Private Letter Ruling 9016032

UIL No. 0046.00-00

Date: January 19, 1990

CC:P&SI:5 -TR-31-2680-89

Dear ***

This is in response to your letter dated July 6, 1989, submitted on behalf of Investor Partnership and Local Partnership requesting rulings on the tax effects of a transaction fully described below.

Investor Partnership's federal partnership information returns are filed with the Internal Revenue Service in City A and are under the audit jurisdiction of the City B District Director. Local Partnership's federal partnership information returns are filed with the Internal Revenue Service in City C and are under the audit jurisdiction of the City C District Director.

Investor Partnership was formed on b as a State D limited partnership. Limited Partnership, a State E limited partnership, has at all times been its sole general partner. Certain individuals were Investor Partnership's initial limited partners. Units of limited partnership interest in Investor Partnership ("Units") are currently being offered to the public at a price of $ *** per Unit pursuant to a prospectus dated c filed (as part of a Registration Statement on Form S-11) with the Securities and Exchange Commission (the "Prospectus"). Through d, the partnership agreement of Investor Partnership had been amended to reflect the admission of limited partner investors (the "Limited Partner Investors") who had acquired e Units. It is anticipated that additional Limited Partner Investors will be admitted to Investor Partnership throughout 19 *** in accordance with the terms of the Prospectus. Investor Partnership is offering a total of f units, and will terminate its offering in g. A majority of the existing Limited Partner Investors are individuals and it is expected that a majority of Limited Partner Investors will be individuals.

Investor Partnership was formed to acquire, develop, rehabilitate, and operate real estate projects throughout the United States. It is anticipated that each of the projects which it develops will qualify for the investment credit on rehabilitated buildings afforded by section 48(g) of the Code.

Investor Partnership generally does not directly acquire interests in real estate projects but instead invests in joint venture partnerships with local real estate developers, which joint venture partnerships acquire, rehabilitate and operate properties. Typically, each joint venture acquires one property. Investor Partnership provides all or most of the equity to the joint venture, and the local developer provides the management and other services required to develop and operate the project. The joint venture partnership incurs expenditures that will qualify for the rehabilitation investment credit. The credit base attributable to the project flows through to Investor Partnership, and, in turn, flows through to the Limited Partner Investors, who claim a portion of the rehabilitation tax credit attributable to the project on their individual income tax returns.

Typically, each local joint venture in which Investor Partnership invests borrows a portion of the project costs from a third party lender and Investor Partnership provides the remaining funds needed by the joint venture for the project as equity. Thus, ultimately all of the costs of rehabilitating a project will be funded from either the joint ventures's equity or the proceeds of the third party loan. However, in keeping with normal construction- industry practices, as the actual rehabilitation work on a project is done, the contractors and subcontractors performing the work are only paid a portion (e.g., percent) of the amount ultimately due them for their work. The remainder is held-back by the construction lender (or the joint venture) and paid when the contractor or subcontractor completes the work it contracted to perform. The amount held back is customarily referred to as “Retainage.”

In addition, before a project is 100 percent complete, the local joint venture may accrue various project costs that will be paid from equity or from advances from the construction lender as soon as such payments can be processed (these accrued expenses and the Retainage are hereinafter referred to as the “Accrued Expenses”). Thus, at any time before the construction of a project is 100% complete, the local point venture may have two liabilities, the loan from the third party lender and the Accrued Expenses.

Investor Partnership provides funds for its equity investments out of the proceeds of its offering of Units. In exchange for its services relating to the acquisition of Investor Partnership's joint venture interests, Limited Partnership, the sole general partner of Investor Partnership, receives a fee equal to approximately *** percent of the Limited Partner Investors' capital contributions to Investor Partnership. Investor Partnership also incurs other expenses related to the investigation and acquisition of joint venture interests, such as legal and accounting expenses, due diligence costs, etc. These expenses and the Limited Partnership Fee are referred to as the “Acquisition Expenses”.

On h, Investor Partnership in return for undertaking to make certain capital contributions, became a general partner of Local Partnership, a State D limited partnership. The purpose of the Local Partnership is to acquire a property located in City F (the “Project”) and to rehabilitate the Project in a manner intended to qualify certain of the costs thereof for a rehabilitation tax credit under Section 48(g) of the Code. Rehabilitation work on the Project commenced in i and is anticipated to be substantially completed and the Project placed in service by g. In connection with the acquisition and rehabilitation of the Project, Investor Partnership has prepared a budget relating to the costs of acquisition, rehabilitation, marketing, leasing, and financing of the Project, a copy of which was submitted with the ruling request.

