent per annum (the “Purchase Money Note”). To evidence its transfer of

the tenant leases for space in the Center, Limited Partnership assigned to Corporation all of its right, title and interest in the leases, including the Lessee Leases.

Contemporaneously with Corporation's purchase of Limited Partnership's interest in the Center, Corporation leased back to Limited Partnership the items purchased by Corporation, pursuant to the terms of a lease by and between Corporation, as lessor, and Limited Partnership, as lessee (the “Master Lease”). Pursuant to the terms of the Master Lease, Corporation assigned the tenant leases to Limited Partnership, with the result that Limited Partnership continues to be the lessor under the tenant leases. Under the terms of the Master Lease, Corporation is obligated to file an election under section 48(d)(1) of the Code, in order that Limited Partnership retain the rehabilitation credits attributable to the qualified rehabilitation expenditures incurred by Limited Partnership in renovating the Project.

Under the Master Lease, Limited Partnership is obligated to make payments of rent based upon the rate of interest payable by Corporation on the Bank financing. The interest rate on the Bank financing currently is 10.05 percent per annum. Limited Partnership's obligation to pay rent under the Master Lease will be offset by the purchase money interest payable by Corporation to Limited Partnership under the Purchase Money Note. The effect of the Master Lease on the Lessee Leases is that the Lessee Leases are subleases and that Limited Partnership is a lessee/sublessor.

Under the Master Lease, Limited Partnership is obligated to pay the rent thereunder in all events. The amount of the rent payable under the Master Lease is sufficient to generate a positive return to Corporation over the *** year term of the Master Lease. Paragraph of the Master Lease provides that it is a net lease and that the rent payable by Limited Partnership thereunder is payable in all events notwithstanding damage or destruction of the property, any taking, or condemnation of the property, eviction, default by lessor, foreclosure on lessor's interest, or any reason. In certain circumstances, Limited Partnership may have the right to purchase the property from Corporation but at a price equal to the greater of the fair market value of the property at that time or an amount calculated to provide Corporation with a guaranteed positive return over the term of the Master Lease. Under the above facts Corporation is guaranteed a specified return over the term of the Master Lease, and, accordingly, the Master Lease is a net lease for purposes of section 48(d)(4) of the Code.

For purposes of determining whether the Lessee Leases qualify as net leases under former section 57(c)(1)(B) of the Code, the Parties believe that it is necessary to compare the revenues derived by Limited Partnership from such leases to the expenses incurred by Limited Partnership that are allocable to the leases. The only revenues are the rent payments to be paid by Lessee, as set forth above. The Parties categorize the expenses as either UNREIMBURSED EXPENSES paid by Limited Partnership or EXPENSES PASSED THROUGH TO OR REIMBURSED BY Lessee under the Lessee Leases.

The expenses that will be passed through to Lessee are defined in paragraph . . . of the Lessee Leases as “all reasonable direct costs of management, operation and maintenance.” Paragraph . . . lists as examples of such types of expenses property taxes, maintenance costs, heat, electricity and other costs typically passed through to lessee under a net lease, and the cost of insurance

carried by Limited Partnership (including the payment of deductibles). Insurance carried by Limited Partnership for which Limited Partnership receives reimbursement from Lessee includes casualty and rental continuation insurance but does not include earthquake insurance.

The expenses that will be paid by Limited Partnership for which it will not receive reimbursement from Lessee include rent due under the Master Lease, rent due under the Ground Lease, and legal and accounting expenses incurred in drafting, negotiating and amending the Lessee Leases and preparing this ruling request.

Paragraph *** of the Lessee Leases allows Lessee to terminate each lease and avoid liability for continued rental payments in the event of certain levels of damage to the premises. However, Limited Partnership represents that the rental continuation benefit in its insurance would guarantee Limited Partnership payment of the remaining rent (including ITC Rent) due under the Lessee Leases while the premises are being rebuilt and thereafter until the premises are rented at a rate at least equal to the rate under the Lessee Leases.

In a letter dated July 13, 1989 the Parties represent that the rental continuation insurance carried by Limited Partnership extends to all forms of rent received by Limited Partnership, including rent in the form of expense reimbursements and expenses directly by Lessee.

