

Private Letter Ruling 8911025, IRC Section 42

December 16, 1988

This letter is in response to a letter dated August 3, 1988, subsequent correspondence from your authorized representative, in which you request a ruling under sections 42 and 183 of the Internal Revenue Code. The facts and representations as submitted are as follows:

A limited partnership (Fund M) will be organized to invest as a limited partner in limited partnerships (the Project Partnerships) formed to acquire, construct, rehabilitate, and operate low-income housing projects (the Projects) located in State N. Fund M intends by these investments to assist in providing affordable housing qualifying for the low-income housing tax credit under section 42 of the Code. The proposed General Partner of Fund M is Taxpayer, a corporation organized under the State O General Not For Profit Corporation Act, but not exempt from federal taxes. Taxpayer represents that the proposed Limited Partners of Fund M will be subchapter C corporations that will not be subject to provisions of section 469 restricting the use of passive activity losses and credits.

Taxpayer's Board of Directors is elected by P, a tax-exempt public charity created with support from Q. P, headquartered in City R with local offices in other cities around the country, provides financial assistance for a wide range of community development activities. It created Taxpayer to address the nation's low-income housing shortage by facilitating corporate investment in low-income housing projects throughout the United States.

Fund M will make investments in the Project Partnerships as the sole limited Partner with a ninety-nine percent share of the profits and losses from operations and a fifty percent share of the profits or losses on any sale. A tax-exempt charitable organization, or a for-profit affiliate of the charitable organization, will be sole General Partner or Co-General Partner with another non-profit or for-profit organization. This tax-exempt charitable organization will be a neighborhood development organization or an affiliate of such an organization.

In 1988 Fund M intends to invest in X low-income housing Project Partnerships. The Project Partnerships will be substantially similar to each other in organization and financing.

Fund M's capital contribution to each Project Partnership, to be paid over the first seven years of the applicable Project Partnership, will provide approximately one-third of the total requirements of each Project. The contribution will include coverage of the funding of an operating reserve to which all excess cash flow from operations will be added, and at the conclusion of the first fifteen years the reserve will be used to reduce the amount of outstanding debt. The establishment of the operating reserve will be required as a condition of receiving financing (described below) from City R. It is not expected that the

Project Partnerships will make cash distributions from operations during this first fifteen-year period, which is the anticipated duration of each Project Partnership.

A significant portion of the funding required by the Project Partnerships to acquire and rehabilitate low-income housing will be provided by loans from City R. The loans will bear a one percent annual rate of interest and will be due at the end of seventeen years, subject to an additional thirteen-year extension. As a condition of each such loan, a regulatory agreement with City R is required, providing that the legal rent charge for any unit financed by the loan will not be in an amount greater than thirty percent of sixty percent during the first seventeen years, and of eighty percent during the next thirteen years if the loan is extended, of area median gross income for a family of four. The City R loans will continue in effect, with anticipated minor adjustments in debt service, upon sale of the Project to any subsequent purchaser meeting reasonable qualification standards, so long as that subsequent purchaser agrees to the rental restrictions.

Throughout the fifteen-year rent restriction period required under section 42 of the Code, 100 percent of the units will be leased to persons with sixty percent or less of area median gross income, and it is anticipated that all of the Projects otherwise will meet all other requirements under section 42 to qualify for the low-income housing credit.

Fund M intends to grant an option to the General Partners of the Project Partnerships to purchase the Projects at the end of the fifteen-year compliance period required for purposes of the credit under section 42 of the Code. The General Partner or its affiliate is granted the option to purchase the property at a price equal to the greater of fair market value or tax due on the sale of the Project plus any outstanding debt, or, if a favorable tax ruling is obtained, a price equal to tax due on the sale of the Project (and any prior capital transactions) plus any outstanding debt. It is anticipated in either case that the City R loan will continue in effect with the General Partner or its affiliate as borrower.

Due to the rent and occupancy restrictions imposed by section 42 of the Code during the first fifteen years, and the restrictions which apply throughout the thirty-year term of the City R loan, the Project will fail to provide any cash distributions to Fund M during operations. If, by reason of the exercise of the option to purchase, the disposition of the Project occurs at the expiration of the first fifteen years of operations, the Project probably will fail to provide any appreciation in value sufficient to return a significant amount to Fund M. Moreover, if a favorable tax ruling is obtained and the Project is sold for a price equal to taxes due on sale plus debt, the Project will fail to provide any return of cash to Fund M other than an amount equal to tax due. However, when the tax benefits, primarily those under section 42, are taken into account, the Project Partnerships invested in by Fund M will enable it to provide returns that compare favorably with returns that the Limited Partners realize generally on their equity capital.

