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Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:6-PLR-120399-98

Date:
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Re:

Legend

Company =

Parent =

Owner =

Project =

Franchisor =

Investor =

Manager =

A =

$w =

$x =

$y =

197

PLR-120399-98

$z

Dear

Pursuant to a power of attorney on file in this office, this responds to a letter submitted on behalf of Company requesting rulings concerning the ability of Owner to pass the rehabilitation credit attributable to the rehabilitation of Project to Company.

FACTS

Company is a Delaware corporation formed for the purpose of entering into a leasing transaction with Owner. Company is a wholly owned subsidiary of Parent, a corporation actively engaged directly and through subsidiaries in numerous business activities, including the ownership and operation of While Parent is a corporation whose stock ownership meets the requirements of section 542(a) of the Internal Revenue Code, it is represented that Parent is not a personal holding company as defined in that provision. Parent files a consolidated income tax return that will include Company. Owner is a limited liability company unrelated to Company or Parent, formed to acquire and rehabilitate the Project. Affiliates of Owner engage in various business activities, including the management and operation of

Company entered into an agreement (Lease) with Owner dated to lease the Project from Owner. The Project has been substantially rehabilitated by Owner and is intended to qualify as a certified historic structure within the meaning of section 47(c)(3)(A) of the Code. A request has been made to A for certification of the completed work on the Project. Owner has agreed to make an election to pass any rehabilitation credit attributable to the rehabilitation of the Project to Company as lessee. A temporary certificate of occupancy was obtained for the Project on

Company also entered into the Management Agreement and the Performance Agreement. These agreements will be described infra.

The Lease term began on (Commencement Date), and continues until unless there is an early termination. It is represented that the Commencement Date occurred prior to the Project being placed in service. Both Owner and Company have the right to terminate the Lease under certain conditions. Company made a Lease Deposit with Owner that is refundable upon termination of the Lease for any reason other than default by Company. At the same

time Company also made a Lease Bonus Payment to Owner to cover pre-opening expenses of the Project and other costs associated with the Project previously incurred by Owner.

Rent payable under the Lease consists of Base Rent, Additional Rent, and Percentage Rent. Base rent is $w per year from the Commencement Date through September 30, 1998, and $x per year thereafter, payable in equal monthly installments. Base Rent was set at an amount equal to 120% of Owner's debt service coverage with respect to the financing costs of the Project. It is represented that the Base Rents and Lease Bonus will exceed the expenses that will economically accrue to Owner over the Lease term.

Additional Rent is 4% of the Gross Revenues, as defined in the Lease, received by Company from Project operations, and is payable quarterly.

Percentage Rent is payable when Gross Revenues for a year exceed Lease-specified Base Gross Revenues. Base Gross Revenues increase each year through the Lease term. Percentage rent is computed in tiers above Base Gross Rentals and is payable quarterly, except that Percentage Rent is deferred to the extent that payment would violate Company's Balance Sheet Covenant to maintain specified levels of Current Assets, as defined in the Lease. Deferred Percentage Rent is deemed to be Accrued Percentage Rent and becomes payable for the next quarter along with any Percentage Rent calculated for that quarter, such combined rent being subject to Company's Balance Sheet Covenant. Upon termination of the Lease any unpaid Percentage Rent and Accrued Percentage Rent become payable without regard to the Balance Sheet Covenant, to the extent of monies received and held by Company from Project operations.

Owner is the franchisee under a Franchise Agreement with Franchisor, a corporation unrelated to either Owner or Company. The Lease provides that Company is responsible for the performance of all obligations imposed on the franchisee under the Franchise Agreement, to the extent the obligations are not Owner's responsibility under the Lease.

Under the Lease, Company is required to pay all taxes relating to the Project and the business operations connected to the Project. Company is also responsible for all maintenance and upkeep of the Project. Any alterations, additions, and improvements made by Company become property of Owner without compensation to Company.

The Lease requires Company to maintain broad form commercial general liability insurance that covers the Project in forms and limits as reasonably determined by

Owner. Company is also required to maintain "all risk" property insurance on the Project. The property insurance must include business interruption coverage maintained in an amount equal to 50% of the estimated Gross Revenue for the 12-month period beginning on the date of the business interruption.

If the Project is closed as the result of a casualty or a governmental condemnation under eminent domain, and Owner determines the Project cannot be reopened within 365 days, then either Owner or Company may terminate the Lease. Company's obligation to pay Base Rent and Additional Rent survives the termination and continues as if the casualty or condemnation had not occurred. Company will be credited with any proceeds from the business interruption insurance maintained by it and paid to Owner for its rent obligations.

Company has represented that the Lease is a net lease within the meaning of section 57(c)(1)(B) of the Code, as in effect on the day before enactment of the Tax Reform Act of 1986.