Lessee has sublet approximately *** square feet of its space in the rehabilitated portion of the Project to W (the Sublessee"). Lessee and Sublessee will not be filing an election under section 48(d)(2) of the Code to pass through the rehabilitation credit to Sublessee.

The first and second rulings requested by the Parties concern whether the rehabilitation credits allocable to that portion of the Project leased by Lessee may be passed through to Lessee without reduction under the short-term lease rule of section 48(d)(2) of the Code. The reduction under section 48(d)(2) hinges upon whether or not the Lessee Leases qualify as net leases under former section 57(c)(1)(B).

Section 38 of the Code provides for a general business credit that includes for a taxable year the investment credit determined under section 46(a). Section 46(a) and (c) provide that the amount of the investment credit for any taxable year is equal to the sum of certain specified percentages of the qualified investment in section 38 property, including the rehabilitation percentage.

Section 48(d)(1)(A) of the Code provides that a person (other than a person referred to in section 46(e)(1)) who is a lessor of property may elect with respect to any new section 38 property to treat the lessee as having acquired such property for an amount equal to the fair market value of such property.

Section 48(d)(2)(A) of the Code generally provides, in the case of certain short term leases, that a person (other than a person referred to in section 46(e)(1)) who is a lessor of property described in section 48(d)(4) may (at such time, in such manner, and subject to such conditions as are provided by regulations prescribed by the Secretary) elect with respect to such property to treat the lessee as having acquired a portion of such property for the amount determined under section 48(d)(2)(B).

Section 48(d)(2)(B) of the Code provides that the amount for which a lessee of property described in section 48(d)(4) shall be treated as having acquired a portion of such property is an amount equal to a fraction, the numerator of which is the term of the lease and denominator of which is the class life of the property leased (determined under section 167(m)), of the amount for which the lessee would be treated as having acquired the property under section 48(d)(1).

Section 48(d)(2)(C) of the Code provides that the qualified investment of a lessor of property described in section 48(d)(4) in any such property with respect to which he or she has made an election under section 48(d)(2) is an amount equal to his or her qualified investment in such property (as determined under section 46(c)) multiplied by a fraction equal to the excess of one over the fraction used under section 48(d)(2)(B) to determine the lessee's investment in such property.

Section 48(d)(3) of the Code provides, in part, that the election provided by section 48(d)(2) may be made with respect to property that would be new section 38 property if acquired by the lessee. For purposes of the preceding sentence and section 46(c), the useful life of property in the hands of the lessee is the useful life of such property in the hands of the lessor. If a lessor makes the election provided by section 48(d)(2) with respect to any property, the lessee shall be treated for all purposes of subpart E as having acquired a fractional portion of such property equal to the fraction determined under section 48(d)(2)(B) with respect to such property.

Section 48(d)(4) of the Code provides that section 48(d)(2) shall only apply to property that -- (A) is new section 38 property, (B) has a class life (determined under section 167(m)) in excess of 14 years, (C) is leased for a period that is less than 80 percent of its class life, and (D) is not leased subject to a net lease (within the meaning of former section 57(c)(1) (as in effect on the day before the date of the enactment of the Tax Reform Act of 1986 (the “1986 Act”))).

Former section 57(c)(1) of the Code generally provided that for purposes of that section, property was considered to be subject to a net lease for a taxable year if -- (A) for such taxable year the sum of the deductions of the lessor with respect to such property that were allowable solely by reason of section 162 (other than rents and reimbursed amounts with respect to such property) is less than 15 percent of the rental income produced by such property, or (B) the lessor is either guaranteed a specified return or is guaranteed in whole or in part against loss of income.

The lease pass-through election under section 48(d)(1) of the Code is subject to a special rule in the case of short-term leases under 48(d)(2). Section 48(d)(2) limits the amount of investment credit passed through to a lessee under a short term lease to the amount of credit allocable to the leased property multiplied by a fraction the numerator of which is the lease term and the denominator of which is the class life of the property being leased. The remaining portion of the credit is available to the lessor. The purpose of this limitation is to avoid the pass-through of credit that is disportionately large in comparison to the lessee's investment in the leased property.

