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Person to Contact:

Telephone Number:

Refer Reply To:
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Date:
MAY 30, 2000

Legend:

Partnership =

State =

Project =

City =

Agency =

Gen Partners =

Ltd Partners =

Trustee =

a =

b =

c =

d =

e =

f =

g =

h =

i =

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Dear :

This letter responds to your letter dated November 29, 1999, submitted on behalf of Partnership, requesting a private letter ruling under § 42(h)(4)(B) and § 42(i)(2)(A) of the Internal Revenue Code. Partnership represents that the facts are as follows:

FACTS:

Partnership is a State limited partnership that was formed on a with Gen Partners and Ltd Partners. On b, Partnership purchased a c-story industrial building in City for $d. Of the purchase price, $e is attributable to the acquisition of the building and the remaining $f is attributable to the land. The purchase was financed by a nonrecourse loan from Agency in the amount of $g (the "Acquisition Loan"), with the balance financed from partner capital contributions. The Acquisition Loan is secured by a first mortgage lien on the property and was financed by the issuance of $g Agency tax-exempt bonds (the "Tax-Exempt Bonds"). Partnership represents that the interest on the Tax-Exempt Bonds is exempt from tax under § 103. Furthermore, the Tax-Exempt Bonds were subject to the limitations on issuance imposed by § 146, and the principal payments on the Acquisition Loan will be applied within a reasonable period to redeem the Tax-Exempt Bonds.

Pursuant to the Acquisition Loan, the proceeds of the Tax-Exempt Bonds were required to be used exclusively to acquire the existing property and to pay expenses incidental to the issuance and sale of the Tax-Exempt Bonds. Accordingly, $h in proceeds of the Tax-Exempt Bonds were used to acquire the property with the remaining $i used to pay expenses incidental to the issuance of the Tax-Exempt Bonds. According to Partnership, none of the proceeds of the Tax-Exempt Bonds have been, or will be, used for any other purposes, including the rehabilitation of the building.

Partnership intends to rehabilitate, own, and operate the building as a multifamily rental housing development to be known as Project, consisting of j residential rental housing units and approximately k square feet of commercial space. Partnership anticipates that rehabilitation expenditures for the building will total $l, which Partnership represents will qualify as "rehabilitation expenditures" within § 42(e)(2) and, therefore, will be treated for purposes of § 42 as a separate new building under § 42(e)(1). Rehabilitation costs will be funded from: (1) capital contributions by the partners, (2) deferred development fees, (3) net cash flow from operations during rehabilitation, (4) a loan from the Affordable Housing Program of the Federal Home Loan Bank, and (5) taxable bonds issued by Partnership in the amount of $m (the "Taxable Bonds"). The interest on the Taxable Bonds is not exempt from tax under § 103. Partnership represents that none of the rehabilitation costs of the building were or will be financed with the proceeds of the Tax-Exempt Bonds, any other obligation the interest on which is exempt from tax under § 103, or any "below-market federal loan" under § 42(i)(2)(D). The Tax-Exempt Bonds and the Taxable Bonds were both issued on q and use Trustee.

Partnership further represents that the issuance of the Tax-Exempt Bonds and Taxable Bonds were independent transactions that were not conditioned upon, or otherwise related to, one another. The Trust Indenture and Loan Agreement for the Tax-Exempt Bonds require that the loan proceeds be used exclusively to acquire the existing building and land and to pay incidental issuance costs.

Partnership has received a reservation of § 42 credits from Agency in the amount of $n for the rehabilitation expenditures based upon the 70 percent present-value credit under § 42(b)(2)(B)(i), taking into account the rehabilitation tax credits under § 47. Partnership intends to claim § 42 credits pursuant to § 42(h)(4) in the amount of $o for the existing building based upon the 30 percent present-value credit under § 42(b)(2)(B)(ii). Partnership represents that at least 50 percent of the acquisition of the existing building and land was financed with the proceeds of the Tax-Exempt Bonds. Upon completion of the rehabilitation, p of the j residential units in the project will be low-income units under § 42(i)(3)(A).

RULINGS REQUESTED:

1. The rehabilitation expenditures paid or incurred by Partnership will not be treated as federally subsidized under § 42(i)(2) as a result of the acquisition of the existing building and land with the proceeds of the Tax-Exempt Bonds, and such rehabilitation expenditures will be treated as a new building which is not federally subsidized under § 42(b).

2. Pursuant to § 42(h)(4)(B), § 42(h)(1) will not apply to the acquisition cost of the existing building because 50 percent or more of the

aggregate basis of the existing building and the land upon which the building is located is financed by an obligation described in § 42(h)(4)(A).

