Private Letter Ruling 199924064, IRC Sec(s). 42

IRC Section 42

Document Date: March 17, 1999

UIL No. 42.10-00

Headnote:

Reference(s): Code Sec. 42;

The Service has ruled that a proposed corporate restructuring of a bank holding company, which holds interests in low-income housing credit property, won't trigger recapture of the low-income housing credit.

Full Text:

Date: March 17, 1999

Refer Reply To: CC:DOM:P&SI:5 PLR-118031-98

LEGEND:
Taxpayer = ***
X District = ***
State 1 = ***
City = ***
Company 1 = ***
Bank = ***
Multiple States = ***
Company 2 = ***

a = ***
b = ***
c = ***
d = ***
e = ***
f = ***
g = ***
h = ***
i = ***
j = ***

Dear ***

This letter responds to your authorized representative's letter dated a, and subsequent correspondence, on behalf of Taxpayer requesting a ruling that a proposed corporate restructuring involving Taxpayer (more fully described in the facts below) will not result in Taxpayer having to recapture low-income housing tax credits (tax credits) under section 42(j) of the Internal Revenue Code. The Internal Revenue Service District Office that will have examination jurisdiction over all returns filed by Taxpayer, Company 1, Bank, Company 2 and the i partnerships is the X District.

The relevant facts as represented in your submission are set forth below.

FACTS

Taxpayer is a registered bank holding company which was incorporated under the laws of State 1 in b. taxpayer is headquartered in City and, as of c, had consolidated total assets of $d.

Company 1 is a wholly-owned subsidiary of Taxpayer which acts as an intermediate bank holding company. Company 1 is the owner of Bank.

Bank is engaged in the commercial banking business in over e banking locations in Multiple States. Bank provides to its business customer's checking and time deposit accounts, cash management services, various types of lending and credit services, and corporate and other trust services. Bank provides to its individual customers checking accounts, money market investment and other money market checking accounts, personal loan management accounts, passbook savings accounts, other time deposit savings

programs, loans (including business, personal, automobile, mortgage, home improvement and educational loans), brokerage services, investment services and a variety of trust services, and also offers credit card services.

Company 2 is currently a wholly-owned subsidiary of Taxpayer and is engaged in the business of providing equity capital to developers of affordable housing projects which are eligible for tax credits. In return for providing equity capital, Company 2 obtains federal income tax benefits derived from the tax credits and operating losses. Company 2 is a limited partner in i limited partnerships and owns at least a j% interest in the profits and losses (and credits) in these partnerships. (The names, addresses, and taxpayer identification numbers of the i limited partnerships are listed in Attachment A and are

incorporated by reference into this ruling).

Other direct or indirect subsidiaries of Taxpayer are in the business of a mortgage banking servicing company, a credit life company, an insurance agency, an investment services company, and various trust companies.

Taxpayer proposes to rearrange its corporate structure (corporate restructuring) in the following manner:

1. Taxpayer will transfer all the outstanding capital stock of Company 2 to Company 1.

2. Company 1 will transfer all the outstanding capital stock of Company 2 to Bank, its wholly-owned subsidiary.

3. Bank will organize a domestic limited liability company (LLC) of which Bank will be the sole member.

4. Bank will cause Company 2, its then wholly-owned subsidiary, to be merged into LLC so that the assets of Company 2 will become the assets of LLC which, as a single member domestic limited liability company, will be disregarded as a separate entity for federal income tax purposes.

As a result of the foregoing events, the assets of Company 2 will, for federal income tax purposes, be deemed to be owned directly by Bank.

The principal business purpose of the corporate restructuring is to make it possible for Bank to utilize a tax benefit derived from operating losses generated by Company 2 for state income tax purposes. The corporate restructuring will not have any substantive effect on the federal income tax filing obligations or liability of the affiliated group of corporations consisting of Taxpayer and its direct and indirect subsidiaries.

In connection with the corporate restructuring, Taxpayer specifically represents that:

1. Taxpayer is a registered bank holding company.

2. Taxpayer is the parent of an affiliated group of corporations which includes Company 1, Bank, and Company 2.

3. The foregoing affiliated group files a consolidated federal income tax return.

4. Company 1 is a wholly-owned subsidiary of Taxpayer which acts as a bank holding company.

5. Bank is a wholly-owned subsidiary of Company 1 which is engaged in the commercial banking business in the f region of the United States.

6. Company 2 is a wholly-owned subsidiary of Taxpayer which provides equity capital to developers of affordable housing projects eligible for tax credits.

7. Between g, and h, Company 2 acquired limited partnership interests in i partnerships, each of which has fewer than 35 partners.

