Private Letter Ruling 8941021, IRC Section 42

July 13, 1989

This letter responds to your letter dated March 30, 1989, and subsequent correspondence submitted on behalf of the below-referenced limited partnerships (collectively the "Partnerships") as their authorized representative, requesting a ruling regarding the application of section 42 of the Internal Revenue Code and Internal Revenue Service Notice 88-91 (1988-36 I.R.B. 28) to the proposed lease of low-income housing projects by the limited partnerships to certain housing cooperatives. The represented facts as they pertain to the request for a ruling are set forth below.

PROJECT A LIMITED PARTNERSHIP

The Project A Limited Partnership is a State E limited partnership that is in the process of constructing and rehabilitating Project A, a *** unit low-income housing development located in City F. First mortgage financing for Project A in the approximate amount of $ *** was provided by Agency H, a state instrumentality of State E. Agency H also provided approximately $ *** of bridge loan financing on the investor limited partner's deferred capital contributions to the Partnership. The Project A Limited Partnership intends to lease the project to a State E cooperative corporation organized for the sole purpose of leasing, managing, and occupying the project pursuant to the terms of a lease agreement described below.

PROJECT B LIMITED PARTNERSHIP

The Project B Limited Partnership is a State E limited partnership that will construct Project B, a *** unit, 3 bedroom townhome development in City F. First mortgage financing for Project B in the approximate amount of $ *** will be provided by Agency H. The Project B Limited Partnership intends to lease the project to a State E cooperative corporation organized for the sole purpose of leasing, managing, and occupying the project pursuant to the terms of a lease agreement described below.

PROJECT C LIMITED PARTNERSHIP

The Project C Limited Partnership is a State E limited partnership that will own and rehabilitate Project C, a 6 story structure located in City F for purposes of providing affordable housing and studio areas for artists. First mortgage financing for Project C in the approximate amount of $*** will be provided by the Agency H. It is anticipated that the Agency H will also provide bridge loan financing to the Project C Limited Partnership on the deferred equity contributions of the investor limited partners. The general partners of the Project C Limited Partnership include Corporation J, a State E non-profit corporation and an organization exempt from tax under section 501(c)(3) of the Code. The Project C Limited Partnership intends to lease the project to a State E cooperative corporation organized for the sole purpose of leasing, managing, and occupying the project pursuant to the terms of lease agreement described below.

PROJECT D LIMITED PARTNERSHIP

The Project D Limited Partnership is a State E limited partnership that will own and rehabilitate Project D, a 16 unit, low- income housing development located in *** connected buildings in City G. Permanent first mortgage financing for Project D in the approximate amount of $ *** will be provided by Agency H. It is anticipated that Agency H will also provide bridge loan financing on the investor limited partners' deferred equity contributions. The Partnership has leased the project to Cooperative I, a State E cooperative, pursuant to the terms and conditions of a lease agreement described below.

BACKGROUND

Each of the above-described State E limited partnerships were formed pursuant to Section a of the State E Uniform Limited Partnership Act for the sole purpose of acquiring, constructing and/or rehabilitating, leasing, owning, and operating a residential low-income housing development located within State E (collectively the "Projects"). Each of the Partnerships is or shall be the fee simple owner of the Project that it has or will develop and each of the Projects is intended to generate low-income housing tax credits pursuant to section 42 of the Code (the "Low-Income Housing Credit"). Each of the Partnerships has sold or will sell its limited partner equity interest to investor limited partners based primarily upon the anticipated benefit of the Low-Income Housing Credit to such investor limited partners. Each of the Partnerships has or will obtain first mortgage financing from Agency H (collectively, the "First Mortgage Loans") and it is anticipated that three of the Partnerships will also obtain loan financing from Agency H on the investor limited partners' deferred equity contributions (the "Bridge Loans").