Company has entered into the Management Agreement with Manager, an affiliate of Owner. Owner is a 99% limited partner in Manager, and another affiliate of Owner is the general partner. The Management Agreement took effect one day before the Commencement Date and continues until the Lease is terminated for any reason, or until it is terminated by Manager or Company. Under the Management Agreement Company has appointed Manager its sole and exclusive agent to operate, direct, manage, and supervise the Project. Company will pay Manager a Base Management Fee, an Incentive Management Fee, and a Fixed Asset Management Fee for these services.

The Base Management Fee is payable monthly and is equal to 3.5% of Gross Revenues for the month. The Incentive Management Fee is payable yearly and is equal to 1.65% of Gross Revenues if Gross Revenues exceed the amount specified for the particular year. The Fixed Asset Management Fee is payable monthly and is equal to $y, adjusted annually for inflation.

Company, Parent, Owner, and Investor (a member investor in Owner) have entered into the Performance Agreement under which Owner has taken on specific obligations and made numerous representations, warranties, and covenants. Among these are the following:

1) Owner has made cost and financial projections that estimate the Project will generate positive cash flow during the period ending 5 years from the date the project is placed in service.

2) Owner shall take all necessary steps to pass the rehabilitation credit attributable to the Project to Company under the applicable provisions of the Code. Owner has warranted that the amount of credit available to Company shall not be reduced by the "at risk" rules under the Code, and that no debt of Owner will be nonqualified nonrecourse financing under the Code.

3) Owner and Company have agreed that the projected amount of rehabilitation credit attributable to the Project will be $z. If the actual credit amount is less than $z Owner will pay to Company 80% of the excess of the projected amount over the actual amount.

It is represented that an affiliate of Company is actively engaged in the business of operating and, for the 12-month period ending December 31, 1998, will have at least one full-time employee substantially all of whose services were in the active management of and at least three full-time nonowner employees substantially all of whose services were directly related to the business. The amount of deductions attributable to this affiliate's business that are allowable solely by reason of sections 162 and 404 exceeds15% of the gross revenues from such business.

LAW AND ANALYSIS

Section 38(b) of the Code provides a credit against income taxes for certain business credits, including the investment credit determined under section 46.

Section 46 of the Code provides that, for purposes of section 38, the amount of the investment credit includes the rehabilitation credit.

Section 47(a)(2) of the Code provides that the rehabilitation credit for any taxable year includes an amount equal to 20% of the qualified rehabilitation expenditures with respect to any certified historic structure.

Section 47(b) of the Code provides that qualified rehabilitation expenditures with respect to any qualified rehabilitated building shall be taken into account for the taxable year in which the qualified rehabilitated building is placed in service.

Section 50(d)(5) of the Code provides that for purposes of Subpart E of the Code rules similar to the rules of former section 48(d), as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990 (Act), shall apply. The following references to section 48 refer to that section as in effect prior to the enactment of the Act.

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

Section 48(a)(1)(E) of the Code provides that, in the case of a qualified rehabilitated building, the portion of the basis attributable to qualified rehabilitation expenditures is section 38 property. Section 48(g)(4) provides that property treated as section 38 property by reason of section 48(a)(1)(E) shall be treated as new section 38 property.

Section 48(d)(2) of the Code provides a special rule for certain short-term leases under which a lessee of property described in section 48(d)(4) will be treated as having acquired a portion, but not all, of the leased section 38 property. Property described in section 48(d)(4) includes real property that is leased for a period that is less than 80% of its class life determined under section 167(m). Under section 48(d)(4)(D), section 48(d)(2) does not apply to property leased subject to a net lease within the meaning of section 57(c)(1)(B) as in effect prior to the enactment of the Tax Reform Act of 1986.

Section 48(d)(6)(C) of the Code provides that in the case of any lease where the lessee is an at-risk lessee, the property is at-risk property, and the at-risk percentage is less than the required percentage, any credit allowable under section 38 to a lessee by reason of an election under section 48(d)(1) shall be allowable only as provided in section 48(d)(6)(D).

Section 48(d)(6)(E) of the Code defines the terms used in section 48(d)(6)(C). The term "at-risk lessee" means any lessee that is a taxpayer described in section 465(a)(1). The term "at-risk property" means any property used by an at-risk lessee in connection with an activity with respect to which any loss is subject to a limitation under section 465.

Section 465(a)(1) of the Code provides that in the case of a C corporation with respect to which the stock ownership requirement of section 542(a)(2) is met, engaged in an activity to which section 465 applies, any loss from such activity for the taxable year is allowed only to the extent of the aggregate amount with respect to which the corporation is at risk (within the meaning of section of 465(b)) for such activity at the close of the taxable year.

Section 465(c)(7)(A) of the Code provides that in the case of a taxpayer that is a qualified C corporation, each qualifying business carried on by such taxpayer shall be treated as a separate activity, and section 465(a) shall not apply to losses from such business.

Section 465(c)(7)(B) of the Code provides that a "qualified C corporation" is a corporation otherwise subject to the limitations of section 465(a) that is neither a personal holding company defined in section 542(a), a foreign personal holding company defined in section 552(a), nor a personal service corporation defined in section 269A(b).

