Private Letter Ruling 8950057, IRC Section 42

Full Text:

September 20, 1989

This letter responds to your letter dated February 13, 1989, and subsequent correspondence submitted on behalf of Taxpayer, as its authorized representative. Rulings are requested regarding when Taxpayer's building was placed in service for purposes of section 42 of the Internal Revenue Code, whether that building qualifies as a "new building" under section 42(i)(4) of the Code, and what is the building's eligible basis under section 42(d)(1). In a letter dated September 1, 1989, you withdrew ruling request number 3. The represented facts as they pertain to the request for rulings are set forth below.

On *** Taxpayer acquired Project. Prior to its acquisition by Taxpayer, Project was held by a series of owners. Project originally was conceived as a condominium project by Partnership A, a State X general partnership, to be constructed on land purchased from Authority on *** Development costs incurred by Partnership A with respect to Project totaled *** In *** on a date Taxpayer claims was prior to Project's completion or placement in service, Partnership A defaulted on its obligations and Project was acquired by the Federal Savings and Loan Insurance Corporation ("FSLIC"). After acquiring Project, FSLIC authorized and undertook further construction of Project. An appraisal dated *** by Appraiser A, placed a fair market value of *** million on Project. On *** a certificate of occupancy with respect to Project was issued by City Y's Building Inspection Division, Department of Public Works, to Partnership A, although by this time FSLIC had acquired Project, as receiver for the mortgagee.

On *** Architect, the architect hired in the design of completion of Project, visited Project and reported that the following work needed to be completed as of that date: (i) the *** floor was completely unfinished, with no heating or air-conditioning, plumbing, partitions or ceilings. Only the walls around the central core were in place; (ii) floors *** through *** were substantially complete, constructed to be used as apartments; (iii) the *** floor was not complete but had only minimum finish as required to obtain a certificate of occupancy from City Y. This floor consisted mostly of *** large open areas with ceilings installed, some heating and air conditioning and lighting. The floors were bare concrete. According to Architect, these *** floor spaces, which provide access to the entire building, were complete enough to meet the minimum requirements for safe occupancy but were not designed for, nor were they usable for the administration of, or for the service facilities required of, a large apartment building; (iv) the grounds were not finished and consisted only of concrete slabs over the underground parking areas with dirt surrounding the building and with a temporary construction fence surrounding the site.

According to Taxpayer, Architect stated that, in order to construct the new tenant finish areas, common areas and access areas noted above, and to have this new construction

meet the requirements of City Y's building Code, it was necessary to extend and modify the existing heating, air conditioning and ventilating systems and the existing lighting and fire protection systems.

V and W purchased Project for *** from FSLIC as receiver for Bank on *** pursuant to the terms of a Purchase and Sale Agreement dated *** and an Extension Agreement dated *** Of the *** paid for Project, *** was in consideration for FSLIC's extension of the *** Purchase and Sale Agreement in accordance with the Extension Agreement. On *** V and W transferred their respective interests in Project to Partnership B, a State X partnership in which V and W were the sole partners. Following the transfer of Project to Partnership B, V and W advertised Project for sale and showed it to potential purchasers.

Taxpayer represents that a review of the *** and *** tax returns of Partnership B shows that Partnership B took no depreciation deductions for Project during its *** and *** tax years. On *** V and W obtained an appraisal of Project prepared by Appraiser B, as of *** (the "Appraisal"). Using the assumption that Project would be developed as a congregate care retirement complex, the Appraisal concluded that as of completion of construction, Project would have a fair market value of *** million. The Appraisal also concluded that at the point of stabilized income Project would have a fair market value of *** million. On *** an updated valuation letter from Appraiser B again used the assumption that Project would be developed as a congregate care retirement facility and reiterated that Project had a fair market value of *** million.

During the period V and W held Project, no improvements were made to Project and Project lay vacant while V and W attempted to sell it. According to Taxpayer, V and W originally had anticipated that Project could be marketed as a suite hotel, but later determined that its best use would be as rental housing for low-income tenants over the age of *** years with leases that offered optional services, such as meals and maid services, for an additional fee.