In order to obtain the benefit of a reduced rate of property tax applicable to its Project, each Partnership has or will enter into a lease of its Project to a State E cooperative corporation organized pursuant to State E Statutes Section b, the members of which are entitled to reside in the residential rental units (collectively the "Cooperative"). As explained in more detail below, in such circumstances the property is treated as "homestead" and the amount of real estate taxes payable with respect to the project is significantly reduced from that which would be payable for multi- family developments classified as "non-homestead" under State E law.

THE STATE E LEASEHOLD COOPERATIVE STATUTE

State E Statute Section c provides for a reduced rate of real estate tax as well as a tax credit mechanism for property that is defined as "homestead" under State E law. State E Statute Section d sets forth the definition of the types of property that will be deemed to be homestead for purposes of the favorable real estate tax treatment accorded by State E Statutes Section c. Generally, homestead property includes property that is used by the owner for purposes of his or her primary residence. However, other types of real estate ownership structures are also granted favorable homestead tax treatment. Of relevance to the Projects owned by the Partnerships, State E Statute Section d Subd. *** (the

"Leasehold Statute") states that homestead tax treatment will be available when one or more dwellings is owned by a non-profit corporation or a limited partnership that operates the property in conjunction with a cooperative association provided certain tests are met. Specifically, the Leasehold Statute provides as follows:

LEASEHOLD COOPERATIVES.

When one or more dwellings or one or more buildings which each contain several dwelling units is owned by a nonprofit corporation subject to the provisions of chapter e or a limited partnership which corporation or partnership operates the property in conjunction with a cooperative association, homestead treatment may be claimed for each dwelling unit occupied by a member of the cooperative. To qualify for the treatment provided by this subdivision, the following conditions must be met:

(a) the cooperative association must be organized under State E Statutes Section b;

(b) the cooperative association must have a lease for occupancy of the property for a term of at least *** years;

(c) to the extent permitted under state or federal law, the cooperative association must have a right under a written agreement with the owner to purchase the property if the owner proposes to sell it; if the cooperative association does not purchase the property when it is offered for sale, the owner may not subsequently sell the property to another purchaser at a price lower than the price at which it was offered for sale to the cooperative association unless the cooperative association approves the sale;

(d) if a limited partnership owns the property, it must include as the managing general partner either the cooperative association or a nonprofit organization operating under the provisions of chapter e; and

(e) the cooperative must meet one of the following criteria with respect to the income of its members:

(1) a minimum of *** percent of members must have incomes at or less than *** percent of area median income;

(2) a minimum of *** percent of members must have incomes at or less than *** percent of area median income; or

(3) a minimum of *** percent of members must have incomes at or less than *** percent of area median income. For purposes of this clause, "member income" shall mean the income of a member existing at the time the member acquires cooperative membership, and "median income" shall mean the City F/State E metropolitan area income as determined by the United States Department of Housing and Urban Development. Homestead treatment must be afforded to units occupied by members of the cooperative

association and the units must be assessed as provided in subdivision ***, provided that any unit no so occupied shall be classified and assessed pursuant to the appropriate class.

In ***, the State E legislature added the income limitations contained in subparagraph f of the Leasehold Statute as an additional requirement. However, this *** amendment was inadvertently made to a companion statute, State E Statute Section f Subd. ***, rather than to the Leasehold Statute. The State E Revisor of Statutes will have the language in subparagraph f inserted into the Leasehold Statute as part of the *** Revisor's Bill. Accordingly, the income limitations set forth in subparagraph f may not currently be a requirement to obtain the benefit of the Leasehold Statute.

Each Partnership has leased or will lease its Project to a cooperative pursuant to a lease agreement (the "Lease Agreement") which satisfies the requirements of the Leasehold Statute. The Leasehold Statute, by its express terms, does not require "ownership" of the development by the leasehold cooperative or its tenants. Rather, the Leasehold Statute specifically contemplates that a limited partnership shall own the development and operate it in conjunction with a cooperative association so long as the other requirements set forth in the Leasehold Statute are satisfied.