LAW AND ANALYSIS FOR ISSUE 1:

Section 42(a) provides, in general, that for purposes of § 38, the amount of the low-income housing credit determined under § 42 for any taxable year in the credit period shall be an amount equal to the applicable percentage of the qualified basis of each qualified low-income building.

Under § 42(b)(2)(B)(i), for buildings placed in service after 1987 the 70 percent present-value credit applies to new buildings which are not federally subsidized for the taxable year. Under § 42(b)(2)(B)(ii), for buildings placed in service after 1987 the 30 percent present-value credit applies to new buildings which are federally subsidized for the taxable year and existing buildings.

Section 42(e)(1) provides that rehabilitation expenditures paid or incurred by the taxpayer for any building shall be treated for purposes of § 42 as a separate new building. Under § 42(e)(2)(B), the term “rehabilitation expenditures” does not include the cost of acquiring any building (or interest therein).

Section 42(i)(2)(A) provides that, except as otherwise provided in § 42(i)(2), a new building shall be treated as federally subsidized for any taxable year if, at any time during such taxable year or any prior taxable year, there is or was outstanding any obligation the interest of which is exempt from tax under § 103, or any below market federal loan, the proceeds of which are or were used (directly or indirectly) with respect to such building or the operation thereof.

The legislative history of § 42 states if any portion of the eligible basis attributable to new construction or the eligible basis attributable to rehabilitation expenditures is financed with federal subsidies, the qualified basis is eligible only for the 30 percent present-value credit, unless such federal subsidies are excluded from eligible basis. A federal subsidy is defined as any obligation the interest on which is exempt from tax under § 103 or a direct or indirect federal loan, if the interest rate on such loan is less than the applicable federal rate. The determination of whether rehabilitation expenditures are federally subsidized is made without regard to the source of financing for the construction or acquisition of the building to which the rehabilitation expenditures are made. 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. II-91 (1986), 1986-3 (Vol. 4) C.B. 91.

Section 1.42-1T(f)(1)(ii) of the temporary Income Tax Regulations provides that for purposes of determining the portion of proceeds of an issue of tax-exempt bonds

used to finance (A) eligible basis of a qualified low-income building, and (B) the aggregate basis of the building and the land on which the building is located, the proceeds of the issue must be allocated in the bond indenture or a related document (as defined in § 1.103-13(b)(8)) in a manner consistent with the method used to allocate the net proceeds of the issue for purposes of determining whether 95 percent or more of the net proceeds of the issue are to be used for the exempt purpose of the issue. If the issuer is not consistent in making this allocation throughout the bond indenture and related documents, or if neither the bond indenture nor a related document provides an allocation, the proceeds of the issue will be allocated on a pro rata basis to all of the property financed by the issue, based on the relative cost of the property.

In the present case, Partnership argues that no portion of the eligible basis of the building attributable to the rehabilitation expenditures will be financed with a federal subsidy. In accordance with the Tax-Exempt Bonds, Partnership used 100 percent of the proceeds to acquire the existing building and land and to pay expenses incidental to the issuance of the Tax-Exempt Bonds. None of the rehabilitation expenditures was to be financed with the proceeds of the Tax-Exempt Bonds. The rehabilitation expenditures will be financed in part by the Taxable Bonds, the interest on which is not exempt from tax under § 103.

Partnership also argues the above cited § 42 Conference Report language demonstrates Congress' intent that the determination of whether rehabilitation expenditures are federally subsidized under § 42(i)(2) is made without regard to the source of financing for the existing building and land. The Conference Report goes on to describe the continuation or assumption of tax-exempt bond financing upon purchase of an existing building as an example of financing that would not taint the rehabilitation expenditures as being federally subsidized. According to Partnership, there is no indication that Congress intended the example as a limit in any way regarding the ability to segregate acquisition financing from rehabilitation financing.

The language of § 42(i)(2)(A) is very broad. If the proceeds of an obligation exempt from tax under § 103 are used directly or indirectly for a building, the building is considered federally subsidized. Clearly there is an indirect benefit to the Partnership's building consisting of the rehabilitation expenditures because of the favorable tax-exempt financing for the acquisition. However, the Conference Report provides a limited exception to the rule in § 42(i)(2)(A) for rehabilitation expenditures. Rehabilitation expenditures will not be considered federally subsidized by reason of certain acquisition financing. We read the example in the Conference Report as requiring that the financing for the acquisition be independent of the financing for the rehabilitation. If the acquisition and rehabilitation financings are independent transactions, the taint of the tax-exempt acquisition financing will not extend to the rehabilitation. However, if the financings are part of one plan of financing, as we have here, the building consisting of the rehabilitation expenditures is federally subsidized under § 42(i)(2)(A).