From the facts as represented, the Lessee Leases satisfy the first three requirements under section 48(d)(4) of the Code to be considered short-term leases. However, the short-term lease rule does not apply to property subject to a net lease under former section 57(c)(1)(B). Accordingly, if the

Lessee Leases are net leases, then the investment credits allocable to that portion of the Project leased to Lessee may be passed through to Lessee without reduction or limitation.

If promulgated as an effective regulation, section 1.57-3(c)(2) of the proposed Income Tax Regulations published in the Federal Register on December 30, 1970, and June 24, 1971, would provide the factors for determining what constitutes a net lease under former section 57(c)(1)(B) of the Code. Section 1.57-3(c)(2) provides, in part, that in determining whether the lessor is assured of a specified return or that the lessor will not suffer a loss as a result of the lease, weight will be given to all the facts and circumstances of each particular case. Thus, an arrangement whereby the lessor is assured by, or on behalf of, the lessee that, during any period, the income the lessor will receive or accrue as a result of the lessee's use of the property during such period will exceed the expenses the lessor will pay or accrue that are attributable to the property, or the lessee's use of the property, by a fixed or determinable amount (or that such income will equal such expense) is a net lease for such period. Further, only that income and those expenses that economically accrue to the lessor during the lease period are taken into account.

The Parties assert that Schedule 1 of their submission, which analyzes Limited Partnership's revenue and expenses (other than expenses for earthquake insurance) from the Lessee Leases, demonstrates that Limited Partnership, as lessor, will have a guaranteed positive economic return from the Lessee Leases. The Parties represent that they have prepared Schedule 1 in accordance economic accrual requirement of section 1.57-3(c)(2) of the proposed regulations. Accordingly, the Parties conclude that based upon the factors pertaining to Limited Partnership's return under the Lessee Leases, the Lessee Leases satisfy the factors that comprise the guaranteed return test of section 1.57-3(c)(1) and (2). Therefore, the Parties conclude that the Lessee Leases are net leases under former section 57(c)(1)(B) of the Code.

Assuming the Parties' assumptions and calculations are accurate, we agree that Limited Partnership has a positive economic return in Schedule 1. Limited Partnership's situation appears similar to the example in section 1.57-3(c)(2) of the proposed regulations that states, " {a} net lease of the type described in this subparagraph will result, for instance, if the lessee is obligated to pay all the expenses attributable to the property that the lessor will incur or accrue for a period covered by the lease and, in the event of complete or partial destruction of the property, the lessee is obligated either to continue to pay the full rent for such period or a lump-sum amount equivalent to the present value of such rental payments."

The above-quoted example's use of the conjunctive "and" suggests that to meet the return test a net lease must satisfy the following two conditions: (1) the lessee must pay the lessor's expenses during the lease period; and (2) the lessee must guarantee the lessor against the loss of income from a casualty to the property. Thus, a net lease should not only be profitable to the lessor but also reduce or eliminate the lessor's risk of loss from the transaction. The positive economic return demonstrated in Schedule 1 only satisfies the first condition of the proposed regulation. The Parties must still demonstrate that Limited Partnership is protected against the risk of loss in income under the Lessee Leases.

The legislative history of former section 57(c)(1)(B) of the Code implies that in a net lease situation, the lessor has a reduced risk of economic loss. The House Report, H.R. Rep. No. 533,

92nd Cong., 1st Sess. (1971), explains that two of the tax preference items subject to the minimum tax on tax preferences are accelerated depreciation on projects subject to a net lease and “excess investment interest.” In the latter case, property subject to a net lease is considered property held for investment (as opposed to property used in a trade or business) the interest paid on which is limited as to the extent to which it is currently deductible. Id., at 46-47. The House Report continues: {C} ases have been called to your committee's attention where an individual leases property to someone else, paying all of the expenses for the care of the property, but being reimbursed for them by the lessee. In this case also, although the 15-percent test {of former section 57(c)(1)(A)} may technically be met, the LESSOR IS NOT AT RISK with respect to the additional expenses {that is, expenses other than, for example, ground rent for which the lessor is at risk} and, therefore, has the equivalent of a net lease. As a result, the bill also provides that the business deductions of the lessor taken into account for purposes of the 15-percent test are not to include expenses for which he is reimbursed by the lessee. Id., at 47 (emphasis added).