The requirements for gaining homestead status for developments leased to cooperative associations under the Leasehold Statute is to be distinguished from the less restrictive requirements necessary to qualify developments actually owned by cooperatives and/or charitable corporations for homestead tax treatment pursuant to State E Statute Section d Subd. ***. This direct ownership vehicle is the type of ownership structure typically contemplated by "cooperative ownership."

Specifically, State E Statute Section d Subd. *** provides as follows:

COOPERATIVES AND CHARITABLE COOPERATIVES. When one or more dwellings, or one or more buildings which each contain several dwelling units, are owned by a corporation or association organized under State E Statutes section b and each person who owns a share or shares in the corporation or association is entitled to occupy a dwelling, or dwelling unit in the building, the corporation or association may claim homestead treatment for each dwelling, or for each unit in case of a building containing several dwelling units, for the dwelling or for the part of the value of the building occupied by a shareholder. To qualify for the treatment provided by this subdivision, the corporation or association must be wholly owned by persons having a right to occupy a dwelling or dwelling unit owned by the corporation or association.

The homestead classification provided pursuant to State E Statute Section d Subd. *** is available only for entities that have ownership of the multi-family development. Under these circumstances, no income limitations are imposed upon the members of the cooperative and no non-profit corporation or limited partnership is required to be involved. In contrast, the Leasehold Statue contemplates ownership of the Project by an entity other than the cooperative entitled to possession and, in such cases, the law restricts the benefit of the favorable homestead tax treatment to those developments that are

occupied by individuals that meet certain income limitations and to those managed by non-profit sponsors or general partners. These income limitations correspond to the income housing limitations imposed for purposes of the Low-Income Housing Credit under section 42 of the Code.

Neither the Cooperative nor any of its members shall have an equity interest in the Partnerships or the Projects. In addition, neither the Cooperatives nor any of their members will be a general or limited partner of the Partnerships nor shall they be allocated or entitled to receive any income, gain, loss, low-income housing tax credit or other tax attribute from the Partnerships at any time.

In summary, State E accords favorable homestead tax treatment to two different types of multi-unit developments associated with cooperatives, the members of which are entitled to reside in the residential units. The first type of arrangement contemplates ownership of the development by a limited partnership with a non- profit general partner that operates the project in conjunction with a cooperative association. To qualify these types of developments for homestead tax treatment under the Leasehold Statute a number of restrictions are imposed on the development and upon the lease agreement. In this situation, the cooperative is not the owner of the project and its members would not be entitled to deduct interest and taxes with respect to the project pursuant to section 216 of the Code. In effect, the State E Legislature has determined to afford favorable property tax treatment to a specialized type of rental housing project in order to encourage greater tenant management of the housing development.

The second type multi-unit development involves direct ownership of the development by a corporation or cooperative and requires merely that the corporation or cooperative be wholly owned by persons having a right to occupy a dwelling unit in the building owned by the corporation or cooperative. This is the type of ownership structure that is typically thought of as "cooperative ownership" and is the type that would enable the resident owners of the cooperative to individually claim a deduction for interest and taxes relative to the development pursuant to Section 216 of the Code.

COOPERATIVE LEASE AGREEMENTS

For purposes of ruling requested herein, the operative economic and business terms of each of the Lease Agreements between the Partnerships and the Cooperatives are represented by the taxpayer to include the following:

(1) Subject to certain termination rights by the Partnership, the Project will be leased to the Cooperative for a *** year term.

(2) The Cooperative will not be required to make an out-of- pocket equity investment in the Project and the Cooperative will not have funds at risk in the Project.

(3) The Cooperative will not have a stated or contingent obligation to make rent payments to the Partnership except to the extent of the rent collected from the members of the Cooperative.

(4) Except as noted in (5) below, the Cooperative will be required to remit to the Partnership all rent collected from the members of the Cooperative, after the payment of all Project costs. Except as noted in (5) below with respect to the Incentive Management Fee, the Cooperative will not have the right to share in any revenues from the Project.