In our view, Partnership's financing for the acquisition and the rehabilitation were arranged as one transaction. The financings for the Tax-Exempt Bonds and Taxable Bonds closed on the same date and use the same bank trustee. Partnership merely allocated the proceeds of the Tax-Exempt Bonds to the acquisition, which is already restricted to the 30 percent present-value § 42 credit, and allocated the proceeds of the Taxable Bonds to the rehabilitation for the 70 percent present-value § 42 credit. Though the Trust Indenture and Loan Agreement for the Tax-Exempt Bonds require that the loan proceeds be used exclusively to acquire the existing building and land, and § 1.42-1T(f)(1)(ii) implies the bond proceeds must be allocated accordingly, the indirect benefit of the Tax-Exempt Bonds to the rehabilitation in the present situation requires that the building consisting of rehabilitation expenditures be considered federally subsidized under § 42(i)(2)(A). As a result, the building consisting of the rehabilitation expenditures is only eligible for the 30 percent present-value credit under § 42(b)(2)(B)(ii).

LAW AND ANALYSIS FOR ISSUE 2:

Section 42(h)(1)(A) provides that the amount of credit determined under § 42 for any taxable year with respect to any building shall not exceed the housing credit dollar amount allocated to such building under § 42(h).

Section 42(h)(4)(A) provides that § 42(h)(1) shall not apply to the portion of any credit allowable under § 42(a) that is attributable to eligible basis financed by any obligation the interest on which is exempt from tax under § 103 if such obligation is taken into account under § 146 and principal payments on such financing are applied within a reasonable period to redeem obligations the proceeds of which were used to provide such financing.

Section 42(h)(4)(B) provides that for purposes of § 42(h)(4)(A), if 50 percent or more of the aggregate basis of any building and the land on which the building is located is financed by an obligation exempt from tax under § 103, § 42(h)(1) shall not apply to any portion of the credit allowable under § 42(a) with respect to such building.

Buildings meeting the requirement of § 42(h)(4)(B) do not need an allocation of § 42 credits by a state or local housing agency under § 42(h)(1). Partnership argues that rehabilitation expenditures should be treated as a separate building for all purposes under § 42, including § 42(h)(4)(B). If that is the case, Partnership's existing c-story industrial building does not need an allocation of credit under § 42(h)(1). However, if § 42(h)(4)(B) applies to Partnership's existing building and rehabilitation expenditures together, Partnership needs an allocation of credit under § 42(h)(1) for the portion of both buildings not financed with an obligation exempt from tax under § 103.

In order to satisfy the rule of § 42(h)(4)(B), 50 percent or more of the aggregate basis of any building and the land on which the building is located must be financed by

an obligation exempt from tax under § 103. Section 42's legislative history does not state how to make the calculation. It appears that the rule was intended to demonstrate a substantial involvement of tax-exempt funds by the taxpayer in the building and land used in providing low-income housing. Consistent with this view, the aggregate basis of the building and the land is the sum of the cost of each as defined in § 1012. Building is not limited to § 1250 property, but includes all property (including § 1245 property and depreciable land improvements) financed with the proceeds of the tax-exempt bonds. Moreover, the definition of building for purposes of § 42(h)(4)(B) includes the building or structure, together with any functionally related and subordinate facilities. See § 1.103-8(b)(4)(i). Thus, a taxpayer cannot separately meet the 50 percent test in § 42(h)(4)(B) for the acquisition and the rehabilitation.

In the case of Partnership's acquisition and rehabilitation, the 50 percent test is applied against all costs for the project which includes the c-story industrial building, land, and the rehabilitation expenditures. Accordingly, Partnership's total costs of $d and $l do not satisfy the 50 percent requirement in § 42(h)(4)(B). Without an allocation of § 42 credit from Agency for the acquisition, Partnership is limited under § 42(h)(4)(A) to the amount of the Tax-Exempt Bonds attributable to the existing building (and not land) as the amount not subject to § 42(h)(1).

No opinion is expressed or implied regarding the application of any other provisions of the Code or regulations. Specifically, we express no opinion on how to make the election under § 42(i)(2)(B)(ii) and whether Project otherwise qualifies for the low-income housing credit under § 42.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the power of attorney on file, this letter is being sent to you as Partnership's authorized legal representative. Also, a copy of this letter is being sent to the second representative listed and to Partnership.

Sincerely yours,

/s/ Harold E. Burghart
HAROLD E. BURGHART
Assistant to the Branch Chief,
Branch 5
Office of Assistant Chief Counsel
(Passthroughs and Special
Industries)

Enclosure:
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