The Senate Report, S. Rep. No. 427, 92nd Cong., 1st Sess. (1971), retained the House provisions and explained the above language as follows:

> Second, the House bill provided that business expenses of a lessor which were reimbursed by the lessee could not be taken into account for purposes of the 15-percent test. Since the LESSOR GENERALLY DOES NOT INCUR ANY RISKS WITH RESPECT TO THE REIMBURSED EXPENSES IN THIS CASE, it was not considered appropriate to take these expenses into account as an indicator of whether the lease constituted a business rather than an investment lease. Of course, TO THE EXTENT A LESSOR IS AT RISK WITH RESPECT TO REIMBURSED EXPENSES, this is a factor to be taken into account in determining whether the expenses may be applied toward satisfaction of the 15-percent test. Id., at 67 (emphasis added).

Although the committee reports relate to the 15-percent test of former section 57(c)(1)(A) of the Code, the risk analysis mentioned therein is applicable to the return test in former section 57(c)(1)(B). Where the lessor is both reimbursed by the lessee for operating expenses incurred as lessor and protected by the lessee against the loss of rental income from interruption of the lease, the nature of the lessor's risk under the lease is closer to that of a passive investor, that is, an investment through a net lease, than that of an active trade or business with the concomitant risks. Section 1.57-3(c)(2) of the proposed regulations expounds on the committee reports by suggesting the factors to consider for guaranteeing the lessor's return (that is, reimbursement by the lessee of lessor's expenses) and reducing the lessor's risk of loss (that is the use of escalator clauses and rental continuation insurance) in a net lease.

In determining whether a lessor is guaranteed against risk of loss, the basic question is whether the lessor is assured the rental payments (or insurance payments to be paid in case of destruction of the premises) will equal or exceed the lessor's costs. For example, where the lessee agrees to pay all the expenses (other than interest) of the building, such as property taxes, insurance and operating expenses, the lessor will be considered guaranteed against risk of loss if the rental payments equals or exceed the lessor's costs (including interest and depreciation on the property) and the lessor is assured that the rental payments or insurance payments will also cover those costs for which the lessor is potentially liable, that is, at risk. With respect to the rental

continuation insurance, therefore, the issue is whether payment by the lessee of the premiums on such insurance, that is, such payment is a reimbursed expenditure, adequately protects the lessor from the POTENTIAL risk of loss in income due to casualty to the property.

To address the net lease issue, we must analyze the Parties's entire transaction to determine whether Limited Partnership is protected against loss from those costs for which Limited Partnership is potentially liable. Although Schedule 1 demonstrates that while the Lessee Leases are in operation Lessee's rental payments will exceed Limited Partnership's costs (omitting reimbursed expenses), Limited Partnership does not represent or demonstrate whether the Lessee Leases will show a positive return in the event of damage or destruction to the premises. In such event, Lessee may elect to terminate the Lessee Leases and, thus, its obligations to pay rentals and to reimburse Limited Partnership for certain expenses will terminate accordingly. Under the Lessee Leases, Lessee reimburses Limited Partnership for rental continuation insurance coverage. Such coverage includes the costs of rebuilding in the event of destruction of the premises and includes a rental continuation benefit that would guarantee Limited Partnership payment of the remaining rent (including ITC Rent) due under the Lessee Leases while the premises are being rebuilt and thereafter until the premises are rented at a rate equal to the rate under the Lessee Leases. Limited Partnership's rental continuation insurance coverage includes payment of those formerly reimbursed expenses such as property taxes that would continue even if the Lessee Leases are terminated.

The Parties question whether the language concerning rental continuation insurance in section 1.57-3(c)(2) of the proposed regulations means that rental continuation insurance is a prerequisite for determining a “net lease.” The rental continuation insurance language relates to that paragraph's earlier statement that in the event of complete or partial destruction of the property, the lessee is obligated either to continue to pay “full rent” for such period covered by the lease or a lump-sum amount equivalent to the present value of such rental payments. The use of rental continuation insurance, although not dispositive of the net lease determination, is intended to be a substitute for the requirement that the lessee protect the lessor against potential loss from casualty to the premises by continuing to pay full rent or by payment of the lump-sum present value equivalent. The use of rental continuation insurance must be considered in addition to the lessee's obligation to pay the lessor's expenses associated with the premises.

