Private Letter Ruling 8930408, IRC Section 42

May 30, 1989

This is in response to the letters dated November 7, 1988, January 30, 1989, and March 24, 1989, submitted on behalf of Taxpayer. In the first letter, private letter rulings were requested under sections 42(e)(4)(A) and 48(g)(2)(C) of the Internal Revenue Code. Specifically, you have requested that we rule as follows:

1) For purposes of utilizing the tax credit for certified rehabilitation expenditures pursuant to section 48(g)(2)(C) of the Code, property may be considered to be placed in service when the actual rehabilitation work deemed necessary by the Secretary of Interior (or his designee) in order to qualify as a "certified rehabilitation" has been completed by the taxpayer; and

2) For purposes of the low-income housing tax credit pursuant to Section 42(e)(4)(A) of the Code, rehabilitation expenditures that are treated as a separate new building are deemed to be placed in service at the close of any 24-month period, over which such expenditures are aggregated, which placement in service date may be different than that determined for purposes of Section 48(g).

An adverse conference was held with the Taxpayer's representative on March 9, 1989. The letter dated March 24, 1989, supplemented and modified the original ruling request. In light of the Service's decision not to rule favorably on the original request, the Taxpayer has amended ruling request number one so that for purposes of section 48(g), the qualified rehabilitation expenditures would be treated as placed in service by x in pp. Taxpayer represents that that is the date on which it affirmed to Corp A that the rehabilitation had been substantially completed. Such a ruling would permit Taxpayer to claim the credit under section 48(g) in taxable year pp.

Taxpayer has made the following representations of fact. Taxpayer is a State Q limited partnership with a General Partner as designated in the legend above. X, a resident of State Q, is President of the General Partner. Taxpayer has been organized in order to purchase, rehabilitate and operate a certain a-unit project ("Project") consisting of k residential rental properties. X is the sole and original limited partner at present, holding d percent of the profits and capital interests of the Taxpayer partnership. The General Partner holds the remaining interests.

On b, Taxpayer purchased the Project, and in c it began making rehabilitation expenditures. The rehabilitation was quite comprehensive in nature and included repair, upgrading or replacement of roofs, windows, doors, brickwork, plumbing and heating systems, kitchens, interior drywall, courtyards and landscaping as well as asbestos removal. Upon acquisition and at all times thereafter the Project remained virtually 100 percent occupied.

Taxpayer's adjusted basis in the Project as of b was $ e. Its adjusted basis in the Project on f (the commencement of the 24-month period elected by Taxpayer for aggregating rehabilitation expenditures) was $ g. Taxpayer provided a month-by-month breakdown of the rehabilitation expenditures made with respect to the Project for the period h through and including j. The rehabilitation work has been performed simultaneously on all k buildings at the Project.

On m a construction loan closing occurred at which time Taxpayer received a construction loan in the amount of $ n from Corp Y (the "Construction Lender"). The Construction Lender received commitments from Corp A and Agency B to provide permanent financing after construction completion.

On p, Taxpayer submitted Parts I and II of an Historic Preservation Certification Application covering the Project to Agency C. On q, Agency C notified Taxpayer that the project had been approved for listing on the State and National Registers of Historic Places (the date of such listing was r).

Taxpayer filed Form 1065, Partnership Return of Income, for taxable year u, in which it claimed depreciation deductions using the straight-line method over a 19-year recovery period relating to the rehabilitation expenditures on the Project incurred during that year. On s, Taxpayer filed an amended Form 1065 correcting the date the expenditures were placed in service so as not to claim depreciation deductions with respect to those expenditures for that year. Taxpayer's rr partnership return claimed no depreciation deductions with respect to rehabilitation expenditures. The General Partner and X each filed corresponding Forms 1120X and 1040X for u. Taxpayer intends to begin the depreciation period for rehabilitation expenditures in the pp taxable year, as stated in the original ruling request.

While rehabilitation work was progressing, on t, the United States Department of Interior, National Park Service, D Regional Office, (the "Regional Office") notified Taxpayer that the rehabilitation "does not conform with the Secretary of Interior's 'Standards for Rehabilitation.'" The Regional Office's denial of the Project was based on two aspects of the rehabilitation work as specified in the ruling request. On v Taxpayer filed an appeal with the Chief Appeals Officer of the Preservation Assistance Division of the National Park Service in Washington D.C.