8. Taxpayer and Bank have no intention of disposing of Bank's interests in LLC or the i partnerships during the compliance period under section 42(i)(1).

9. Bank intends to hold the interests in the partnerships for the same purposes that Company 2 is holding them.

10. Taxpayer has owned 100% of the stock of Company 2 at all times since the organization of Company 2.

11. All the assets of Company 2 will be transferred to the LLC pursuant to the proposed merger.

12. The basis of the interests in the i partnerships in the hands of Bank will be determined in whole or in part by reference to the basis of the interests in the hands of Company 2 pursuant to section 334.

13. Neither Bank nor LLC will file an election to cause LLC to be treated as an entity separate from Bank for federal income tax purposes.

14. Taxpayer, Company 1, Bank, and Company 2 are not entities described in section 593(a)(1).

RULING REQUESTED

Taxpayer requests the Service to rule that none of the low-income housing tax credits with respect to the i partnerships claimed by Company 2 and reported on the consolidated tax return of Taxpayer will be subject to recapture under section 42(j) of the Code as a result of its proposed corporate restructuring.

LAW AND ANALYSIS

Section 38(a) provides for a general business credit against tax that includes the amount of the current year business credit. Section 38(b)(5) provides that the amount of the current year business credit includes the low-income housing credit determined under section 42(a).

Section 42(a) provides that, for purposes of section 38, the amount of the low-income housing credit determined under section 42 for any taxable year in a 10-year credit period shall be an amount 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, and (ii) 30 percent of the qualified basis of existing buildings, and of new buildings that are federally subsidized for the taxable year.

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

Under section 42(j)(1), if at the close of any taxable year in the compliance period, the amount of the qualified basis of any building with respect to the taxpayer is less than the amount of such basis as of the close of the preceding taxable year, the taxpayer's tax for the taxable year will be increased by the credit recapture amount. The credit recapture amount is determined under section 42(j)(2) and section 42(j)(3).

Generally, under section 42(j)(1), any disposition by a taxpayer of a building (or an interest therein) upon which credits were claimed during the compliance period is a recapture event. Under section 42(j)(6), however, no recapture will be imposed on a disposition of a low-income building (or an interest therein) if the taxpayer furnishes to the Secretary a bond, and it is reasonably expected that the building will continue to be operated as a qualified low-income building through the end of the compliance period.

Little guidance is available to illustrate when, under section 42(j), a reduction in qualified basis of a building with respect to the taxpayer has occurred or when there has been a disposition that requires the taxpayer to post a bond to avoid recapture. However, analogous provisions concerning recapture of investment tax credit (ITC) property provide relevant guidance for determining recapture under section 42(j).

Under section 50(a)(1), if during any taxable year ITC property is disposed of or otherwise ceases to be ITC property with respect to the taxpayer before the close of the recapture period, the tax for such taxable year shall be increased. Currently, there are no regulations under section 50. However, for property placed in service before January 1, 1991, former section 47(a)(1) (and the regulations thereunder) contained a similar ITC recapture rule. The regulations under former section 47 (which are still effective) mirror the general recapture rule of former section 47 that a disposition or cessation of ITC property before the close of the estimated useful life of the property that was taken into account in computing the taxpayer's qualified investment will result in ITC recapture. However, there are a number of exceptions to the general rule concerning the recapture of ITC property. For example, section 1.47-6(a)(2) of the Income Tax Regulations provides a de miminis rule that permits a partner to dispose of up to 33-1/3 percent of its proportionate interest in the general profits of a partnership (or in a particular item of section 38 property) before ITC recapture applies. Rev. Rul. 90-60, 1990-2 C.B. 6, adopts a similar de minimis rule for purposes of section 42(j) whereby no bond is required to avoid or defer recapture for any disposition(s) by a partner of its interest in a low-income building held through certain partnerships (e.g., small partnerships with less than 35 partners as described in section 42(j)(5)) until the partner has disposed of more than 33-1/3 percent of its greatest total interest in the building held through the partnership. Also, section 1.47-3(f)(1) of the regulations (reflected now, in part, in

section 50(a)(4)) provides an exception to ITC recapture in the case of a mere change in form of conducting a trade or business.

Section 1.1502-3(f)(2)(i) of the regulations provides generally that during a consolidated return year a transfer of section 38 property (which includes ITC property) from one member of an affiliated group to another member of the group during a consolidated return year is not treated as a disposition within the meaning of former section 47(a)(1). This exception applies even if the member transfers its total interest in the section 38 property to the other member of the group.