Whether Limited Partnership is guaranteed against potential loss in the event of destruction of the premises depends on the terms of Limited Partnership's rental continuation insurance coverage. Because the above analysis requires that Lessee pay full rent in the event of a casualty, the rental continuation insurance coverage must also be sufficient to pay full rent to Limited Partnership. Full rent includes both the monthly rental payments and payment of Limited Partnership's expenses for which Lessee was previously obligated to pay, that is, reimbursed expenses under the Lessee Leases. Because the Parties represent that the rental continuation insurance carried by Taxpayer extends to all forms of rent received by Taxpayer, including rent in the form of expense reimbursements and expenses paid directly by lessees, Taxpayer is guaranteed against loss under the return test. Therefore, the Lessee Leases are net leases under former section 57(c)(1)(B) of the Code.

The third ruling requested by the Parties concerns whether Lessee will have to recapture any of the rehabilitation credits passed through under either of the Lessee Leases, if, after 5 full years from the last date on which any portion of the qualified rehabilitation expenditures subject to one of the Lessee Leases was placed in service, that lease is terminated or no longer qualifies as a net lease under former section 57(c)(1)(B) of the Code.

Section 47(a)(5)(A) of the Code provides that if, during any taxable year, section 38 recovery property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer before the close of the recapture period, then, except as provided in section 47(a)(5)(D), the tax under that chapter for such taxable year shall be increased by the recapture percentage of the aggregate decrease in the credits allowed under section 38 for all prior taxable years that would have resulted solely from reducing to zero the qualified investment taken into account with respect to such property. Under section 47(a)(5)(B), there is no recapture of investment credit on section 38 recovery property if there is a disposition of the property after five full years after the property was first placed in service.

Section 1.47-2(b)(2)(iii) of the Income Tax Regulations provides, in part, that if the lessor of new section 38 property made a valid election to treat the lessee ashaving purchased such property for purposes of the credit allowed by section 33, but the lease is terminated and the property is transferred by the lessee to the lessor or to any other person, such transfer shall be considered to be a disposition by the lessee.

The rehabilitation credit, as part of the investment credit, is subject to recapture in the event of the early disposition of the property attributable to the qualified rehabilitation expenditures. If either Lessee Lease is terminated, there will be a disposition under section 47(a)(5) of the Code and section 1.47-2(b)(2)(iii) of the regulations. However, if such termination occurs after five full years from the last date on which any portion of the qualified rehabilitation expenditures subject to that particular Lessee Lease was placed in service, there will be no recapture of the rehabilitation credits passed through to Lessee. Moreover, if either of the Lessee Leases fails to qualify as a net lease under former section 57(c)(1)(B) after the expiration of the 5-year recapture period applicable to that particular lease, there will be no recapture of rehabilitation credits.
The fourth ruling requested by the Parties concerns whether, under section 48(d)(5) of the Code, Lessee must amortize over a 19- year period 50 percent of the rehabilitation credits it receives under section 48(d)(1).

Section 48(a)(1)(E) of the Code provides that “section 38 property” means, in the case of a qualified rehabilitated building, that portion of the basis attributable to qualified rehabilitation expenditures. Section 48(b)(1) provides that “new section 38 property” means section 38 property the original use of which commences with the taxpayer.

Section 48(d)(1)(A) of the Code provides that a person who is a lessor of property may elect with respect to any new section 38 property to treat the lessee as having acquired such property for an amount equal to the fair market value of such property.

Section 48(q)(1) of the Code provides that if a credit is determined under section 46(a) with respect to section 38 property, the basis of such property shall be reduced by 50 percent of the amount of the credit so determined.

Section 48(d)(5) of the Code provides, in part, that in the case of any property with respect to which an election is made under section 48(d) -- (A) section 48(q) (other than section 48(d)(4)) shall not apply with respect to such property, and (B) the lessee of such property shall include ratably in gross income over the shortest recovery period that could be applicable under section 168 with respect to such property an amount equal to 50 percent of the amount of the credit allowable under section 38 to the lessee with respect to such property.

