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Dear :

This letter responds to a letter dated Date1, and subsequent correspondence, submitted on behalf of Taxpayer and Taxpayer 2, requesting a letter ruling under §§ 168(e)(2) and 1250 of the Internal Revenue Code regarding a mixed-use development.

FACTS

Taxpayer and Taxpayer 2 represent that the facts are as follows:

Developer was formed to develop and renovate Project, a building located at A, into a mixed-use development consisting of hotel rooms and residential rental apartments. Project was originally built in Date2 and renovated in Date3, and consists of an East section that is B stories tall, and a West section that is C stories tall. The

East and West sections were built to function as one building and are treated as such. The floor elevations are identical between the structures (except at the B<sup>th</sup> floor addition). In Date4, an atrium was carved out at the middle of the building down to floor D.

Project received funds under the Federal new markets tax credit (NMTC), under Federal and State A historic tax credits (HTC) financing structures, and from the U.S. Department of Housing and Urban Development (HUD). As a condition to receiving HUD mortgage insurance for the residential portion of the building, Project was required to enter into a HUD regulatory agreement subject to the requirements under 24 CFR part 200, subpart A.

The building was divided into two separate condominiums in order to satisfy HUD regulatory requirements that the owner of the residential rental portion of Project not engage in any business activity that is not in connection with the residential portion of Project. The two condominiums are comprised of Hotel Condominium Unit and Apartment Condominium Unit (collectively, the Units). The Units are located on a single tract of land and will be placed in service within the same 12-month period.

The Hotel Condominium Unit is owned by Taxpayer. Taxpayer is a State A limited liability company that is treated as a partnership for Federal income tax purposes. Taxpayer is owned E% by CDE 2, G% by Investors, and F% by Investors2, K% by Developer, and L% by CDE 1. In turn, CDE 1 is owned H% by Bank Fund and I% by CDE 1 Affiliate. Bank Fund is owned J% by Bank. CDE 2 is owned H% by HTC Fund and I% by CDE 2 Affiliate. HTC Fund is owned J% by Company. Investors2 is owned H% by HTC Fund and I% by Developer.

The Apartment Condominium Unit is owned by Taxpayer 2. Taxpayer 2 is a State A limited liability company that is treated as a partnership for Federal income tax purposes. Taxpayer 2 is owned K% by Developer, M% by CDE 1, N% by CDE 3, and O% by Investors. CDE 3 is owned H% by HTC Fund and I% by CDE 2 Affiliate. Taxpayer and Taxpayer 2 represent that they are owned 100% by the same entities such that Taxpayer and Taxpayer 2 are controlled partnerships under § 707(b)(1)(B).

The terms of the HUD financing preclude the Hotel Condominium Unit lenders from holding a security interest in the Apartment Condominium Unit. HUD has a first mortgage lien against the Apartment Condominium Unit, which includes the residential component, retail component, and parking component. There is no cross-collateralization between the Units. However, each source of financing has been conditioned on the commitment of the other financing sources to Project as a whole with one set of financial projections. Moreover, the Flow of Funds Memorandum dated Date7, prepared for the closing of the NMTC, HTC, and HUD financing of Project, reinforces the interdependency of each source of financing with regard to the entire Project. For instance, HUD loan proceeds must be released and applied to the

acquisition of the Apartment Condominium Unit before any further funds will be released by the Hotel Condominium Unit lenders. Furthermore, the investment in Project by the members of the Units is underwritten on a combined basis, and to the extent the required return from the investment in Project is not achieved by the investment in Taxpayer 2, then the members expect and require that the return from the investment in Taxpayer offset the expected underperformance of Taxpayer 2.

On Date5, Taxpayer 2 entered into the HUD regulatory agreement which provided that the owner may not engage, except for natural persons, in any other business or activity, including the operation of any other rental project, or incur any liability or obligation not in connection with the project, without the prior written approval of the Secretary of HUD.

