

Private Letter Ruling 199903005, IRC Section 42

UIL No. 42.10-00

Headnote:

Reference(s): Code Sec. 42;

The Service has ruled that the transfer of a partnership's bare legal title in low-income housing credit property to the partnership's general partner won't trigger recapture of the low-income housing credit.

Full Text:

Release Date: 1/22/1999

Date: October 21, 1998

Refer Reply To: CC:DOM:P&SI:5 - PLR-111405-98

LEGEND:

Taxpayer = \*\*\*

General Partner = \*\*\*

Limited Partner = \*\*\*

Entity 1 = \*\*\*

State = \*\*\*

County = \*\*\*

County Board = \*\*\*

City = \*\*\*

Act 1 = \*\*\*

Act 2 = \*\*\*

Agency 1 = \*\*\*

Agency 2 = \*\*\*

State Code = \*\*\*

b = \*\*\*

c = \*\*\*

d = \*\*\*

e = \*\*\*

f = \*\*\*

g = \*\*\*

h = \*\*\*

m = \*\*\*

n = \*\*\*

q = \*\*\*

r = \*\*\*

s = \*\*\*  
t = \*\*\*  
u = \*\*\*  
v = \*\*\*  
x = \*\*\*  
y = \*\*\*  
bb = \*\*\*  
cc = \*\*\*  
dd = \*\*\*  
ee = \*\*\*  
ff = \*\*\*  
gg = \*\*\*  
hh = \*\*\*  
ii = \*\*\*

Dear \*\*\*

This letter responds to a letter dated b, and subsequent correspondence, submitted on behalf of Taxpayer requesting a ruling under section 42 of the Internal Revenue Code. You request a ruling regarding the application of section 42(j) to a proposed transfer of bare legal title to certain real property owned by Taxpayer to General Partner.

Taxpayer represents the following facts:

General Partner, the formal successor to Entity 1, is a State non-profit corporation organized under Act 1. As indicated in a determination letter from the Internal Revenue Service dated c, General Partner is a charitable organization exempt from federal income taxes under section 501(c)(3). According to its Articles of Incorporation, General Partner is dedicated to providing housing, both owner occupied and for rental, to persons and families that would not otherwise qualify or be able to afford housing in City, and to acquiring, building, developing, leasing, and selling housing for these purposes.

On d, General Partner acquired title to s acres of land in City from Agency 1. General Partner proposed to build a t unit apartment complex dedicated for low-income housing on u acres of the parcel (the Project). Under the provisions of Act 2, General Partner organized Taxpayer on e. General Partner then placed title to the Project in Taxpayer. The sole asset held by Taxpayer is the Project.

General Partner, the sole general partner of Taxpayer, holds a gg percent profit and loss sharing interest in Taxpayer. Under the limited partnership agreement, General Partner is charged with the responsibility of managing the property to eliminate to the maximum extent possible the necessity of providing the partners a profit on the operations. To achieve this result, the limited partnership agreement creates a rent reduction account for all cash remaining after the payment of overhead. This account is dedicated to reducing rents for the low-income units in the Project, which is the only project in State where

excess cash flow is used to maximize the number of dwelling units available to very low-income residents.

On f, Taxpayer entered into a subscription agreement with Limited Partner, a C corporation, whereby Limited Partner became the sole limited partner of Taxpayer holding a cc percent profit and loss sharing interest.

Taxpayer began operating the Project on g. Taxpayer's compliance period began the year the buildings in the Project were placed in service, which was calendar year ended x. In keeping with the charitable purpose of the Project, all available cash is used to increase the number of low-income units and especially very low-income units, and to provide funds for extreme hardship and catastrophic losses of needy residents of the Project. As a result, the number of units in the Project made available to tenants whose income was no greater than 50 percent of the area median income has increased from n to ee. This increase has been accomplished by reducing the number of units made available to tenants whose income is no greater than 60 percent of the area median income from hh to g units, and the number of market rate units from dd to v units.