On *** Corp U, a State Z corporation, entered into a contract to purchase a *** percent interest in Project for *** The sale of Project to the Corp U closed on *** Corp U acquired Project subject to a first mortgage of *** million, tendered the sum of *** (payable at closing) and executed a recourse promissory note in the amount of *** The promissory note carries interest on the principal balance at the rate of *** percent per annum, which was payable in interest-only installments on *** and *** and thereafter in monthly interest-only installments, with all unpaid principal and accrued and unpaid interest due on or before *** Taxpayer represents that Corp U's financial statements indicate that Corp U has the capacity to meet its obligations under the promissory note. A second deed of trust was executed to secure payment of the Corp U's promissory note in the original principal amount of ***.

Also on *** in response to a condition of Corp U for its purchase of the *** percent interest in Project, Partnership B entered into a Standard Form of Agreement Between Owner and Contractor (the "Construction Contract"), for the purpose of (i) building out the lobby and the common areas (including the kitchen and dining room) of Project, (ii)

completing the mechanical building systems, (iii) adding offices to Project and (iv) providing landscaping parking lot requirements. Under the terms of the Construction Contract, construction was to commence on *** and substantial completion was to be achieved by *** During construction, the City Y Fire Department required the testing of the entire building's fire alarm system, smoke detection system, smoke evacuation system, pressurization system and emergency generator system prior to allowing any occupancy of the building.

In *** V and W requested their real property and casualty insurer increase coverage on Project to *** million. The insurer refused on the basis that Project was not yet completed and that its sprinkler system was not in working order and had not been tested for approval.

According to Taxpayer, in *** the City Y Fire Department's Fire Prevention Bureau searched its files for evidence that an inspection of Project had been made. The agency was unable to locate evidence of a Fire Department inspection, despite the fact that an agent of the Fire Department had signed the certificate of occupancy issued by the Building Inspection Division of City Y's Public Works Department. In the Fire Prevention Bureau conducted an inspection indicating that Project's fire alarm and protection system required testing prior to occupancy of Project. Testing of Project's elevator recall system, the installation of missing exit lights and the replacement of fire extinguishers also were required prior to occupancy of the building.

On ***. Corp U, V and W transferred their respective *** percent, *** percent and *** percent interests in Project to Taxpayer (in which partnership interests are held *** percent by Corp U, *** percent by V and *** percent by W). Taxpayer represents that prior to its ownership, Project was never advertised for lease and no tenant leases were executed. A representation was made to W in a letter dated *** from Corp T (the agent for FSLIC in its capacity as receiver for Bank, the construction loan lender to the Partnership A) to the effect that, to the best of Corp T's knowledge, Project was never leased out or placed in service prior to or during the ownership by FSLIC.

Immediately upon acquiring Project, Taxpayer partitioned the lobby to create a walkway required for tenants to gain access to Project's elevators, constructed a security desk and reception area and requested the City Y Fire Department to conduct certain tests required prior to occupancy of the units. In anticipation of rental of Project units to elderly tenants, Taxpayer hired two full-time receptionists to provide around-the-clock reception services essential in the event of a medical emergency. In addition, window coverings, as required by the City Y tenant rules, were added to each unit in Project. Refrigerators and microwave ovens, which were being stored, were placed in each unit. Advertising for tenants began on *** when Taxpayer advertised the units for rental in Paper. As of *** there was no tenants under lease for occupancy in Project. Taxpayer represents that as of the date of its request for rulings, all approvals relating to the kitchen required for final completion of Project have been obtained. The capital expenditures of Taxpayer with respect to depreciable additions and improvements to Project totaled *** by the end of ***.

Each tenant in Project must complete a lease agreement which sets forth the rule that monthly rental rates will be determined by a formula, administered by the State X Housing Finance Authority, that sets income eligibility limits and determines rental fees based on the City Y area median gross income. No tenant is accepted unless his or her income is *** percent or less of the City Y area median gross income, as adjusted for family size. Each tenant must certify that the income information provided is true and complete and must permit verification of such amounts and sources. No monthly rental rate charged for units in Project is greater than *** percent of *** percent of the City Y area median gross income.