Apartment Condominium Unit consists of the residential component, retail component, and the parking component. The residential component consists of P apartment units and occupies all floors from floor Q and above. The retail component consists of approximately R square feet of commercial space and is located on the ground floor. The parking component consists of approximately S parking spaces, with spaces interspersed for residential tenants on the ground floor, the interior portion of floors T and U, and the garage. The garage is internal to the building with one entrance and exit for use by both residential tenants and hotel guests. There are approximately V parking spaces on the ground floor with a few spaces dedicated to the hotel manager and several other hotel personnel. The rest of the parking spaces are available for guests of the residential tenants or hotel guests on a non-reserved basis. Parking on interior floors T and U are reserved exclusively for residential tenants on a reserved parking space basis.

Hotel Condominium Unit occupies the perimeter of floors T and U, all of floors W and D, plus a portion of the lobby on the ground floor. Taxpayer entered into a long-term lease agreement with Taxpayer 2 to lease X parking spaces for the use of the hotel guests. The parking spaces are located in the garage and comprise about Y of the spaces available in the garage. The hotel parking spaces are in the center of the garage and are valet only.

The Apartment Condominium Unit and the Hotel Condominium Unit will have separate fitness centers for the apartment residents and hotel guests, respectively. However, apartment residents could use the Hotel Condominium Unit's fitness center and hotel guests could use the Apartment Condominium Unit's fitness center by accessing them through their respective lobbies.

In the Amended and Restated Master Declaration of Condominium and By-Laws, dated Date6, the Units share numerous common elements including, but not limited to, exterior envelope including masonry exterior and roofing, mechanical plant and distribution, plumbing distribution, fire protection system, and shared freight elevator

and path of egress. The electrical service to the building is fed from the same utility-owned vault to a common electrical room in the basement of the building. There are separate meters for each Unit's consumption, but each component is fed from the same house meter. In addition, all sidewalks, walkways, driveways, elevators and stairwells are available for use by both the residential tenants and hotel guests.

Moreover, Project will be operated as one single, integrated building and marketed as a single mixed-use development. Both Units have been designed by the same architect and engineering team and the construction is being completed by the same general contractor and subcontractors. The building is designed as an integrated mixed-use development with common points of circulation and common paths of ingress and egress encouraging shared usage of amenities and parking.

Z elevators are for the exclusive use of the Hotel Condominium Unit and provide access to the hotel rooms on floors I through D. Z separate elevators are for the exclusive use of the Apartment Condominium Unit and grant access to the residential floors and parking areas. AA of the Apartment Condominium Unit elevators grant access to the parking areas on floors I and U. One freight elevator provides access to all floors in the Hotel Condominium Unit and Apartment Condominium Unit.

All of each Unit is accessible to the other Unit, without exiting the building, via the respective lobbies. Hotel guests and apartment residents access the other Unit through secure points at the lobby level which then provide access to the floors in the other Unit. For instance, apartment residents can access the hotel through a key-card controlled glass door that connects the hotel and apartment lobbies. The connecting egress stairwells can access either Unit and there are secured doors on floor I and U that provide emergency access from the Hotel Condominium Unit components at the perimeter of these floors to the Apartment Condominium Unit parking component on these floors. These egress stairs are intended for emergency or maintenance use only.

For security purposes, only the apartment residents have direct access to the residential floors without going through the lobby. Thus, direct access to the garage is limited to the apartment residents and valet parking attendants.

A restaurant, part of the Apartment Condominium Unit, adjoins the hotel lobby and entry to the restaurant is through a glass door that remains open to ensure movement between the Units. An apartment resident can access the restaurant space by walking across the hotel lobby without having to leave the building.

Moreover, apartment residents may purchase maid services and room services from the hotel, and rent hotel rooms at favorable pricing. The residential tenants may also use the hotel valet service to park their car. The garden atrium, owned by the Apartment Condominium Unit, may be leased at little or no cost by the Hotel

Condominium Unit. These shared services produce additional synergies between the Units.

