

Private Letter Ruling 9207027

PARTNERSHIP ALLOCATIONS HAVE SUBSTANTIAL ECONOMIC EFFECT.

Date: November 19, 1991

CC:P&SI-1 – TR-31-959-91

Dear ***

This responds to a letter dated November 12, 1991, and prior correspondence, submitted on behalf of P by its authorized representative requesting a ruling that a special allocation in P's partnership agreement will have substantial economic effect under section 704(b) of the Internal Revenue Code.

P, a limited partnership, will invest in other partnerships that own interests in real estate projects qualifying for the low-income housing credit under section 42 of the Code.

The limited partners of P will be subchapter C corporations. Some of the corporations will meet the definition under section 465(a)(1)(B) of the Code ("closely-held corporate limited partners"). Some of the partnerships that P invests in will produce tax benefits that cannot be used by the closely-held corporate limited partners of P because of the at-risk limitations of sections 42(k) and 465. The partnership agreement calls these investments "special investments." However, the at-risk limitations will not affect the ability of other limited partners of P ("widely-held corporate limited partners") to use the tax benefits from special investments. Investments of P that produce tax benefits that can be used by both closely-held and widely-held corporate limited partners are called "general investments" by the partnership agreement.

At the time a corporation becomes a limited partner of P, that corporation's partnership interest is designated a closely-held corporate limited partnership interest or a widely-held corporate limited partnership interest. The designation of that partnership interest will never change even if the interest is transferred. The designation of a partnership interest will not affect the amount of the required contribution to P. At the time P invests in another partnership, that investment will be designated a special investment or a general investment.

The effect of the special allocation in the partnership agreement is to segregate the special investments from the general investments and to allocate all tax benefits and economic consequences of the special investments only to the widely-held corporate limited partners, which are able to use those tax benefits. Closely-held corporate limited partners will receive allocations only from general investments. Tax benefits and economic consequences of general investments will also be allocated to widely-held corporate limited partners of P. However, a widely-held corporate limited partner will have a smaller proportionate interest in general investments than a closely-held corporate limited partner.

It has been represented that none of the investments of P have been identified and that it is not presently known what the tax benefits and economic consequences of any of the investments will be. It has been represented that special investments and general investments are likely to have different operating and tax results and long-term residual values. Specifically, special investments may be riskier than general investments because qualified financing would not be available, thereby creating an increased risk of default and risk of loss of capital. Many special investments are acquired out of foreclosure or are being bailed out of unsuccessful operations. The risk of default on a special investment may be compounded by higher leverage and a higher interest rate required by a non-qualified lender. These factors would increase the tax losses related to, decrease the cash flow from, and lower the residual values of, special investments (as a class) relative to general investments. Non-qualified lenders of special investments are likely to require shorter term financing than qualified lenders of general investments, which would impact both tax and economic results. Because non-qualified indebtedness is most likely to be used with investments acquired out of foreclosure, which tend to be non-subsidized projects eligible for the nine percent low income housing credit, the eligible (and depreciable) basis of special investments will likely be less than the eligible (and depreciable) basis of subsidized projects eligible for the four percent credit. Those special investments that are successful are likely to have a relatively high potential residual value compared to general investments. General investments are likely to produce relatively predictable allocations compared to special investments. Finally, the acquisition cost (and related benefit ratio) of special investments is likely to be lower than general investments because there will be less competition to acquire special investments because fewer taxpayers will be able to use the tax benefits of special investments.

The partnership agreement provides that the partners' capital accounts shall be maintained in accordance with section 1.704-1(b)(2)(iv) of the Income Tax Regulations. The partnership agreement also provides that upon termination and winding up of P, after payment of, or reasonable provision for, the debts and obligations of P, the remaining assets of P shall be distributed to all partners with positive capital accounts in the ratio of their respective positive capital accounts to the sum of all positive capital accounts. The partnership agreement does not provide a negative capital account restoration obligation. However, the partnership agreement does provide a qualified income offset. The partnership agreement contains language complying with the requirements of the alternate test set forth in section 1.704-1(b)(2)(ii)(d).

Section 704(b) of the Code provides that a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if (1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or (2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

Section 1.704-1(b)(2)(iii)(a) of the regulations provides in part that economic effect will not be substantial if, at the time the allocation becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to the consequences if the allocation were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to the consequences if the allocation were not contained in the partnership agreement. In determining the after-tax economic benefit or detriment to a partner, tax consequences that result from the interaction of the allocation with the partner's tax attributes that are unrelated to the partnership will be taken into account.

At the time the special allocation became part of P's partnership agreement, the after-tax economic consequences to the closely-held corporate limited partners could be enhanced because the special allocation ensures that they will receive allocations of tax benefits only from partnerships that produce tax benefits that the closely-held corporate limited partners can use without limitation under sections 42(k) and 465 of the Code. However, there is not a strong likelihood that the after-tax economic consequences to no limited partner will be substantially diminished by the special allocation. It is expected that special investments will have a higher degree of risk, higher leverage, a higher interest rate, shorter maturity schedules, and other substantial differences from general investments. The effect of the allocations derived from special investments will be both impossible to predict at the outset and very different from those derived from general investments.

Accordingly, we conclude that the special allocation in P's partnership agreement has substantial economic effect under section 704(b) of the Code.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code, including whether any other allocations in P's partnership agreement have substantial economic effect under section 704(b).

A copy of this letter should be attached to the first tax return filed by P. A copy is enclosed for that purpose.

This ruling 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.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to P's authorized representative.

Sincerely yours,

Claire E. Toth

Chief, Branch 1

Office of the Assistant

Chief Counsel

(Passthroughs and Special
Industries)

Enclosures (2):

Copy of this letter

Copy for section 6110 purposes