Project offers a number of tenant amenities. Each unit is equipped with standard-sized kitchen appliances, including microwave ovens and dishwashers. Project also offers tenant facilities, such as a swimming pool and whirlpool, underground parking garage, television lounge, library and game room, guestrooms, and a juice and snack bar. These facilities are available to all tenants at no additional charge. Project contains a beauty/barber shop offering services to all tenants for a nominal charge. Additionally, Project offers to all tenants meals in its private dining room, for an additional charge. The dining room also is used daily for activities such as card games and exercise classes that are open to all tenants at no additional charge. The juice and snack bar is located in the dining room.

Project comprises a total of *** square feet. The beauty/barber shop occupies *** square feet and Project's kitchen occupies *** square feet. The remaining footage (*** square feet) is devoted to low-income rental units and the tenant facilities described above which are available to all tenants at no additional charge.

Project is intended to qualify as a "qualified low-income housing project" under the low-income housing credit of section 42 of the Code. The State X Housing and Finance Authority (the "Agency") allocated a low-income housing credit in the amount of *** to Project on *** based on an eligible basis of *** and an applicable percentage of *** percent. In its preliminary application to the Agency for a reservation of low-income housing credit, Taxpayer attributed *** percent of the cost of Project to the land on which it was constructed. Elections were made to defer the start of the credit period to *** the year succeeding the year the building was placed in service, under section 42(f)(1)(B) and to satisfy the "40-60" minimum set-aside requirement under section 42(g)(1)(B) in which at least 40 percent of the tenants must have gross incomes of 60 percent or less of the City Y area median gross income. Taxpayer represents that *** percent of the tenants in Project must have incomes of 60 percent or less of the City Y area median gross income.

Taxpayer represents that the amendments made by section 201(a) of the Tax Reform Act of 1986 (the "1986 Act") apply to Project. According to Taxpayer, after the transfer of Project to FSLIC, no subsequent owner of Project, including V, W, and Taxpayer, acquired Project from an owner in whose hands Project could be treated as transition property under section 203(a) and (b) of the 1986 Act.

Section 38(b)(5) of the Code provides for a low-income housing credit. Section 42(a) provides that for purposes of section 38, the amount of the low-income housing credit determined under this section for any taxable year in the credit period shall be an amount equal to -- (1) the applicable percentage of (2) 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)(2)(A) of the Code provides that the term "applicable percentage" means the appropriate percentage prescribed by the Secretary for the month in which the building is placed in service. 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 tax 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 tax year (30 percent present value credit). The appropriate credit percentages for each month are published in the monthly revenue ruling containing the applicable Federal rates. Section 42(i)(4) defines a new building as a building, the original use of which begins with the taxpayer.

For purposes of section 42 of the Code, residential rental units must be "for use by the general public" and all of the units in a project must be used on a non-transient basis. Residential rental units are not for use by the general public, for example, if the units are provided only for members of a social organization or provided by an employer for its employees. Generally, a unit is considered to be used on a non-transient basis if the initial lease term is six months or greater. Additionally, no hospital, nursing home, sanitarium, lifecare facility, retirement home, or trailer park may be a qualified low-income project. See 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-95 (1986), 1986-3 (Vol. 4) C.B. 95 (the "Conference Report").

Notice 89-6, 1989-2 I.R.B. 16, states that regulations under section 42 of the Code will provide that the term "for use by the general public" shall be determined in a manner consistent with the Department of Housing and Urban Development ("HUD") housing policy governing non-discrimination as evidenced by HUD rules and regulations. See HUD Handbook 4350.3 (or its successor). Accordingly, owners of residential rental units that give preferences to certain classes of tenants (e.g., the homeless, disabled and/or handicapped) will not violate the general public use requirement if such preferences would not violate any HUD policy governing non-discrimination expressed in the HUD hand-book. However, if residential rental units are restricted to a class of residents that would violate HUD housing policy (e.g., residential rental units provided solely for members of a social organization or by an employer for its employees) then the building in which these units are located will be ineligible for the credit.