On w, a construction inspector (the "Construction Inspector") certified to the Construction Lender, Corp A and Agency B that the work had been "substantially completed" except for "punch list" items and work that could not be performed due to lack of cooperation by tenants. On x, Taxpayer certified to Agency B that the work was "substantially completed" as part of Agency B's rent restructuring. On y the architect inspecting the Project (the "Inspecting Architect") declared that the work had been "completed satisfactorily." The Department of Buildings' *** wrote to the Inspecting Architect on aa that the work had been "noted to have been completed . . ." Because the Project continued to be occupied, no new certificates of occupancy were issued.

Subsequent to the Construction Inspector's Certificate of Completion, substantial rehabilitation work continued on the Project. In addition to the "punch list" items listed in Schedule 1 of that Certificate, a total of $ bb in rehabilitation expenditures were incurred by Taxpayer during the period from cc to and including j. Acting pursuant to its authority under State Q law to establish rents following the completion of rehabilitation, Agency B set rents at the Project effective dd.

On ee a hearing on the denial of the Historic Preservation Certification Application -- Part 2 was held before the Chief Appeals Officer, Cultural Resources, National Park Service, U.S. Department of Interior (the "Chief Appeals Officer"). On ff the Chief Appeals Officer issued his ruling, in which he affirmed the initial denial dated t. However, he stated that: as appropriate under certain circumstances, in accordance with 36 C.F.R. 67.6(c), I have further determined that the project can be brought into conformance with the {Secretary of the Interior's} Standards, and gain certification, upon satisfactory completion of the corrective revisions described below.

Taxpayer requested that the Chief Appeals Officer rule on whether such modifications would qualify the Project for historic preservation certification, notwithstanding the fact that there had been no prior review of these matters and the fact that his decision would be a final administrative decision on the question. The Chief Appeals Officer encouraged Taxpayer to submit a proper amendment through Agency C to the Regional Office for the required changes. On gg Taxpayer notified Agency C that it intended to follow the Chief Appeals Officer's recommendation and would submit an appropriate amendment. On hh Taxpayer's consultant submitted shop drawings for proposed design changes pursuant to the suggestion of the Chief Appeals Officer. The changes have not yet been completed.

On jj Taxpayer made application to the State Q Division of Housing and Community Renewal ("DHCR"), a state housing credit agency within the meaning of section 42(h) of the Code, for low-income housing credits with respect to the rehabilitation of the k buildings comprising the Project. The rehabilitation is intended to qualify pursuant to section 42(e) as separate new buildings. On ff DHCR informed Taxpayer that it had allocated an aggregate of $ mm in low-income housing credits to the k buildings comprising the Project, effective that date.

Section 42(a) of the Internal Revenue Code provides for a low- income housing credit if certain conditions are met. Eligible buildings that otherwise qualify under section 42 qualify for a 70 percent present value credit under section 42(b) if they are "new buildings" within the meaning of section 42(b)(1)(A). Section 42(e)(1) provides that for purposes of the section 42 low-income housing credit, rehabilitation expenditures paid or incurred by the taxpayer with respect to any building shall be treated as a separate new building. Section 42(e)(3)(A), however, provides that section 42(e)(1) only applies to rehabilitation expenditures with respect to any building if the qualified basis attributable to such rehabilitation expenditures incurred during any 24-month period, when divided by the low-income units in the building, is $ 2,000 or more.

Section 42(e)(4)(A) of the Code provides that for purposes of applying this section with respect to expenditures that are treated as a separate building by reason of this subsection, such rehabilitation expenditures shall be treated as placed in service at the close of the 24-month period referred to in section 42(e)(3)(A). Accordingly, only those rehabilitation expenses incurred within a 24- month period prior to placing a project in service are eligible for the section 42 low-income housing credit.

Regarding the 24-month period prior to which rehabilitation expenses are placed in service, Notice 88-116, 1988-44 I.R.B. 22, provides that the placed in service date under section 42(e)(4)(A) is the close of any 24-month period over which such expenditures are aggregated. The placed in service date determination of section 42(e)(4)(A) applies even if tenants occupied the building during the rehabilitation period. The determination of the placed in service date for rehabilitation expenses sharply contrasts with the placed in service date for new or existing buildings defined in the same notice. The placed in service date for new or existing buildings is the date on which the building is ready and available for its specifically assigned function.

