Private Letter Ruling 9044037, IRC Section 42

August 2, 1990

Dear ***

This is in response to your March 13, 1990, letter and subsequent correspondence submitted on behalf of Partnership in which you requested a ruling concerning the availability to Partnership of the low-income housing credit under section 42 of the Internal Revenue Code. The facts as represented in your ruling request are set forth below.

Partnership is a State A limited partnership organized under the State A Uniform Limited Partnership Act and is presently comprised of the Institute, a State A nonprofit corporation, as the general partner ("General Partner") and Individual, as the initial limited partner ("Initial Limited Partner"). The General Partner has a a percent interest, and the Initial Limited Partner has a b percent interest, in profits, losses, gains, credits, and distributions of Partnership.

The General Partner has no stockholders, and its sole member is Charity. The General Partner's board of directors consists of 4 individuals, 3 of whom are selected by Charity. The fourth director is the executive director of the Nonprofit Corp, a State A nonprofit corporation that is not affiliated with Charity. The Initial Limited Partner is an individual who has been residing in State B for the past 5 years and is not related to the General Partner or to Charity, or any of their affiliates.

On c, Partnership acquired an existing low-income housing project known as Project from Charity. Partnership leased from Charity the land on which Project is situated, and purchased Project (including certain personal property therein) for $d. The purchase price was paid for with funds paid to Charity in the amount of $e, with the assumption of certain third-party obligations of Charity related to the building in the amount of $f, and with a note for the balance in the amount of approximately $g. Partnership financed the cash payment of $e to Charity with the proceeds of a loan in the amount of $h from Bank. Partnership also agreed to reimburse Charity for certain predevelopment costs of $i related to the rehabilitation, which amounts are to be paid to Charity upon close of Partnership's construction loan.

Upon completion of the rehabilitation, Project will consist of j rental units and commercial space, all of which will be rehabilitated for a total projected rehabilitation cost of approximately $k. The construction is expected to begin in l and to be completed in m. Approximately n of the units are expected to qualify as low-income units as defined in section 42(i)(3) of the Code.

Partnership has received under section 42(h)(1)(E) of the Code an allocation of 1989 low-income housing credits in the amount of $o from the State A State Housing Finance Commission with respect to the rehabilitation expenditures for Project ("Carryover

Allocation"). Documentation for the Carryover Allocation names Partnership as the owner to whom the housing credit dollar amount allocation was made.

Project is also a certified historic structure selected for placement on the National Register of Historic Places. The rehabilitation is being completed in a manner that will qualify Project as a "qualified rehabilitated building" under section 48(g) of the Code, and thereby entitle Partnership to the investment tax credit under section 46(a)(3) for qualified rehabilitation expenditures.

Partnership intends to admit a corporate investor ("Investor Limited Partner") as the sole limited partner for approximately $p. The Investor Limited Partner is a corporation that will be able to take advantage of the tax credits. At the time the Investor Limited Partner is admitted, the Initial Limited Partner will withdraw from Partnership and Partnership will return her capital contribution. Partnership must admit the Investor Limited Partner before the rehabilitation expenditures are completed so that it will be a partner in Partnership when the rehabilitation expenditures are placed in service.

Partnership has requested the following ruling:

1. Partnership is the "taxpayer" for purposes of the "10 percent exception" of section 42(h)(1)(E) of the Code.

In a subsequent correspondence, Partnership withdrew a ruling request number 2 included in its original submission. This withdrawn ruling request pertained to the application of section 42(d)(7) ("step-into- the-shoes rule") to the incoming Investor Limited Partner.

Section 38(a) of the Code provides for a general business credit against the tax imposed by chapter 1 for the tax year that includes the amount of the current year business credit. The amount of the current year business credit includes, under section 38(b)(5), the low-income housing credit determined under section 42(a).

The regime governing the low-income housing credit is contained in section 42 of the Code. As part of this regime, section 42(a) begins by providing that the amount of the low-income housing credit determined for any tax year in the 10-year credit period shall be an amount equal to the applicable percentage of the qualified basis of each qualified low-income building. Pertinent terms contained in section 42(a) are defined in subsections that follow it.

Thus, under section 42(b)(2)(A) of the Code, the term applicable percentage means, for any qualified low-income building placed in service by the taxpayer after 1987, the appropriate percentage prescribed by the Secretary for the earlier of (i) the month in which the building is placed in service, or (ii) at the election of the taxpayer (i) the month in which the taxpayer and housing credit agency enter into an agreement with respect to such building (which is binding on such agency, the taxpayer, and all successors in interest) as to the housing credit dollar amount to be allocated to such building, or (ii) in

the case of any building to which section 42(h)(4)(B) applies, the month in which the tax-exempt obligations are issued. Additionally, a month may be elected under clause (ii) only if the election is made not later than the 5th day after the close of such month. Such an election, once made, shall be irrevocable.

Section 42(b)(2)(B) of the Code 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 under section 42(a) that will have present value equal to (i) 70 percent of the qualified basis of a building described in section 42(b)(1)(A), and (ii) 30 percent of the qualified basis of a building described in section 42(b)(1)(B).

Section 42(c)(1)(A) of the Code defines the qualified basis of any qualified low-income building for any tax year as an amount equal to (i) the applicable fraction (determined as of the close of such tax year) of (ii) the eligible basis of such building (determined under section 42(d)(5)).