The Local Partnership will finance the cost of acquiring and rehabilitating the Project out of the proceeds of Investor Partnership's capital contribution of approximately $j and a mortgage loan in the maximum principal amount of approximately $k. In connection with the acquisition of its interest in the Local Partnership, Investor Partnership will pay Acquisition Expenses of $1.

To enable the Limited Partner Investors to properly calculate their rehabilitation tax credit attributable to the Project, Investor Partnership must report to them sufficient information to apply the rules of section 46(c)(8) of the Code. Investor Partnership must specifically report what part of the nonrecourse debt of the Project is attributable to the qualified rehabilitation expenditures, as that term is defined in section 48(g)(2) of the Code (“QREs”), so that the Limited Partner Investors can determine whether they have satisfied the requirements of section 46(c)(8)(D)(ii)(II) of the Code.

For purposes of this ruling request, Investor Partnership and the Local Partnership have made the following representations:

1. With respect to the Limited Partner Investors, all of the indebtedness of the Local Partnership will be “nonrecourse financing” within the meaning of section 46(c)(8)(D)(iii) of the Code.

2. As of *** , the Local Partnership anticipates it will have been advanced approximately $m from an unrelated commercial lender and will have incurred $n of Accrued Expenses.

3. Following its rehabilitation, the Project will be a qualified rehabilitated building as described in section 48(g) of the Code and section 1.48-12 of the Income Tax Regulations.

4. Although Investor Partnership borrowed funds from Limited Partnership to make its initial capital contribution to the Local Partnership, the loan to Limited Partnership was repaid after the first admission of Investor Limited Partners to Investor Partnership. Thus, Investor Partnership's investment in the Local Partnership and the amount of the Acquisition Expenses payable with respect to its investment in the Local Partnership have been, and will be funded from the equity contributions of the Limited Partner Investors.

5. Investor Partnership may borrow funds from Limited Partnership to make capital contributions to other joint venture partnerships. However, all such loans will be repaid from the proceeds of the sale of Units to Limited Partner Investors by

6. The Acquisition Expenses paid with respect to the acquisition of the interest in the Local Partnership by Investor Partnership were costs incurred in locating, evaluating and acquiring the investment in the Local Partnership.

7. Throughout the *** period following the date on which the Project is “placed in service” for purposes of Section 48 of the Code, Investor Partnership's percentage interest in the profits and losses from operations of the Local Partnership will be o percent.

On these facts, the following rulings were requested:

1. For purposes of determining whether a Limited Partner Investor has satisfied the requirement of Code section 46(c)(8)(D)(ii)(II) that “the amount of nonrecourse financing with respect to [the] property does not exceed 80 percent financing of the Project should be prorated among the QREs, the acquisition costs of the land and building shell, and the various other costs of the Project based upon the respective amounts of such costs.

2. For purposes of applying the 80 percent test to the Project, the amount of the Acquisition Expenses should be treated as Project costs, and a portion of Investor Partnership's allocable share of the nonrecourse financing of the Project should be prorated to them.

3. For purposes of applying section 46(c)(8) of the Code, Accrued Expenses should not be considered to be an independent source of financing, but should be treated as having been paid out of the equity or construction-loan financing (as the case may be) of the Local Partnership at the time such Expenses are initially incurred.

Sections 46(c)(8), 46(c)(9), and 47(d)(1) of the Code contain rules for determining the credit base of section 38 property.

Section 46(c)(8)(A) of the Code provides that the credit base of any property to which paragraph (c) applies shall be reduced by the nonqualified nonrecourse financing with respect to the property as of the close of the tax year in which the property is placed in service. Section 46(c)(8)(B) provides that the at-risk" rules apply to any property that is placed in service during the tax year by a taxpayer described in section 465(a)(1), and used in connection with an activity with respect to which loss is subject to limitation under section 465. As a result of the Tax Reform Act of 1986, the at-risk rules of section 465 and, correspondingly, those under section 46(c)(8) were extended to real estate and, hence, the Project.

Section 46(c)(8)(D)(i) of the Code provides that "nonqualified nonrecourse financing" means any nonrecourse financing other than "qualified commercial financing." For purposes of section 46(c)(8) of the Code, "nonrecourse financing" includes:

> 1) any amount with respect to which the taxpayer is protected against loss through guarantees, stop-loss agreements, or other similar arrangements; and
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> 2) except to the extent provided in regulations, any amount borrowed from a person who has an interest (other than as a creditor) in the activity in which the property is used or from a related person to a person (other than the taxpayer) having such an interest. Section 46(c)(8)(D)(iii).

In general, the determination of whether a partner's or S corporation shareholder's allocable share of any financing is nonqualified nonrecourse financing must be made at the partner or shareholder level. In this situation, because the Limited Partner Investors will have no obligation to make further contributions to Investor Partnership or the Local Partnership or to repay indebtedness directly to the lenders, we assume for purposes of this ruling that the debt incurred by the Local Partnership or Investor Partnership will be "nonrecourse financing" with respect to the Limited Partner Investors.