Thus, unlike the determination of a placed in service date for new or existing buildings, the placed in service date for rehabilitation expenditures treated as a new building is based on the 24-month period a taxpayer chooses to aggregate its rehabilitation expenditures incurred on behalf of the low-income housing project. Furthermore, the fact that an inspector determines that rehabilitation work was substantially completed prior to the end of a taxpayer's chosen 24-month period to aggregate rehabilitation expenses does not affect the taxpayer's right to choose the last day of that 24-month period as the date on which the rehabilitation expenditures were placed in service.

In this case, Taxpayer has chosen the 24-month period from f to nn to aggregate its rehabilitation expenses incurred in connection with the Project. Therefore, Taxpayer requests a ruling that the placed in service date for the Project's rehabilitation expenditures is nn. Regardless of when the Project may be considered to be placed in service for purposes of section 48(g)(2)(c) of the Code, for purposes of section 42(e)(4)(A), we conclude that the Project was placed in service on the last day of the 24-month period chosen by Taxpayer to aggregate its rehabilitation expenses.

Section 48(g)(1)(A) of the Code provides that the term "qualified rehabilitated building" means any building (and its structural components) if --

(i) such building has been substantially rehabilitated,

(ii) such building was placed in service before the beginning of the rehabilitation, and

(iii) in the case of any building other than a certified historic structure, in the rehabilitation process --

(I) 50 percent or more of the existing external walls of such building are retained in place as external walls,

(II) 75 percent or more of the existing external walls of such building are retained in place as internal or external walls, and

(III) 75 percent or more of the existing internal structural framework of such building is retained in place.

Under paragraph (B) of that section, the building must be first placed in service before 1936. In the case of a building other than a certified historic structure, a building shall not be a qualified rehabilitated building unless the building was first placed in service before 1936.

Paragraph (C) of that section defines "substantially rehabilitated." In general, for purposes of subparagraph (A)(i), a building shall be treated as having been substantially rehabilitated only if the qualified rehabilitation expenditures during the 24-month period selected by the taxpayer (at the time and in the manner prescribed by regulations) and ending with or within the taxable year exceed the greater of --

(I) the adjusted basis of such building (and its structural components), or

(II) $ 5,000. The adjusted basis of the building (and it structural components) shall be determined as of the beginning of the first day of such 24-month period, or of the holding period of the building, whichever is later. For purposes of the preceding sentence, the determination of the beginning of the holding period shall be made without regard to any reconstruction by the taxpayer in connection with the rehabilitation.

Section 48(g)(2)(A) defines "qualified rehabilitation expenditures" to include any amount properly chargeable to capital account for property for which depreciation is allowable under section 168 and which is residential rental property (within the meaning of section 168) in connection with the rehabilitation of a qualified rehabilitated building. Certain expenditures are not included such as the cost of acquisition, enlargements, or any expenditure attributable to the rehabilitation of a certified historic structure or a building in a registered historic district, UNLESS the rehabilitation is a CERTIFIED REHABILITATION (within the meaning of section 48(g)(2)(C)). Section 48(g)(2)(C) defines "certified rehabilitation" as any rehabilitation of a certified historic structure that the Secretary of the Interior has certified to the Secretary of the Treasury as being consistent with the historic character of such property or the district in which such property is located.

Section 48(g)(3)(A) defines "certified historic structure" as including any building (and its structural components) that is listed in the National Register, or is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.

Section 1.48-12(f)(2)(i) of the Income Tax Regulations discusses when the rehabilitation credit may be claimed. It provides that the credit is generally allowed in the taxable year

in which the property attributable to the expenditure is placed in service, provided the building is a qualified rehabilitated building for the taxable year. (The regulations refer to section 1.48-12(b), section 46(c), and section 1.46-3(d)). For purposes of section 46(c), property attributable to qualified rehabilitation expenditures will not be treated as placed in service until the building with respect to which the expenditures are made meets the definition of a qualified rehabilitated building under section 48(g)(1) of the Code. In the first taxable year for which the building becomes a qualified rehabilitated building, the property described in section 48(a)(1)(E) attributable to expenditures described in paragraph (c) will be considered to be placed in service, if such property was considered placed in service under section 46(c) and the accompanying regulations (without regard to paragraph (f)(2)(i)) in that taxable year or a prior taxable year. For purposes of the preceding sentence, the requirement in section 48(g)(1)(A)(iii) and section 1.48-12(b)(3) relating to the definition of a qualified rehabilitated building shall be deemed to be met if the taxpayer reasonably expects that no rehabilitation work undertaken during the remainder of the rehabilitation process will result in a failure to satisfy the requirements of paragraph (b)(3). If the requirements of paragraph (b)(3) are not satisfied, the credit will be disallowed for the taxable year in which it was claimed. If a taxpayer fails to complete physical work on the rehabilitation prior to the date that is 30 months after the date that the taxpayer filed a tax return on which the credit is claimed, the taxpayer must submit a written statement to the District Director stating such fact prior to the last day of the 30th month, and shall be requested to consent to an agreement under section 6501(c)(4) extending the period of assessment for any tax relating to the item for which the credit was claimed.