In a HUD opinion letter dated *** a residential rental project may give preference to the elderly provided that the project complies with HUD's policies prohibiting discrimination with respect to the named categories of sex, color or national or religious affiliation, and does not discriminate on the basis of class membership, membership in the sponsoring

organization, or handicap. (See Figure 2-2 of HUD Handbook 4350.3.) A project must also comply with HUD regulations implementing the 1988 amendments to the Fair Housing Act regarding discrimination against families with children.

Notice 88-116, 1988-44 I.R.B. 22, provides that the placed in service date for a new or existing building used as residential rental property is the date on which the building is ready and available for its specifically assigned function, i.e., the date on which the first unit in the building is certified as being suitable for occupancy in accordance with state or local law. Under Notice 88- 116, a building may be placed in service even if the rental units in the building are not currently occupied by low-income tenants.

The definition of the term "placed in service" contained in Notice 88-116 is similar to the language used to define that term in the depreciation and investment credit regulations. Under section 1.167(a)-11(e)(1)(i) of the Income Tax Regulations, for purposes of the allowance for depreciation (allowed under section 167 of the Code), property is first placed in service when it is placed in a condition or state of readiness and availability for a specifically assigned function. Similarly, under section 1.46-3(d), property is first placed in service for purposes of the investment credit in the earlier of (i) the taxable year in which, under the taxpayer's depreciation method, the period for depreciation with respect to the 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.

Under the facts presented, no owner of Project other than Taxpayer engaged in the trade or business of renting apartments in Project. No owner other than Taxpayer advertised Project for rent to tenants or made Project available for rent. No owner of Project entered into a lease of any apartment until after Taxpayer acquired Project. No owner of Project attempted to sell individual apartments to purchasers. Although FSLIC undertook further construction of Project, its agent represents in its capacity as receiver for Bank that at no time did FSLIC hold out any of the apartments in Project for rent or place Project in service. V and W, as owners of Project, likewise only held Project for sale.

Work to complete Project for occupancy was undertaken only by Taxpayer. The *** City Y certificate of occupancy issued to FSLIC evidences availability for occupancy under local law, and under the facts is not by itself determinative of whether Project was placed in service under section 42 of the Code. Thus, Taxpayer placed Project in service in *** the year Project was ready and available as residential rental property.

Under section 42(i)(4) of the Code, a "new building" is a building the original use of which begins with the taxpayer. Because we conclude that Project was originally placed in service by Taxpayer, Project is a new building under section 42(i)(4).

Based upon the above facts and representations, and provided that restricting Project to the elderly does not violate any HUD non- discrimination policy, we rule as follows:

(1) For purposes of section 42 of the Code, Project was placed in service in *** by Taxpayer.

(2) With respect to Taxpayer, Project is a "new building" under section 42(i)(4) of the Code qualifying for the 9 percent credit described in section 42(b)(1)(A).

No opinion is expressed or implied regarding the application of any other provisions of the Code or regulations. Specifically, no opinion is expressed regarding whether Project qualifies as a low-income housing project under section 42(g)(1) of the Code or the application of the at-risk rules under section 42(k) to Project's financing. This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) provides that it may not be used or cited as precedent.

Temporary or final regulations pertaining to the issues addressed in this ruling have not been adopted. This ruling is issued under the authority of Rev. Proc. 88-18, 1988-20 I.R.B. 32, that enables the Service to issue rulings for Code sections enacted or amended by the 1986 Act or the Revenue Act of 1987. Therefore, this ruling may be modified or revoked by the Service. However, when the criteria in section 16.05 of Rev. Proc. 89-1, 1985-1 I.R.B. 20 are satisfied, a ruling is not modified or revoked retroactively except in rare or unusual circumstances.

In accordance with the power of attorney on file, a copy of this letter is being sent to you as Taxpayer's authorized representative.

A copy of this letter should be attached to the income tax return of Taxpayer for the taxable year in which Taxpayer placed Project in service.

Sincerely yours,

Susan Reaman

Assistant to the Chief, Branch 5

Office of the Assistant Chief Counsel

(Passthroughs and Special Industries)