Under section 46(c)(8)(D) of the Code for any nonrecourse financing to be considered at risk, and therefore not reduce the credit base, that financing must be "qualified commercial financing".

Section 46(c)(8)(D)(i) of the Code, provides that the term "qualified commercial financing" means any financing with respect to any property if -- (I) such property is acquired by the taxpayer from a person who is not a related person, (II) the amount of nonrecourse financing with respect to such property does not exceed 80 percent of the credit base of such property, and (III) such financing is borrowed from a qualified person or represents a loan from any Federal, State, or local government or instrumentality thereof, or is guaranteed by any Federal, State, or local government. Such term shall not include any convertible debt.

The property referred to in (I) and (II) with respect to the Project consists of the qualified rehabilitation expenditures made to rehabilitate the Project.

Because in this situation the loan and capital contributions to Local Partnership are used to pay for the entire expenses related to the Project and not just the QRES it is necessary to allocate the debt and equity pro rata among the various project costs. Under this proration method a percentage of debt will be allocated to each expenditure based on its cost. All expenditures relating to the Project that are funded by the initial capital of the Project would be included, whether such expenditures were capitalizable into the basis of the Project, capitalizable into an intangible asset or deducted by the taxpayer. (While there are sound reasons to limit this allocation method to only those costs capitalized into the building, we do not feel compelled to reach that conclusion. In this situation, there is a pool of funds consisting of part debt and part equity. Because this pool is used to fund all of the Project's expenses an allocation to all expenses is appropriate). After application of this allocation method, the taxpayer can then ascertain whether the financing attributable to the QRES satisfies the “80 percent” test. In this situation, the 80 percent test is passed after allocation of the financing among the various expenses of the Project.

We do not agree, however, with Investor Partnership's assertion that the Acquisition Expenses incurred by the Investor Partnership (consisting primarily of the fee paid to its general partner) is eligible for treatment under this allocation method. In our view, it is only the expenses incurred by the taxpayer that qualifies the property for the credit -- here, the Local Partnership -- that can be included in the allocation method. For although the credit will ultimately be passed through to the Limited Partner Investors, it is the Local Partnership that has incurred the debt and it is from the Local Partnership's pool of funds that the various Project costs are paid. In addition, the fee paid the Investor Partnership's general partner is not the result of arms-length negotiations and could always be increased to the necessary level to insure that the 80 percent test was passed for the QREs were it to be included in the allocation. Accordingly, we hold that such amounts may not be included when the financing is allocated among the various Project costs.

With regard to the Accrued Expenses we agree with Investor Partnership that such amounts are not a separate financing for purposes of the section 46(c)(8) rules. At any point before the Project is completed, the Local Partnership will have two liabilities, the mortgage loan to a construction lender (who is unrelated to the Local Partnership, Investor Partnership or any of their affiliates) and Accrued Expenses. The Accrued Expenses are liabilities in part for construction expenses that have been incurred, but for which the lender or the Local Partnership has not yet advanced funds because administrative procedures for such advances are not complete and are in part Retainage. Thus, Accrued Expenses will be paid from the proceeds of the mortgage loan or out of the Local Partnership's equity in due course. Because the Accrued Expenses will be paid by advances from the construction lender or out of equity in due course, and because the lender or the Local Partnership (as the case may be) has set aside funds for this purpose, the Accrued Expenses may be treated as effectively paid out of the construction loan proceeds or the Local Partnership's equity (as the case may be) at the time they are initially incurred.

Accordingly, based solely on the facts as represented and the discussion of law above we rule that:

> 1. For purposes of determining whether the nonrecourse financing on the Project meets the 80-percent test of section 46(c)(8)(D)(ii)(II) of the Code, the debt financing of the Project may be prorated among the qualified rehabilitation expenditures, the acquisition costs of the land and building shell, and the various other costs of the Project based upon the respective amounts of such costs.
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> 2. For purposes of applying the 80-percent test to the Project, the Acquisition Expenses incurred by Investors Partnership will not be treated as Project costs and no amount of the nonrecourse financing may be allocated to them.

3. For purposes of section 46(c)(8) of the Code, the Accrued Expenses as discussed above will not be an independent source of financing, but may be treated as having been paid out of the equity or construction-loan financing (as the case may be) of the Local Partnership at the time such expenses are incurred.

This ruling is directed only to the taxpayers that requested it. Section 6110(j) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,

James F. Ranson

Chief, Branch 5

Office of the Assistant Chief

Counsel

(Passthroughs & Special

Industries)