Section 48(g)(2)(A) of the Code provides that the term “qualified rehabilitation expenditures” includes any amount chargeable to capital account for property depreciable under section 168 and that is nonresidential real property. Former section 48(g)(2)(A) provided, in part, that a qualified rehabilitation expenditure must have been for real property with a recovery period of 19 years.

Section 1.46-3(d) of the regulations provides that property is considered placed in service in the earlier of the taxable year in which, under the taxpayer's depreciation practice, the period with respect to such property begins, or the taxable year in which the property is placed in a condition or state of readiness and availability for a specifically assigned function.

Section 203(B)(1)(A) of the 1986 Act provides that the amendments made by section 201 of the 1986 Act to section 168 of the Code shall not apply to any property that is constructed, reconstructed, or acquired by the taxpayer pursuant to a written contract that was binding on March 1, 1986. Under section 203(b)(2) such property must have a class life of at least 7 years and, with respect to property with a class life of 20 years or more, must be placed in service prior to January 1, 1991.

Prior to its amendment by section 21 of the 1986 Act, section 168(c)(2)(D) of the Code provided that “19-year real property” meant section 1250 class property that did not have a present class life of 12.5 years or less and was not low-income housing. Such property had a recovery period of 19 years unless a taxpayer elected to use the straight line method under former section 168(b)(3)(A), in which case alternative recovery periods of 35 or 45 years were available.

Because the portion of the basis of the Project attributable to qualified rehabilitation expenditures would be considered new section 38 property, Limited Partnership can elect to pass through the rehabilitation credit attributable to the expenditures to Lessee under sections 46(a) and 48(d)(1)(A) of the Code. Under section 48(d)(5), Lessee must ratably include in gross income 50 percent of the allowable credit over the shortest recovery period applicable under section 168.

Limited Partnership entered into the contract for the renovation of the Project on May 23, 1985, and under section 1.46-3(d) of the regulations the renovated Project was placed in service prior to January 1, 1991. Such property therefore qualified as transition property under section 203(b) of the 1986 Act and is subject to the provisions of section 168 of the Code as in effect prior to the 1986 Act. Under section 48(g)(2)(A) and former section 168(c)(2)(D), the qualified

rehabilitation expenditures would be considered 19-year real property. The shortest recovery period applicable to the expenditures is 19 years. Therefore, Lessee would take 50 percent of the allowable credit into income ratably over 19 years.

The fifth ruling requested by the Parties concerns whether or not Lessee must accelerate the amount required to be amortized under section 48(d)(5)(B) of the Code if there is a termination or failure to renew either of the Lessee Leases.

Section 48(d)(5)(C) of the Code provides that in the case of any property with respect to which an election is made under section 48(d)(5), in the case of a disposition of such property to which section 47 applies, section 48(d)(5) shall be applied in accordance with regulations prescribed by the Secretary.

Although the Service has not issued any regulations under section 48(d)(5)(C) of the Code, if, after 5 full years from the last date on which any portion of the qualified rehabilitation expenditures subject to the Lessee Leases was placed in service, either of the Lessee Leases is terminated or Lessee fails to renew either of the Lessee Leases, section 48(d)(5)(C) will not affect the pass through of any rehabilitation credit to Lessee because the credit recapture period has ended.

The sixth ruling requested by the Parties concerns what rehabilitation percentage may be used for the qualified rehabilitation expenditures incurred on the Project.

Section 251(a) of the 1986 Act generally reduces the credit percentage with respect to rehabilitation expenditures. Section 251(d)(2)(A) provides that the amendments made by that section and section 201 shall not apply to any property placed in service before January 1, 1994, if such property is placed in service as part of a rehabilitation that was completed pursuant to a written contract that was binding on March 1, 1986.

Section 251(d)(5) of the 1986 Act provides for the reduction in credit percentages for property subject to the transitional rules of section 251(d)(2). The credit for rehabilitation of certified historic structures is not reduced by section 251(d)(5). Former section 46(b)(4)(A) of the Code provided that the rehabilitation percentage for a certified historic structure was 25 percent. Former section 46(b)(4)(C)(iii) of the Code provided that the term “certified historic structure” means a qualified rehabilitated building that meets the requirements of section 48(g)(3).

Section 48(g)(2)(C) of the Code defines the term “certified rehabilitation” as any rehabilitation of a certified historic structure that the Secretary of the Interior has certified to the Secretary as being consistent with the historic character of such property or the district in which such property is located.