Project will have separate managers for the hotel, residential rental, and retail components but each manager will report to a project manager, an agent of Developer. The manager of each component is responsible for the leasing of space in their respective component and entering into service contracts that are specific to their component. For instance, the retail manager will enter into storefront maintenance and cleaning contracts.

However, the project manager is responsible for managing Project as a single building. For instance, the project manager will work with the manager of each component to arrive at leasing targets and operating budgets. The project manager is also responsible for entering into certain contracts for the building as a whole, such as for security, fire alarms, building maintenance, and elevator maintenance. Moreover, the project manager is also responsible for larger financial issues of the property, such as: conversion and closing of the construction loan to permanent loan for the Apartment Condominium Unit; refinancing the Hotel Condominium Unit debt; and consolidating component level reports prepared by the individual managers into a property level projection that includes cash and tax projections.

Also, the project manager is responsible for budgeting the entire Project, for making loan payments and distributions for both Units, and for managing the security concerns that arise from the interconnected nature of the uses of both Units. Moreover, the project manager works with the individual component managers to maximize the synergy of the uses of both Units. For instance, the project manager decides whether and how much of a discount Taxpayer should offer Taxpayer 2 for maid service, room service, or valet service to the residential tenants and whether and how much a discount Taxpayer 2 should offer Taxpayer for access to the atrium in the Apartment Condominium Unit.

Due to HUD regulatory requirements, Apartment Condominium Unit costs must be separate from other aspects of Project. For instance, Apartment Condominium Unit has a separate construction budget and construction contract. Therefore, the Hotel Condominium Unit and the Apartment Condominium Unit will maintain separate entities, separate sets of books and records, separate income statements, balance sheets, and tax returns. However, interim accounting reports and operating projections for the Units are reviewed internally by Developer as one Project on a monthly basis. In addition, the financial statements are prepared for Project as a whole.

Financial statements that combine information from both Units are vital to analyze the overall return on investment for the owners of both Units. In order to achieve the required return on investment, the partnership agreements permit cross-collateralization of distributable cash flow of the Units. For instance, if there is a

shortfall in actual distributable cash flow from Taxpayer 2 to an investor, the investor can look to Taxpayer to receive their allocable distributable cash flow.

#### RULINGS REQUESTED

Taxpayer and Taxpayer 2 request the Internal Revenue Service issue the following rulings:

(1) Apartment Condominium Unit and Hotel Condominium Unit may be treated as a single building for purposes of determining whether Project (and its structural components) is residential rental property or nonresidential real property under § 168(e)(2).

(2) Apartment Condominium Unit and Hotel Condominium Unit may be treated as a single item of section 1250 property for purposes of § 1250.

#### LAW AND ANALYSIS

Section 168(e)(2) defines the terms “residential rental property” and “nonresidential real property” for purposes of determining depreciation under § 168. Section 168(e)(2)(A)(i) provides that the term “residential rental property” means any building or structure if 80 percent or more of the gross rental income from such building or structure for the taxable year is rental income from dwelling units. For this purpose, § 168(e)(2)(A)(ii) provides that the term “dwelling unit” means a house or apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, or other establishment more than one-half of the units in which are used on a transient basis.

Section 168(e)(2)(B) provides that the term “nonresidential real property” means section 1250 property which is not (i) residential rental property, or (ii) property with a class life of less than 27.5 years.

Section 168(i)(12) provides that the term “section 1250 property” has the meaning given such term by § 1250(c). Section 1250(c) provides that the term “section 1250 property” means any real property (other than section 1245 property, as defined in § 1245(a)(3)) that is or has been property of a character subject to the allowance for depreciation provided in § 167. See also § 1250-1(e) of the Income Tax Regulations.

Section 1.1250-1(a)(2)(ii) provides that, for purposes of applying depreciation recapture rules of § 1250, the facts and circumstances of each disposition is considered in determining what is the appropriate item of section 1250 property. In general, a building is an item of section 1250 property, but in an appropriate case more than one building may be treated as a single item. For example, if two or more buildings or structures on a single tract or parcel (or contiguous tracts or parcels) of land are operated as an integrated unit (as evidenced by their actual operation, management,

financing, and accounting), they may be treated as a single item of section 1250 property.