Based upon General Partner's charitable status and the Project's charitable purpose, General Partner sought for the Project an exemption from ad valorem taxes pursuant to the State Code, which provides in relevant part that property belonging to any charitable corporation used exclusively for the purposes for which such corporation is organized is exempt from State ad valorem taxes. However, the requested tax exemption was denied. The matter currently is on appeal before the district court in County. During this appeal, the County Board has asserted that the Project is not entitled to the requested exemption because it does not belong to a charitable organization. On m, the judge handling the appeal advised Taxpayer that the application for tax exemption will be dismissed unless record title is transferred to General Partner (or another charitable organization). Under State law, record title is synonymous with the term "bare legal title."

Consequently, Taxpayer proposes to transfer bare legal title to the Project to General Partner by a quitclaim deed. Concurrently, Taxpayer will execute a claim of interest in the Project and record it in County. Also, General Partner and Limited Partner will enter into a memorandum of understanding whereby the parties each will acknowledge 1) that all rights and obligations associated with the ownership of the Project, including the right to receive all income from the operations and sale of the Project, and the obligation to pay all costs and expenses associated with the ownership, operation, and sale of the Project will remain with Taxpayer, and 2) that the transfer of the Project will not result in a sale or exchange (i.e., change in ownership) of the Project for federal income tax purposes. The transfer of bare legal title is not intended to alter the rights and obligations of the partners under the limited partnerships agreement, and Taxpayer will continue to operate as though title to the Project was held in the name of Taxpayer.

The proposed transaction will not result in a transfer of the benefits and burdens of ownership (for federal and state income tax purposes) and will not constitute a sale or exchange (for federal and state income tax purposes) of the Project.

The proposed transaction has been disclosed to City officials. The ad valorem tax paid by Taxpayer for h was approximately \$ff.

Based on the expectation that Taxpayer would receive the ad valorem tax exemption in bb and subsequent years, General Partner began using all cash available at the end of h to increase the number of units available to very low-income residents and for other special and catastrophic needs in early bb. Because Taxpayer has not yet received this tax exemption, the debt service coverage ratio as of y is below the ratio required by the loan agreement with Agency 2, which holds the first mortgage on the Project. As a result, Taxpayer currently is in default under the loan agreement thereby jeopardizing the financial viability of the Project. The elimination of the ad valorem tax would cure the loan default.

If Taxpayer does not receive the ad valorem tax exemption, its ability to continue the charitable purpose of the Project is also jeopardized. Taxpayer will have to dramatically reduce its rental subsidies to very low-income persons in order to generate the funds necessary to pay the ad valorem tax and to maintain the debt service coverage ratio required by the loan agreement. This reduction in rental subsidies will likely displace r very low-income families from the Project. Absent a favorable ruling, Limited Partner will not consent to the transaction. This consent is required to effect the transaction pursuant to ii of the limited partnership agreement and to allow Taxpayer to receive the ad valorem tax exemption essential to its financial existence. Accordingly, Taxpayer contends that the receipt of a favorable ruling is a required event necessary to ensure its continued financial feasibility.

Based on the foregoing, which assumes that under these facts the transfer of bare legal title to the Project from Taxpayer to General Partner is not a sale or exchange (for federal and state income tax purposes), and does not result in a shift in the benefits and burdens of ownership (for federal and state income tax purposes), Taxpayer requests a ruling that the section 42(j) recapture provisions do not apply to the proposed transfer of bare legal title to the Project by Taxpayer to General Partner.

Section 42(a) provides a tax credit for investment in low-income housing buildings placed in service after December 31, 1986. For any taxable year in a ten-year credit period, the amount of credit is equal to the applicable percentage of the qualified basis of each qualified low-income building.