(5) The Project D Cooperative will have the right to share in a portion of the revenues from the Project for its services rendered in supervising the management and operation of the Project in accordance with its undertakings pursuant to the Lease Agreement (the "Incentive Management Fee"). The Incentive Management Fee is paid only to the extent of a portion of positive cash flow after the payment of all other operating expenses for the Project. It is projected that for the first *** years of the Project's operation the aggregate Incentive Management Fee available to the Project will be less than one- half of one percent of the overall operating receipts of the Project for such period.

(6) The Cooperative will not be ultimately liable to third parties with respect to any of the

Project's operating expenses, including, without limitation, insurance and real estate taxes.

(7) The Cooperative is not an obligor on any debt financing secured by the Project and will have no obligation to any of the Project lenders with respect to the repayment thereof.

(8) The Cooperative shall have a right of first refusal to purchase the Project in the event of sale, transfer or other disposition of the Project occurring within the ***-year term of the Lease Agreement at a price and terms equivalent to a bona fide offer for the Project received from a third party. The Cooperative's right of first refusal is not effective until a bona fide offer is received from a third party for the purchase of the Project. To exercise this right, payment for the project by the Cooperative must be for the same amount and pursuant to the same terms and conditions as that of the bona fide third party purchase.

(9) The Cooperative, as a lessee under the Lease Agreement, will not be allocated any

Low-Income Housing Credit, net profits, net losses or other tax benefits from the Project.

(10) The Partnership is fully liable to third parties and Project lenders with respect to payment of operating expenses and debt service, respectively. Except for the Incentive Management Fee, the Partnership is entitled to receive all the net proceeds from the operation of the Project. All of the appreciation in the value of the Project will inure to the benefit of the Partnership and its partners.

Under the terms of the Lease Agreement, the Cooperative would be required to rent each of the dwelling units in the Project to an individual who will satisfy the applicable income limitations under Section 42 of the Code. The rents charged with respect to the dwelling units are intended to be kept at a level that will satisfy the applicable rent restrictions under section 42 of the Code. The tenant would also be required to become a member of the Cooperative as a condition of such tenant's right to occupy a dwelling unit pursuant to the rental agreement with the Cooperative. Upon the termination or expiration of the rental agreement, the tenant will be required to terminate his or her membership in the Cooperative and surrender his or her membership certificate.

Section 38(a) of the Code 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) of the Code, added by section 252 of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 106, provides that, for purposes of section 38, the amount of the low-income housing credit determined under section 42 for any tax year in the credit period shall be an amount equal to the applicable percentage of the qualified basis of each "qualified low-income building."

Section 42(c)(2)(A) of the Code defines the term "qualified low- income building" as any building that is part of a qualified low- income housing project at all times during the period beginning on the 1st day in the compliance period on which such building is part of such a project, and ending on the last day of the compliance period with respect to such building.

Section 42(g)(1) of the Code defines the term "qualified low- income housing project" as any project for residential rental property if the project meets the requirements of subparagraph (A) or (B), whichever the taxpayer elects. The election is irrevocable. Section 42(g)(1)(A) states that the project meets the requirements of subparagraph (A) if 20 percent or more of the residential units in the project are both rent-restricted and occupied by individuals whose income is 50 percent or less of area median gross income, as adjusted for family size. Section 42(g)(1)(B) states that the project meets the requirements of subparagraph (B) if 40 percent or more of the residential units in the project are both rent-restricted and occupied by individuals whose income is 60 percent or less of area median gross income, as adjusted for family size.

Section 42(g)(2)(A) of the Code provides that a residential unit is rent-restricted if the gross rent (defined in section 42(g)(2)(B)) that is paid for the unit does not exceed 30 percent of the income limitation that section 42(g)(1) imposes upon the occupants of such unit.

Notice 88-91 indicates that final regulations under section 42 of the Code will provide that the term "qualified low-income building" includes residential rental property that is an apartment building, a single family dwelling, a townhouse, a rowhouse, a duplex, or a

condominium. The Notice also indicates that a qualified low-income building does not include residential rental property owned or leased by a cooperative housing corporation or a tenant- stockholder, as those terms are defined under section 216(b)(1) and (2) of the Code.