Section 48(g)(3)(A) of the Code defines the term “certified historic structure” as any building (and its structural components) which -- (i) is listed in the National Register, or (ii) is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary as being of historic significance to the district.

Under section 251(d)(2)(A) of the 1986 Act and section 1.46-3(d) of the regulations, the renovation of the Project is transition property because the contract was executed on *** and the property has been placed in service prior to January 1, 1994. Section 251(d)(5) does not reduce the rehabilitation percentage for certified historic structures subject to the transitional rules. Therefore, assuming the rehabilitation is a certified rehabilitation under section 48(g)(2)(C) of the Code, the applicable rehabilitation percentage for the qualified rehabilitation expenditures with respect to the Project is 25 percent.

The seventh ruling requested by the Parties concerns the proper tax year in which that Lessee may claim the rehabilitation credits allocable to the space it leases in the Project.

Section 48(d)(1) of the Code imposes a limitation on the election to pass the credit through to a lessee that only "new" section property is eligible. To this effect, section 48(g)(4) provides that property that is treated as section 38 property by reason of section 48(a)(1)(E) is treated as new section 38 property. Assuming that all the other requirements in section 46(a)(1)(E) (which includes qualified rehabilitation expenditures within the definition of section 38 property) are met, property attributable to rehabilitation expenditures should constitute "new section 38 property" as required by section 48(d)(1).

Under section 46(a) and (c), any qualified rehabilitation expenditures placed in service during a taxable year constitute a "qualified investment" that gives rise to an investment for that year based on the rehabilitation percentage. Thus, if a lessor placed in service any qualified rehabilitation expenditures during a taxable year and makes the election under section 48(d)(1) to treat a lessee as having acquired such expenditures, then the lessee will be entitled to claim an investment credit for such expenditures for the taxable year during which they are placed in service.

The Parties represent that Limited Partnership placed the qualified rehabilitation expenditures in service during *** for which Limited Partnership and Lessee made an election under section 48(d)(1) of the Code to pass through the investment credit to Lessee. Because the Parties represent that Lessee is a calendar year taxpayer, Lessee's *** calendar year is the proper year for Lessee to claim the rehabilitation credits attributable to Limited Partnership's qualified rehabilitation expenditures.

The eighth ruling requested by the Parties concerns whether the sale-leaseback involving Corporation and Limited Partnership is a disposition under section 47 of the Code.

Section 47(a)(1) of the Code and section 1.47-1(a) of the regulations provide that, if during any taxable year any property is disposed of or otherwise ceases to be section 38 property with respect to the taxpayer before the close of the useful life that was taken into account in computing the credit under section 38, the tax for such taxable year shall be increased. Section 47(a)(5) provides a similar rule for section 38 recovery property.

Section 1.47-3(g) of the regulations provides, in part, that notwithstanding the provisions of section 1.47-2, relating to "disposition" and "cessation," section 1.47-1 shall not apply where section 38 property is disposed of and as part of the same transaction is leased back to the vendor

even though gain or loss is recognized to the vendor-lessee and the property ceases to be subject to depreciation in his or her hands.

The rehabilitation credit, as part of the investment credit, is subject to recapture under section 47(a) of the Code in the event of the early disposition of the property attributable to the qualified rehabilitation expenditures. However, assuming that Corporation and Limited Partnership's sale-leaseback is valid for federal income tax purposes, that sale-leaseback is not a disposition under section 1.47-3(g) of the regulations.

The ninth ruling requested by the Parties concerns whether Limited Partnership can elect to pass through the rehabilitation credits under section 48(d)(1) of the Code because of Corporation and Limited Partnership's sale-leaseback of the Project.

Section 48(d)(1) of the Code provides, in part, that a person who is a lessor of property may elect with respect to any new section 38 property to treat the lessee as having acquired such property.

Section 1.48-4(e)(1) of regulations provides, in part, that if the lessee of property is treated, under section 1.48-4, as having purchased all or a portion of such property and if such lessee leases such property to a sublessee, the qualified investment with respect to such property in the hands of the sublessee shall be determined under section 1.48-4(c) and (d) as if the original lessor had leased the property directly to the sublessee for the term of the sublessee's lease on the date possession of the property is transferred to the sublessee.