Taxpayer has sponsored other partnerships similar to Fund M. These other partnerships include Fund S, Fund T (which will invest in projects throughout the country, excluding State U), and Fund V. Taxpayer, through the funds it sponsors, is potentially the largest source of private sector funding for low-income housing in the United States.

Fund T and Fund V are substantially identical to Fund M in structure, objectives and formative state. Fund V, in addition, will require that the Projects funded through its Project Partnerships will qualify for the low-income housing credit available under the State U Revenue and Taxation Code. The provisions of State U law dealing with the low-income housing credit require a 30-year compliance period as opposed to the 15-year compliance period required under section 42 of the Internal Revenue Code. In this respect, the State U requirement is the same in length as the requirement imposed by City R under the financing arrangements applicable to the Fund M Project Partnerships.

Taxpayer requests that our ruling be directed to Fund M, Fund T, and Fund V (the Funds) and to their General Partners and Limited Partners (the Partners).

A ruling is requested that the "not-for-profit" rules under section 183 of the Code will not limit credits and deductions otherwise available to the Funds and the Partners arising from the acquisition, construction, rehabilitation, and operation of low-income housing through the Project Partnerships.

Section 183(a) of the Code provides that if an individual or an S corporation engages in a not-for-profit activity, no deduction attributable to such activity shall be allowed under chapter 1 (sections 1 through 1564) except as provided in section 183.

Section 1.183-2(a) of the Income Tax Regulations provides, in part, that the determination of whether an activity is engaged in for profit is to be made by reference to objective standards, taking into account all the facts and circumstances of each case. Although a reasonable expectation of profit is not required, the facts and circumstances must indicate that the taxpayer entered into the activity, or continued the activity, with the objective of making a profit.

Although section 183(a) of the Code refers to activities of individuals or S corporations, it also applies to the activities of partnerships. Rev. Rul. 77-320, 1977-2 C.B. 78, holds that section 183 limits deductions at the partnership level and that the partners' distributive shares must reflect the adjustment in allowable deductions.

For buildings placed in service after 1986 and before 1991, section 42 of the Code provides a low-income housing credit. In general, the credit is received annually over a 10-year credit period with respect to each qualified low-income building, and is earned over a 15-year compliance period that commences with the first year of the credit period. The credit rates vary depending on when the buildings are placed in service, whether they are new or existing, and whether or not they are federally subsidized. With respect to each qualified building, the 10 level annual credit amounts will have present value (as of the last day of the credit period's first year) equal to 70 percent of the qualified basis of a new building that is not federally subsidized, or 30 percent of the qualified basis of a new building that is federally subsidized and of an existing building. A building is a qualified low-income building if (i) at all times during the 15-year compliance period it is part of a "qualified low-income housing project", and (ii) the amendments made by section 201(a)

of the Tax Reform Act of 1986 (pertaining to modification of the accelerated cost recovery system) apply to the building.

Under section 42(g)(1) of the Code a project constitutes a qualified low-income housing project if either at least 20 percent of the units are occupied by individuals with incomes of 50 percent or less of median gross income, or at least 40 percent of the units are occupied by individuals with incomes of 60 percent or less of area median gross income. Additionally, section 42(g)(2) provides that the rent charged tenants cannot exceed 30 percent of the applicable income limitation under section 42(g)(1). The basis of a building for depreciation purposes is not reduced by the amount of low-income housing credits claimed. S. Rep. No. 313, 99th Cong., 2d Sess. 767 (1986), 1986-3 (Vol. 3) C.B. 1, 767.

Based on the above facts and representations, the Service will not apply the "not-for-profit" rules of section 183 of the Code to disallow credits and deductions to the Funds and the Partners attributable to a qualified low-income housing project as that term is defined under section 42(g).

No opinion is expressed or implied regarding whether the Projects in general will qualify for the low-income housing credit under section 42 of the Code, and no opinion is expressed or implied regarding the limitation of passive activity losses under section 469 or the restrictions on interest deductions under section 163.

This letter is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent. Temporary or final regulations pertaining to the issues addressed in this ruling have not been adopted. This ruling is issued under the authority of Rev. Proc. 88-18, 1988-20 I.R.B. 32, that enables the Service to issue rulings that previously would have been precluded by the provisions of section 5.07(2) of Rev. Proc. 88-1, 1988-1 I.R.B. 11. Therefore, this ruling may be modified or revoked by the Service. However, when the criteria in section 16.05 of Rev. Proc. 88-1 are satisfied, a ruling is not modified or revoked retroactively, except in rare or unusual circumstances.

A copy of this letter should be filed with each Partner's income tax returns for the taxable years in which the transactions covered by this ruling are consummated.

In accordance with the Power of Attorney on file in this office, a copy of this letter is being sent to your authorized representative.