Section 1.46-3(d)(1) of the regulations provides that for purposes of the credit allowed by section 38, property will be considered placed in service in the earlier of the following taxable years:

(i) The taxable year in which, under the taxpayer's depreciation practice, the period for depreciation with respect to such property begins; or

(ii) The taxable year in which the property is placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business, in the production of income, in a tax-exempt activity, or in a personal activity. Thus, if property meets the condition of sub-division (ii) in a taxable year, it will be considered placed in service in such year notwithstanding that the period for depreciation with respect to such property begins in a succeeding taxable year because, for example, under the taxpayer's depreciation practice such property is accounted for in a multiple asset account and depreciation is computed under an "averaging convention," or depreciation with respect to such property is computed under the completed contract method, the unit of production method, or the retirement method.

Under section 1.48-12(c)(6) of the regulations, once the substantial rehabilitation test is met for a taxable year, the amount of qualified rehabilitation expenditures upon which a credit can be claimed for the taxable year is limited to the expenditures incurred:

(i) Before the beginning of a measuring period during which the building was substantially rehabilitated that ends with or within the taxable year, provided that the expenditures were incurred in connection with the rehabilitation process that resulted in the substantial rehabilitation of the building;

(ii) Within a measuring period during which the building was substantially rehabilitated that ends with or within the taxable year, and

(iii) After the end of a measuring period during which the building was substantially rehabilitated but prior to the end of the taxable year with or within which the measuring period ends.

Taxpayer originally requested a ruling under section 48(g) of the Code that the qualified rehabilitation expenditures should be treated as placed in service at the time that the physical work was completed that will lead to the appropriate certification by the Secretary of Interior. In light of the Service's decision not to rule favorably on that original request, Taxpayer requested a ruling that the qualified rehabilitation expenditures will be treated as placed in service by x, the date on which Taxpayer affirmed to Agency B that the rehabilitation had been substantially completed, with the result that Taxpayer would claim the section 48(g) credit in the pp taxable year. The affirmation on pp addressed the completion of the rehabilitation measures rather than the placement in service of the underlying building itself, that had been addressed the month before in the Construction Inspector's Certificate of Completion. According to Taxpayer, the Construction Inspector provided along with his report two schedules of "punch list items" and "unperformed work," eleven pages of rehabilitation measures that had not been completed. As shown in Taxpayer's Exhibit "A", after the date of the Construction Inspector's report, and between cc and j, Taxpayer incurred $ bb in expenditures in order to continue the rehabilitation work. Although the work continued through pp and is still being done, by x Taxpayer believed that the rehabilitation had been substantially completed so that it could make its affirmation to Agency B at that time. Based solely on Taxpayer's representations of fact and the sections of the Code and regulations set forth above, we conclude that for purposes of section 48(g) of the Code, the qualified rehabilitation expenditures in question may be treated as placed in service on x.

In summary, we rule as follows:

(1) For purposes of section 42(e)(4)(A) of the Code, the Project was placed in service on the last day of the 24-month period chosen by Taxpayer to aggregate its rehabilitation expenses, that being from f to nn.

(2) Based on the action taken by Taxpayer on x, the date on which Taxpayer affirmed to Agency B that the rehabilitation had been substantially completed, the qualified rehabilitation expenditures in question will be treated as placed in service during pp, with the result that Taxpayer may claim the section 48(g) credit for the pp taxable year. See section 5.02(1) of Rev. Proc. 87-57, 1987-2 C.B. 687, with respect to the use of the mid-month convention for residential rental property.

Please note that no opinion is expressed or implied as to the application of any section of the Internal Revenue Code other than those specifically set forth above. Section 6110(j)(3) states that a private letter ruling may not be used or cited as precedent. A copy of this letter is enclosed for section 6110 purposes. A copy of this letter is being sent to Taxpayer and should be attached to the federal income tax information return filed for the appropriate taxable year.