In the case of any qualified low-income building placed in service by the taxpayer after 1987, section 42(b) provides, in part, that the term "applicable percentage" means the appropriate percentage prescribed by the Secretary for the month applicable under section 42(b)(2)(A)(i) or (ii). Section 42(b)(2)(B) provides that the percentages prescribed by the Secretary for any month shall be percentages that will yield over a 10-year period amounts of credit that have a present value equal to: (i) 70 percent of the qualified basis of new buildings that are not federally subsidized for the taxable year (70-percent present

value credit), and (ii) 30 percent of the qualified basis of existing buildings, and of new buildings that are federally subsidized for the taxable year (30-percent present value credit).

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 (defined in section 42(c)(1)(B)) of the eligible basis of such building. In general, under section 42(d)(1), 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 42(j) provides rules concerning the recapture of low-income housing tax credits.

Section 42(j)(1) provides that if as of the close of any taxable year in the compliance period, the qualified basis of any building with respect to the taxpayer is less than the amount of qualified basis as of the close of the preceding taxable year, the taxpayer's tax for the taxable year shall be increased by the credit recapture amount. The credit recapture amount for a recapture event occurring during any year in the credit period (as defined in section 42(f)(1)) is one-third of all credits claimed (assuming no prior recapture amount has been paid) plus interest at the overpayment rate under section 6621, beginning with the date the recaptured amount was claimed.

The legislative history to section 42 provides that generally, any change in ownership during the compliance period is a recapture event and that all dispositions of ownership interests in buildings are treated as transfers for purposes of recapture. See 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess., II-96 and II-102 (1986), 1986-3 (Vol. 4) C.B. 1, 96, 102. However, under section 42(j)(6), in the case of a disposition of a building or an interest therein, a taxpayer can avoid recapture liability for the disposition if the taxpayer posts a satisfactory bond using Form 8693, Low-Income Housing Credit Disposition Bond, and it is reasonably expected that the building will continue to be operated as a qualified low-income building for the remaining compliance period of the building.

Taxpayer represents in the above facts that the transfer of bare legal title from Taxpayer to General Partner is not a sale or exchange for federal and state income tax purposes and will not result in a shift of the benefits and burdens of ownership for federal and state income tax purposes from Taxpayer to General Partner. This representation is a material fact in this case. Therefore, the issue being considered in this case is not whether a sale or exchange or a transfer of the burdens and benefits of ownership is, for federal income tax purposes, a recapture event under section 42, but whether the transfer of bare legal title under the above facts is a disposition or change in ownership contemplated by the section 42 legislative history that results in a recapture event.

The transfer of bare legal title under the above circumstances would not be made for the

evasion or avoidance of federal income tax. Further, the federal tax treatment of the proposed transaction has been disclosed to City officials. Taxpayer represents that all indicia of ownership of the Project (other than bare legal title), and each partner's

distributive share of income, gain, loss, deduction, or credit (or items thereof) would remain unchanged. Consequently, the transfer of bare legal title in this case is not a disposition or change in ownership contemplated by the section 42 legislative history to result in a recapture event.

Accordingly, based solely on the representations and the relevant law set forth above, we rule as follows:

The transfer of bare legal title to the Project by Taxpayer to General Partner will not, under these facts, result in recapture under section 42(j).

Under the power of attorney on file, we are sending a copy of this ruling to your authorized representative.

No opinion is expressed or implied regarding the application of any other provisions of the Code or regulations. Specifically, no opinion is expressed or implied regarding whether the transfer of bare legal title to the Project from Taxpayer to General Partner is a sale or exchange (for federal or state income tax purposes), or causes a shift in the benefits and burdens of ownership (for federal or state income tax purposes). Nor is any opinion expressed or implied regarding whether the Project otherwise qualifies for the low-income housing credit under section 42.

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.

Sincerely yours,

Kathleen Reed

Assistant to the Branch Chief, Branch 5

Office of the Assistant Chief Counsel (Passthroughs and Special Industries)