Section 168(e)(2)(A) was amended by § 11812(b)(2)(A) of the Revenue Reconciliation Act of 1990, Pub. L. 101-508, 1991-2 C.B. 484, 543 (the “1990 Act”). Prior to this amendment, § 168(e)(2)(A) provided that the term “residential rental property” has the meaning given such term by § 167(j)(2)(B).

Prior to the enactment of the 1990 Act, § 167(j)(2)(B) provided in pertinent part that a building or structure shall be considered to be residential rental property for any taxable year only if 80 percent or more of the gross rental income from such building or structure for such year is rental income from dwelling units (within the meaning of former § 167(k)(3)(C)).

Former § 1.167(j)-3(b)(1)(ii) provided that in any case where two or more buildings or structures on a single tract or parcel (or contiguous tracts or parcels) of land are operated as an integrated unit (as evidenced by their actual operation, management, financing, and accounting), they may be treated as a single building for purposes of determining whether the building or structure is residential rental property.

Thus, for purposes of determining if Apartment Condominium Unit and Hotel Condominium Unit are residential rental property or nonresidential real property under § 168(e)(2), these buildings may be treated as a single building when they are on a single tract of land or parcel (or contiguous tracts or parcels) and they are operated as a single integrated unit. For making the latter determination, the relevant factors are the actual operation, management, financing, and accounting for the buildings. See § 1.1250-1(a)(2)(ii); see also former § 1.167(j)-3(b)(1)(ii).

In this case, Taxpayer and Taxpayer 2 represent that the Units are located on the same single tract of land, located at A. Further, the Apartment Condominium Unit and Hotel Condominium Unit are contained in one physical building.

Because of the HUD financing, Taxpayer and Taxpayer 2 represent that the HUD regulatory requirements are the reason that the ownership of the Apartment Condominium Unit and Hotel Condominium Unit is separated into two partnerships, Taxpayer and Taxpayer 2. Taxpayer and Taxpayer 2 also represent that they are owned 100% by the same entities and are controlled partnerships under § 707(b)(1)(B). These facts support treating Taxpayer and Taxpayer 2 as being allowed to qualify the Units as a single building under § 168(e)(2) provided that the Apartment Condominium Unit and the Hotel Condominium Unit are operated as a single integrated unit. This determination is made by evaluating the actual operation, management, financing and accounting for Project. We recognize, however, that integration of certain business activities of the Units is constrained by the limitations imposed by the HUD regulatory requirements.

With regard to the operation of Project, Taxpayer and Taxpayer 2 represent that the entire Project will be placed in service within the same 12-month period. The same engineering and architectural teams are involved in the renovation of both Units and both Units are being completed by the same general contractor and subcontractors. Project will operate as a single integrated building with common points of circulation and common paths of ingress and egress encouraging shared usage of amenities and parking. All of each Unit is accessible to the other, without exiting the building, via the respective lobbies. However, for security reasons, separate elevators will be used for each Unit, and only the apartment residents have direct access to the residential floors without going through the lobby.

Moreover, one freight elevator provides access to all floors in the Hotel Condominium Unit and Apartment Condominium Unit. Hotel guests and apartment residents access the other Unit through secure points at the lobby level which then provide access to the floors and fitness center in the other Unit, as well as to the retail and restaurant space on the ground level.

Moreover, apartment residents may purchase maid services and room services from the hotel, and rent hotel rooms at favorable pricing. The apartment residents may also use the hotel valet service to park their car. The garden atrium, owned by the Apartment Condominium Unit, may be leased at little or no cost by the Hotel Condominium Unit.

