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, ID No.

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June 24, 2014

Legend

A =

B =

X =

Y =

D1 =

D2 =

D3 =

D4 =

Y1 =

Y2 =

m =

n =

r =

s =

t =

Dear

This responds to the letter dated August 19, 2013, and subsequent correspondence submitted on behalf of A, B, and X by their authorized representative, requesting a ruling under subchapter S.

A and B currently own and have always owned all X shares. On D1, X, an S corporation, used its disregarded entity to acquire a r% limited partnership interest in Y, a limited partnership. A developer had formed Y on D2 to develop, finance, construct, own and operate a low-income rental apartment complex.

In D3, after X acquired an interest in Y, Y began construction on the apartment complex. Y completed construction of the apartment complex in D4 and began renting units. The low-income rental apartment complex received a subaward (Subaward) under § 1602 of the American Recovery and Reinvestment Tax Act of 2009 (the Act) of $m in Y1 and $n in Y2. X was allocated $s in Y1 and $t in Y2 of the Subaward received by the apartment complex.

Law and Analysis:

Section 42 provides a 10-year tax credit for investment in qualified low-income buildings. Funds raised through § 42 tax credits assist in making the acquisition, construction, and re-habilitation of low-income housing projects commercially viable. States receive annually a certain amount of § 42 credits based on their population (Credit Ceiling). Each state has a designated agency that administers the § 42 credit program. Developers request § 42 credits from the State agency for a perspective project through a competitive process. If successful, the “project” is allocated credit from the Credit Ceiling by the State agency.

In 2009, Congress enacted § 1602 of the Act, which provides that the Treasury Secretary shall make a grant to the housing credit agency of each state in an amount equal to such state’s low-income housing grant election amount (calculated based on the state’s housing credit ceiling).

The legislative history of § 1602 explains that:

> The current economic downturn has reduced the attractiveness of low-income housing tax credits to potential investors, in part, because some potential investors have reduced or no taxable income to offset with these tax credits. The Committee believes that this provision gives State allocating agencies added flexibility and will encourage the building of more low-income housing in the short term until investors can again use these tax credits. H.R. Rep. No. 111-8 Part 2, 111th Cong., 1st Sess. 98 (2009).

Under § 1602 of the Act, States exchanged with the Treasury Department a portion of their § 42 Credit Ceiling for cash, from which the State Agency then made a Subaward to developer applicants.

Notice 2010-18, 2010-1 C.B. 525, provides that, based on the legislative history of the Act, Subawards made pursuant to § 1602(c) of the Act are excluded from the gross income of recipients and are exempt from taxation. In addition, the legislative history of the Act provides that grants received under this provision (i.e., cash assistance received under § 1602 of the Act) do not reduce the tax basis of a qualified low-income building. By extension, Notice 2010-18 provides that Subawards under § 1602(c) of the Act used in a qualified low-income building are not federal grants for purposes of § 42(d)(5)(A) and do not otherwise reduce the depreciable or eligible basis of the building.

Section 702(a)(7) provides that each partner shall take into account separately his distributive share of the partnership's other items of income, gain, loss, deduction, or credit, to the extent provided by regulations.

Section 1.702-1(a)(8)(ii) provides that each partner must take into account separately the partner's distributive share of any partnership item which, if separately taken into account by any partner, would result in an income tax liability for that partner, or for any other person, different from that which would result if that partner did not take the item into account separately. Form 1065 K-1 lists tax-exempt income separately.

Section 702(b) provides that the character of any item of income included in a partner's distributive share under § 702(a)(1) through (7) shall be determined as if such item were realized directly from the source from which realized by the partnership or incurred in the same manner as incurred by the partnership.

Section 705(a)(1)(B) provides that the adjusted basis of a partner's interest in a partnership shall be increased by his distributive share for the taxable year and prior taxable years of income of the partnership exempt under title 26.

Section 1367(a)(1)(A) provides, in part, that the basis of each shareholder's stock in an S corporation shall be increased for any period with respect to that shareholder for such period by items of income described in § 1366(a)(1)(A).

Section 1366(a)(1)(A) provides, in part, that in determining the tax under chapter 1 (Normal Taxes and Surtaxes) of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends, there shall be taken into account the shareholder's pro rata share of the corporation's items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder.

The legislative history of § 1367 provides that the basis adjustment rules for S corporations generally will be analogous to those provided for partnerships under § 705. S. Rep. No. 97-640, 97th Cong. 2d Sess. 16, 18 (1982).

Section 1.1366-1(a)(2)(viii) provides that for purposes of subchapter S, tax-exempt income is income that is permanently excludible from gross income in all circumstances in which the applicable provision of the Internal Revenue Code applies. For example, income that is excludible from gross income under § 101 (certain death benefits) or § 103 (interest on state and local bonds) is tax-exempt income, while income that is excludible from gross income under § 108 (income from discharge of indebtedness) or § 109 (improvements by lessee on lessor's property) is not tax-exempt income.

Section 1368(e)(1)(A) provides that the term "accumulated adjustments account" (AAA) means an account of the S corporation which is adjusted for the S period in a manner similar to the adjustments under § 1367 (except that no adjustment shall be made for income (and related expenses) which is exempt from tax under Title 26 and the phrase "(but not below zero)" shall be disregarded in § 1367(a)(2)) and no adjustment shall be made for Federal taxes attributable to any taxable year in which the corporation was a C corporation.

Based on the legislative history of the Act, Notice 2010-18 provides that the Subawards are excluded from the gross income of recipients and are exempt from taxation, and that the Subwards do not otherwise reduce the depreciable or eligible basis of the building. Therefore, similar to §§ 101 and 103, the Subawards are permanently excludible from gross income.

Based solely on the facts and the representations submitted, we conclude that A and B may increase the basis in their stock of X pursuant to § 1367(a)(1) to the extent A and B are allocated a share of tax-exempt income from the Subaward. X would not include the tax-exempt income from the Subaward in AAA because § 1368(e)(1)(A) provides that AAA does not include income exempt from tax.

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 X was or is a small business corporation under § 1361(b), whether A or B was or is a shareholder of X, whether Y was or is a partnership under § 761, whether X was or is a partner in Y, or whether any portion of tax-exempt income attributable to the Subaward allocated by Y to X has substantial economic effect under § 704(b).

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

Pursuant to the power of attorneys on file with this office, a copy of this letter is being sent to A's, B's, and X's authorized representative.

Sincerely,

Bradford R. Poston
Senior Counsel, Branch 3
(Passthroughs & Special Industries)

Enclosures (2)
Copy of this letter
Copy for § 6110 purposes