

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:5 – PLR-135566-02

Date:

October 22, 2002

LEGEND:

Taxpayer =

State =

Place =

Agency =

Date 1 =

Date 2 =

\$X =

\$Y =

Dear :

This letter responds to a letter dated June 20, 2002, submitted on behalf of Taxpayer, requesting a private letter ruling regarding §§ 42 and 263A of the Internal Revenue Code. Specifically, the issue is whether the substitute cost method under Notice 88-99, 1988-2 C.B. 422, may be used to determine eligible basis under § 42.

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Taxpayer represents the following facts:

Taxpayer is a State limited partnership. Taxpayer was formed to acquire land and to construct, own, and lease an apartment complex located at Place as a qualified low-income building eligible for the low-income housing credit under § 42.

On Date 1, Taxpayer submitted to Agency a cost certification reflecting an eligible basis of \$X, including \$Y of substitute costs under Notice 88-99. On Date 2, Agency determined to disallow the inclusion of the \$Y of substitute costs in eligible basis unless Taxpayer received a favorable private letter ruling.

Section 42(a) provides that the amount of the low-income housing credit for any taxable year in the credit period is an amount equal to the applicable percentage of the qualified basis of each qualified low-income building.

Section 42(c)(1)(A) provides that the qualified basis of any qualified low-income building for any taxable year is an amount equal to the applicable fraction (determined as of the close of the taxable year) of the eligible basis of the building.

Section 42(d)(1) provides that the eligible basis of a new building is its adjusted basis as of the close of the first taxable year of the credit period.

Section 263A(b)(1) provides that § 263A applies to real property produced by the taxpayer.

Section 263A(a)(1)(B) provides that in the case of any property to which § 263A applies, any costs described in § 263A(a)(2) shall be capitalized.

Section 263A(a)(2) provides that those costs with respect to any property are (A) the direct costs of such property, and (B) such property's proper share of those indirect costs part or all of which are allocable to such property.

Section 263A(f)(1) provides that § 263A(a) shall only apply to interest costs that are (A) paid or incurred during the production period, and (B) allocable to property that is described in § 263A(b)(1) and that has (i) a long useful life, (ii) an estimated production period exceeding two years, or (iii) an estimated production period exceeding one year and a cost exceeding \$1,000,000.

Section 263A(f)(2)(A) provides that in determining the amount of interest required to be capitalized under § 263A(a) with respect to any property (i) interest on any indebtedness directly attributable to production expenditures with respect to such property shall be assigned to such property ("traced debt"), and (ii) interest on any other indebtedness shall be assigned to such property to the extent that the taxpayer's interest costs could have been reduced if production expenditures (not attributable to

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indebtedness described in § 263A(f)(2)(A)(i)) had not been incurred (“avoided cost debt”).

Section 263A(f)(2)(C) provides that except as provided in regulations, in the case of any flow-through entity, § 263A(f)(2) shall be applied first at the entity level and then at the beneficiary level.

Section 263A(i)(1) provides that the Secretary of the Treasury shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of § 263A, including regulations to prevent the use of related parties, pass-through entities, or intermediaries to avoid the application of § 263A.

Notice 88-99 provides guidance concerning forthcoming regulations interpreting the interest capitalization requirements of § 263A(f).

Section XII(A) of Notice 88-99 provides that with respect to any flow-through entity producing qualified property, *i.e.*, property to which the interest capitalization rules apply, the entity shall first capitalize interest on its traced and avoided cost debt allocable to its production expenditures. If the production expenditures of the flow-through entity exceed its traced and avoided cost debt, the deferred asset method of capitalizing and recovering costs shall apply unless the entity elects the use of the substitute cost method as described in section IX. The term “flow-through entity” shall mean a partnership or an S corporation.

Under section IX(B)(1) of Notice 88-99, a taxpayer may elect the substitute cost method. Under the substitute cost method, the producing taxpayer shall capitalize, during each year of the production period, certain substitute costs in lieu of the taxpayer’s related parties being required to capitalize interest on their related party avoided cost debt. Substitute costs consist of a pro-rata amount of all the taxpayer’s costs that would be otherwise deductible by the taxpayer for the current taxable year, after application of all provisions of the Code. For example, substitute costs would typically include marketing and advertising expenses, as well as certain types of general and administrative expenses not otherwise subject to capitalization under the Code.

Under section IX(B)(2) of Notice 88-99, the producing taxpayer shall capitalize its substitute costs up to an amount equal to the additional interest that would have been capitalized by the taxpayer had the taxpayer’s eligible debt been equal to the average balance of its accumulated production expenditures during the production period. The amount of additional interest shall be determined by applying (i) the average Federal long-term rate (within the meaning of section 1274(d)) in effect during the production period within the taxable year, to (ii) the average balance of the taxpayer’s remaining production expenditures outstanding during such time (*i.e.*, the excess of the taxpayer’s production expenditures over the actual balances of the taxpayer’s traced and avoided cost debt).

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Under section IX(B)(4) of Notice 88-99, substitute costs capitalized by the taxpayer under the substitute cost method shall be included in the accumulated production expenditures of the property and in inventory cost or basis in the same manner as all other capitalized costs under section 263A or 460. Similarly, such costs shall be recovered in the same manner and at the same time as all other costs that are capitalized with respect to the property (e.g., as cost of goods sold, an adjustment to basis, depreciation, or amortization).

Accordingly, based solely on the representations and the relevant law set forth above, we conclude that Taxpayer may use the substitute cost method under Notice 88-99 to determine eligible basis under § 42(d).

No opinion is expressed or implied regarding the application of any other provisions of the Code or Income Tax Regulations. Specifically, we express no opinion on whether any other requirement of § 42 is met or whether Taxpayer has correctly calculated the substitute cost method under Notice 88-99.

This letter 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. Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling may be modified or revoked by the adoption of temporary or final regulations to the extent the regulations are inconsistent with any conclusion in this ruling. See section 12.04 of Rev. Proc. 2002-1, 2002-1 I.R.B. 1, 50. However, when the criteria in section 12.05 of Rev. Proc. 2002-1 are satisfied, a ruling is not revoked or modified retroactively, except in rare or unusual circumstances.

According to the power of attorney on file with the ruling request, a copy of this letter is being sent to Taxpayer's authorized representative.

Sincerely yours,

/s/ Harold E. Burghart

HAROLD E. BURGHART
Senior Advisor, Branch 5
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures:

Copy of letter

Copy for section 6110 purposes