With regard to management of Project, Taxpayer and Taxpayer 2 represent that a single project manager is responsible for entering into certain contracts on behalf of the whole building. For instance, the project manager contracts for fire alarm monitoring, sprinkler testing and maintenance, heating and cooling maintenance, building security, elevator repair and maintenance, and bidding for casualty insurance, snow removal, and landscaping contracts. The individual components are responsible for entering into contracts that are specific to their respective component. Moreover, the project manager coordinates with the manager of each component to arrive at leasing targets and the operating budget for Project, and makes loan payments and distributions for both Units. Further, the project manager works with the individual component managers to maximize the synergy of the uses of both Units. For instance, the project manager decides whether and how much of a discount Taxpayer should offer Taxpayer 2 for maid service, room service, or valet service to the residential tenants and whether and how much a discount Taxpayer 2 should offer Taxpayer for access to the atrium in the Apartment Condominium Unit.

With regard to financing of Project, Taxpayer and Taxpayer 2 represent that separate funding was used for the Apartment Condominium Unit and the Hotel Condominium Unit. Project is not cross-collateralized because the terms of the HUD financing preclude the Hotel Condominium Unit lenders from holding a security interest

in the Apartment Condominium Unit. However, funding for Project was otherwise interrelated and interdependent. Each source of financing for Project is conditioned on the commitment of the other financing sources to Project as a whole with one set of financial projections. Also, the Flow of Funds Memorandum dated Date7, shows the interdependency of each source of financing for the entire Project. For example, HUD loan proceeds must be released and applied to the acquisition of the Apartment Condominium Unit before any further funds will be released by the Hotel Condominium Unit lenders.

Further, the Units are owned directly or indirectly by the same investors, and these investors contributed substantial equity to Taxpayer and Taxpayer 2 to finance the construction of Project. The investors view Project as a single enterprise. As such, the investment in Project is underwritten on a combined basis, and to the extent an investor's required rate of return is not achieved by the investment in Taxpayer 2, then the investors expect and have required that the return from the investment in Taxpayer offset the expected underperformance of Taxpayer 2.

Finally, with regard to the accounting for Project, Taxpayer and Taxpayer 2 represent that due to HUD regulatory requirements, Apartment Condominium Unit must maintain separate cost reports. Therefore, Hotel Condominium Unit and Apartment Condominium Unit will maintain separate sets of books and records, separate income statements, balance sheets, and tax returns. However, Developer will review, on a monthly basis, interim accounting reports and operating projections that consist of combined financial information from both Units. In addition, the financial statements are prepared for Project as a whole. The combined financial statements are used by Developer and the partners to manage operations and analyze overall return on investment for the partners in both Units.

Taxpayer's and Taxpayer 2's facts and representations about the operation, management, financing, and accounting of Project show that the two condominiums (Hotel Condominium Unit and the Apartment Condominium Unit) composing Project are to be operated as a single integrated unit.

## CONCLUSIONS

Based solely on the facts and representations submitted and the relevant law and analysis as set forth above, we conclude that the:

(1) Apartment Condominium Unit and Hotel Condominium Unit may be treated as a single building for purposes of determining whether the building (and its structural components) is residential rental property or nonresidential real property under § 168(e)(2).

(2) Apartment Condominium Unit and Hotel Condominium Unit may be treated as a single item of section 1250 property for purposes of § 1250.

Except as specifically set forth above, we express no opinion concerning the tax consequences of the facts described above under any other provision of the Code. Specifically, no opinion is expressed or implied on (i) whether the Units composing Project are nonresidential real property or residential rental property for any taxable year under § 168(e)(2), (ii) what components of such buildings are section 1245 property (as defined in § 1245(a)(3)), (iii) whether the Units composing Project qualify for the rehabilitation credit under § 47 (including whether such buildings may be treated as a single building under § 47), and (iv) whether the Units qualify for the new markets tax credit under § 45D.

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

In accordance with the power of attorney, we are sending a copy of this letter to Taxpayer's and Taxpayer 2's authorized representative. We are also sending a copy of this letter to the appropriate Industry Director, LB&I.

Sincerely,

Kathleen Reed

KATHLEEN REED  
Chief, Branch 7  
Office of Associate Chief Counsel  
(Income Tax and Accounting)

Enclosures (2):  
copy of this letter  
copy for section 6110 purposes