The Parties represent that although Corporation and Limited Partnership's sale-leaseback includes the qualified rehabilitation expenditures incurred by Limited Partnership in rehabilitating the Project, Corporation assigned back to Limited Partnership all of its interest in such expenditures and in all of project's tenant leases. Thus, Limited Partnership was retained as the lessor under the Lessee Leases.

The Parties also represent that under paragraph *** of the Master Lease, Corporation is obligated to file an election under section 48(d)(1) of the Code, in order that Limited Partnership may use the rehabilitation credits attributable to the rehabilitation of the Project. Consistent with this provision, Limited Partnership represents that it and Corporation will file an election under section 48(d)(1) and section 1.48-4 of the regulations to pass through any of the rehabilitation credits to Limited Partnership that Corporation would otherwise be entitled to claim.

Because section 1.48-4(e)(1) of the regulations allows for the pass through of investment credit from a lessee/sublessor to a sublessee, assuming that Corporation makes the election under section 48(d)(1) of the Code to pass through the rehabilitation credits to Limited Partnership, Limited Partnership, as lessee/sublessor, can elect to pass through a portion of the rehabilitation credits allocable to the portion of the Project leased to Lessee under the Lessee Leases.

Accordingly, based solely upon the information submitted, provided that the Project is a "qualified rehabilitated building" under section 48(g)(1) of the Code and the rehabilitation is a "certified rehabilitation" under section 48(g)(2)(C), we rule as follows:

1. All of the rehabilitation credits allocable to that portion of the Project leased by Lessee may be passed through to Lessee, without reduction under section 48(d)(2) of the Code, if the Lessee Leases qualify as net leases under former section 57(c)(1)(B).

2. For purposes of section 48(d)(2) of the Code, each of the Lessee Leases will be a net lease within the meaning of former section 57(c)(1)(B), for the period beginning with the commencement of that particular Lessee Lease and ending 5 years from the last date on which any portion of the qualified rehabilitation expenditures subject to that particular Lessee Lease was placed in service.

3. There will not be recapture of any rehabilitation credits passed through to Lessee under either of the Lessee Leases, if, after 5 years from the last date on which any portion of the qualified rehabilitation expenditures subject to that particular Lessee Lease was placed in service, that particular Lessee Lease is terminated or no longer qualifies as a net lease within the meaning of former section 57(c)(1)(B) of the Code.

4. Under section 48(d)(5)(B) of the Code, Lessee must amortize into income 50 percent of the rehabilitation credits passed through to it and 19 years is the proper period over which such amortization must take place.

5. There will not be any acceleration of the amount Lessee will be required to amortize into income if either of the Lessee Leases is terminated after 5 years from the last date on which any portion of the qualified rehabilitation expenditures subject to that particular Lessee Lease was placed in service.

6. The rehabilitation percentage applicable to the qualified rehabilitation expenditures incurred by Limited Partnership with respect to the rehabilitation of the Project is 25 percent, as determined under former section 46(b)(4)(A) of the Code.

7. The *** calendar year is the proper year for federal income tax purposes for Lessee to claim the rehabilitation credits allocable to the space leased by it in the Project.

8. The sale and leaseback of the Project involving Corporation and Limited Partnership is not a disposition for recapture purposes under section 47(a) of the Code.

9. After the sale and leaseback of the Project, and provided that Corporation makes the election to pass through the rehabilitation credits to Limited Partnership, Limited Partnership as lessee/sublessor is the proper party under section 48(d)(1) of the Code to pass through to Lessee the rehabilitation credits allocable to the space leased by Lessee in the Project.

Other than rulings eight and nine, no opinion is expressed or implied concerning the federal income tax consequences of Corporation and Limited Partnership's sale-leaseback. Nor is an opinion expressed or implied regarding any other application of the Code or regulations to this transaction.

This ruling is directed only to the Parties who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent. In accordance with the powers of attorney on file, a copy of this letter is being to your authorized representatives. A copy of this letter should be attached to the appropriate federal income tax returns for the tax year in which the election or elections under section 48(d) are made.

Sincerely yours,
James Ranson
Chief, Branch 5 Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)
Enclosure: 6110 copy