Section 216(b)(1) defines a "cooperative housing corporation" as a corporation --

(A) having one and only one class of stock outstanding,

(B) each of the stockholders of which is entitled, solely by reason of their ownership of stock in the corporation, to occupy for dwelling purposes a house, or an apartment in a building, owned or leased by such corporation,

(C) no stockholder of which is entitled (either conditionally or unconditionally) to receive any distribution not out of earnings and profits of the corporation except on a complete or partial liquidation of the corporation, and

(D) 80 percent or more of the gross income of which for the taxable year in which the taxes and interest described in section 216(a) are paid or incurred is derived from tenant stockholders.

Section 216(b)(2) defines a "tenant-stockholder" as a person who is a stockholder in a cooperative housing corporation, and whose stock is fully paid-up in an amount not less than an amount shown to the satisfaction of the Secretary as bearing a reasonable relationship to the portion of the value of the corporation's equity in the house or apartment building and the land on which situated that is attributable to the house or apartment that such person is entitled to occupy.

Since the publication of Notice 88-91, the Internal Revenue Service has decided that forthcoming regulations under section 42 of the Code will modify the rule in that Notice that a qualified low- income building does not include residential rental property owned or leased by a cooperative housing corporation or a tenant-stockholder. The intent of that rule is to preclude members of any housing cooperatives that own or lease qualifying property from claiming the low-income housing credit with respect to such property.

Under the Lease Agreements between the Partnerships and the Cooperatives (the Incentive Management Fee to the Project D Cooperative notwithstanding), the Partnerships have retained the benefits and burdens of ownership of their Projects. Accordingly, the Partnerships are deemed the owners of their Projects for federal income tax purposes. The Cooperatives, as nominal lessees, merely act as conduits between the Partnerships, as the owners, and the members of the Cooperatives, as tenants. As such, no credits, depreciation deductions, interest, real estate taxes, or other tax benefits are available to the Cooperative lessees or tenant-members of such Cooperatives pursuant to the Lease Agreements. Because no Cooperative or tenant-member has an ownership interest in a Project for purposes of claiming the section 42 credit, the Lease Agreements

between the Partnerships and the Cooperatives do not violate the intent of the rule in Notice 88-91.

Therefore, based upon the above facts and representations, we rule as follows:

Assuming all other requirements of section 42 of the Code are satisfied, the Projects will continue to be classified as qualified low-income housing projects for purposes of section 42 at all times subsequent to the lease of the Projects from the Partnerships to the Cooperatives pursuant to the terms the Lease Agreements, and the Partnerships shall be entitled to claim the section 42 credit generated by the Projects notwithstanding the provisions of Notice 88-91.

No opinion is expressed or implied regarding whether the Projects or tenant-members thereof are cooperative housing corporations or tenant-stockholders as those terms are defined under sections 216(b)(1) and (2) of the Code -- such determinations having no adverse consequences to the ruling herein granted. Nor is an opinion expressed or implied regarding the application of any other provisions of the Code or regulations. This ruling is directed only to the taxpayers who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Because this ruling is issued under the authority of Rev. Proc. 88-18, 1988- 20 I.R.B. 32, and section 5.07(3) of Rev. Proc. 89-1, 1989-1 I.R.B. 8, this ruling may be modified or revoked by the Service. However, when the criteria in section 16.05 of Rev. Proc. 89-1 are satisfied, a ruling is not revoked or modified retroactively, except in rare or unusual circumstances.

In accordance with a telephone communication with you on ***, the original of this letter is being sent to you as the Partnership's authorized representative.

A copy of this letter should be attached to the federal income tax return of each limited partnership taxpayer for the first taxable year in the credit period for which the section 42 credit is claimed.

Sincerely yours, James Ranson Chief, Branch 5

Office of the Assistant Chief Counsel

(Passthroughs and Special Industries)