Section 465(c)(7)(C) of the Code provides that, with respect to a qualified C corporation, a "qualified business" is any active business if (1) the corporation had at least one full-time employee engaged in the active management of such business, (2) the corporation had at least three full-time nonowner employees providing services directly related to such business, (3) the amount of the deductions attributable to such business that are allowable solely by reason of sections 162 and 404 exceeds 15% of the gross income from such business, and (4) such business is not an excluded business.

Section 465(c)(7)(E)(ii) of the Code provides that the term "excluded business" means equipment leasing and any business involving master sound recordings, films, videos, or tangible or intangible assets associated with literary, artistic, musical, or similar properties.

Section 465(c)(7)(F) of the Code provides that for purposes of section 465(c)(7) the component members of an affiliated group of corporations shall be treated as a single taxpayer.

Our analysis of the present case assumes that the Project qualifies as a certified historic structure, and the rehabilitation of the Project as a certified rehabilitation, within the meaning of the applicable rehabilitation credit provisions under section 47 of the Code. This letter expresses no opinion with regard to these matters.

The preceding discussion indicates that the amount of section 38 credit passed to a lessee by a lessor of new section 38 property under section 48(d)(1) of the Code is subject to limitation under certain circumstances. If a lease has a term that is less than 80% of the leased property's class life the lease is a short-term lease for purposes of the section 48(d)(2) limitation. With respect to the present case, the portion of the Project's basis attributable to qualified rehabilitation expenditures is new section 38 property under sections 48(a)(1)(E) and 48(g)(4). No determination has been made that the Lease is a short-term lease for purposes of section 48(d)(2), even if its term is less than 80% of the class life of the Project as determined under section 167(m). However, assuming that the Lease is a short-term lease under section 48(d)(2), if the Lease is a net lease within the meaning of former section 57(c)(1)(B), section 48(d)(2) would not apply to limit the amount of rehabilitation credit attributable to the rehabilitation of the Project available to Company, assuming Owner makes an election

under section 48(d)(1) to pass the credit to Company. Company has represented that the Lease is a net lease within the meaning of former section 57(c)(1)(B). While we make no determination regarding whether the Lease is a net lease under this provision, as more fully discussed below, for purposes of continuing our analysis of the present case we assume that the representation is accurate.

The rehabilitation credit available to Company may also be limited under section 48(d)(6)(C) of the Code if Company is an at-risk lessee of at-risk property, as those terms are defined in section 48(d)(6)(E). Because Parent is a corporation whose stock ownership meets the requirements of section 542(a), Company is an at-risk lessee. However, based upon the representations submitted with the ruling request, we conclude that Company is not a lessee of at-risk property. Company is a qualified C corporation within the meaning of section 465(c)(7)(B). Under section 465(c)(7)(F) the component members of an affiliated group of corporations filing a consolidated tax return are treated as a single taxpayer. Company is a component member of an affiliated group of corporations filing a consolidated tax return. Another member of the group operates , the operation meets the employee and expense tests of section 465(c)(7)(C), and the operation of is not an excluded business under section 465(c)(7)(E)(ii). Therefore, the affiliated group is a taxpayer that carries on a qualifying business, and losses from that business are not subject to section 465(a)(1). Accordingly, the Project is not at-risk property as defined by section 48(d)(6)(E) because it is not used in an activity that is subject to section 465(a)(1), and the amount of rehabilitation credit attributable to the rehabilitation of the Project available to Company is not limited under section 48(d)(6)(C).

CONCLUSIONS

Based solely on the facts as presented, Company's representations, and the analysis set forth above, we reach the following conclusions:

1. If the Lease is a net lease within the meaning of former section 57(c)(1)(B), former section 48(d)(2) will not apply to limit the amount of rehabilitation credit attributable to the rehabilitation of the Project available to Company.

2. The "at risk" limitations of former section 48(d)(6)(C) of the Code will not apply to limit the amount of rehabilitation credit attributable to the rehabilitation of the Project available to Company.

Company has represented that the transaction denominated "Lease" is a net lease within the meaning of former section 57(c)(1)(B). The Service does not issue advance rulings or determinations concerning whether a transaction is, in fact, a true lease because such rulings or determinations involve issues of true ownership, which

are inherently factual. Accordingly, this office has not made any determination about the characterization of the transaction here as a lease, a financing arrangement, or a sale. Consequently, this office also has not made any determination as to whether the transaction is a net lease within the meaning of former section 57(c)(1)(B), or for any other purpose. If the Service, upon audit, subsequently determines that the transaction here is not a true lease for federal income tax purposes, or is not a net lease for purpose of former section 57(c)(1)(B), then all rulings in this letter are void from the inception of the transaction.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of the transaction described above under any other provision of the Code. This ruling is directed only to the taxpayer on whose behalf it was requested. Section 6110(k)(3) provides that it may not be cited or used as precedent.

Sincerely yours,

Charles B. Ramsey

Charles B. Ramsey
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Office of the Assistant Chief Counsel
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Enclosures: 2
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