Rev. Rul. 75-245, 1975-1 C.B. 6 involves the sale of a corporate partners partnership interest to a member of the corporate partner's affiliated group during a consolidated return year. The revenue ruling relies on section 1.1502-3(f)(2)(i) of the regulations in finding an exception to the recapture provisions of former section 47(a)(1). The revenue ruling concludes that section 1.1502-3(f)(2)(i) was intended to prevent recapture for transfers of section 38 property between members of an affiliated group, and that no recapture occurred under the circumstances.

Sections 301.7701-1 through 301.7701-3 of the regulations provide that certain organizations, including entities organized under the limited liability company act of a state, that have a single owner may elect to be recognized as separate entities or disregarded as entities separate from their owners for federal income tax purposes. If such an entity is wholly-owned by a corporation, and the entity does not elect to be treated as an entity separate from its owner, its assets and activities are treated as the assets and activities of a division of the corporate owner.

Section 708(a) provides that a partnership shall be considered as continuing if it is not terminated. Section 708(b)(1)(B) provides that, for purposes of section 708(a), a partnership shall be considered terminated if within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

In the present case, the Taxpayer represents that Taxpayer, Company 1, Bank, and Company 2 are members of an affiliated group that file a consolidated federal income tax return. Taxpayer intends to transfer all of its outstanding capital stock of Company 2 to Company 1, with a subsequent transfer by Company 1 of all the outstanding capital stock of Company 2 to Bank. Bank will organize and be the sole member of an LLC. Neither Bank nor LLC will file an election under section 301.7701-3(b)(1) of the regulations to cause LLC to be treated as an entity separate from Bank for federal income tax purposes.

Bank will then cause Company 2, its then wholly-owned subsidiary, to be merged into LLC.

Taxpayer further represents that the merger of Company 2 into LLC will result in the assets of Company 2 becoming the assets of LLC, and a complete liquidation of Company 2 into Bank under section 332. Also, because Company 2's interests in each of the i partnerships exceeds 50% of the capital and profits of each partnership, the merger of Company 2 into the LLC (which is treated as a section 332 liquidation of Company 2) and the resulting transfer to LLC of all of Company 2's limited partner interests in the i partnerships will result in a technical termination of these small partnerships under section 708(b)(1)(B).

In the instant case, LLC is not a member of the affiliated group because it is disregarded for federal income tax purposes as an entity separate from its owner, Bank. The assets of LLC, however, including its interests in the i partnerships following the merger of Company 2 into LLC, are for that same reason treated for federal income tax purposes as being owned by Bank, which is a member of the consolidated group. LLC's partnership interests in the i partnerships (which continues to hold the section 42 property) are therefore treated as having been transferred from one member of the group (Company 2)

to another member of the same group (Bank).

Based on the analogous recapture provision under former section 47(a) and the analogous application of section 1.1502- 3(f)(2)(i) of the regulations which is intended to prevent recapture of ITCs for transfers of section 38 property between members of an affiliated group, the proposed transfer of Company 2's interests in the i partnerships (and underlying section 42 property held by the partnerships) to Bank through the merger of Company 2 into LLC, will not be treated as a disposition of section 42 property resulting in recapture of section 42 credits under section 42(j).

Furthermore, under section 1.708-1(b)(1)(iv) of the regulations, the terminated partnerships are treated as contributing their assets to new partnerships in exchange for partnership interests which are then distributed to the continuing partner and the new partner (Bank) in liquidation of the terminated partnerships. Based upon the analogous application of the deemed contribution of the section 42 property to the new partnerships under section 1.708-1(b)(1)(iv) will not be treated as a disposition of section 42 property resulting in recapture of section 42 credits under section 42(j).

Accordingly, based solely on the taxpayer's representations of fact and relevant law as set forth above, we conclude that none of the tax credits with respect to the i partnerships claimed by Company 2 and reported on the consolidated tax return of Taxpayer will be subject to recapture under section 42(j) as a result of the corporate restructuring.

We express no opinion on whether Bank or any other member of the consolidated group qualifies for the low-income housing credit under section 42, or whether any other requirement of section 42 is met. Also, no opinion is expressed or implied regarding the application of section 1.708-1(b)(1)(iv) of the regulations to the technical termination of a large partnership to which section 42(j)(5) applies.

Further, this ruling does not protect Bank or, if applicable, any member of the affiliated group from liability for the amount of any tax credits claimed by Company 2 or the group (through Company 2's interest in the i partnerships) from a determination of recapture under section 42(j) that may result from a disposition or noncompliance event occurring after the corporate restructuring.

In accordance with the power of attorney, we are sending a copy of this letter ruling to the Company's authorized representatives.

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.

Sincerely yours,

Susan Reaman

Chief, Branch 5

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