Section 42(c)(1)(B) provides that the term applicable fraction means the smaller of the unit fraction or the floor space fraction. The unit fraction is the number of low-income units divided by the number of all residential rental units in the building. The floor space fraction is the floor space of the low-income units divided by the floor space of all the residential rental units in the building. Generally, in these calculations, low-income units are those units presently occupied by qualifying tenants, whereas residential rental units are all units, whether or not presently occupied. See 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-89 (1986), 1986-3 (Vol. 4) C.B. 89.

Eligible bases, whether for new or existing buildings, are determined under section 42(d) of The Code. Thus, under section 42(d)(1), the eligible basis of a new building is its adjusted basis as of the close of the first tax year of the credit period. Under section 42(d)(2), the eligible basis of an existing building is (i) in the case of a building which meets the requirements of section 42(d)(2)(B), its adjusted basis as of the close of the first tax year of the credit period, and (ii) zero in any other case. Section 42(e)(1) provides generally that certain rehabilitation expenditures paid or incurred by the taxpayer for a building shall be treated for purposes of section 42 as a separate new building. Thus, the eligible basis for substantial rehabilitation is determined under section 42(d)(1).

The adjusted basis is determined by taking into account the adjustments described in section 1016 of the Code (other than paragraphs (2) and (3) of section 1016(a), relating to depreciation deductions), including, for example, the basis adjustment provided in section 48(q) for any rehabilitation credits allowed under section 38. The cost of land is not included in adjusted basis. See 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-89 (1986), 1986-3 (Vol. 4) C.B. 89.

In general, for purposes of the low-income housing credit, the term residential rental property has the meaning given in the regulations under section 103 of the Code. Under these regulations, residential rental property includes residential rental units, facilities for use by the tenants, and other facilities reasonably required by the project. Eligible basis

may include the cost of such facilities and amenities (e.g., stoves, refrigerators, air conditioning units, etc.) only if the included amenities are comparable to the cost of the amenities in the low-income units. Additionally, the allocable cost of tenant facilities, such as swimming pools, other recreational facilities, and parking areas, may be included provided there is no separate fee for the use of these facilities and they are made available on a comparable basis to all tenants in the project. See 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-89 (1986), 1986-3 (Vol. 4) C.B. 89.

Section 42(h)(1)(A) of the Code provides that the amount of the credit determined under section 42 shall not exceed the housing credit dollar amount allocated to such building. Implicit in this subsection is the requirement, with exceptions, that a taxpayer receive a housing credit dollar amount allocation from the appropriate State housing credit agency. The general timing for receiving a housing credit dollar amount allocation is linked, with exceptions, to the year that a building is placed in service. Thus, section 42(h)(1)(B) provides that except in the case of an allocation that meets the requirements of subparagraphs (C), (D), and (E) of section 42(h)(1), an allocation shall be taken into account under section 42(h)(1)(A) only if it is made not later than the close of the calendar year in which the building is placed in service.

One exception to this general timing requirement for credit allocations is the 10 percent carryover credit exception ("10- Percent-Carryover-Credit Exception") in section 42(h)(1)(E). Section 42(h)(1)(E)(i) of the Code provides that an allocation meets the requirements of section 42(h)(1)(E) if such allocation is made with respect to a qualified building that is placed in service not later than the close of the second calendar year following the calendar year in which the allocation is made. Under section 42(h)(1)(E)(ii), the term "qualified building" means any building that is part of a project if the taxpayer's basis in such project (as of the close of the calendar year in which the allocation is made) is more than 10 percent of the taxpayer's reasonably expected basis in such project (as of the close of the second calendar year referred to in clause (i)). Additionally, such term does not include any existing building unless a credit is allowable under section 42(e) for the rehabilitation expenditures paid or incurred by the taxpayer with respect to such building for a tax year ending during the second calendar year referred to in section 42(h)(1)(E)(i) or the prior tax year.

An allocation pursuant to section 42(h)(1)(E) of the Code is made by an allocation document satisfying the procedural and informational requirements in Notice 89-1, 1989-2, I.R.B. 10. Under that notice, the following rules apply for purposes of the 10 percent basis exception in 42(h)(1)(E). (1) Basis means the adjusted basis of land and depreciable real property, whether or not such amounts are includable in the eligible basis; however, an allocation pursuant to section 42(h)(1)(E) is based upon items includable in eligible basis. (2) A taxpayer has basis in land and other acquired real property when the benefits and burdens of ownership have been transferred to the taxpayer. In the case of purchased property, this transfer normally occurs at closing. For example, amounts paid to acquire an option to purchase land or a building are not includable in basis because the full benefits and burdens of ownership have not been transferred to the taxpayer; nor have the benefits and burdens of ownership been transferred merely because a nonrefundable

downpayment is made. (3) Whether a taxpayer has basis in construction costs depends upon the method of accounting used by the taxpayer. For example, the cost of construction services is included in the basis of an accrual method taxpayer when the services are performed, and in the basis of a cash method taxpayer when the bill for such services is paid. (4) With respect to taxpayers who are members of partnerships or other flow-through entities, the accounting method of the flow-through entity shall be applied to determine whether the 10 percent exception applies.

Rule (4) above addresses situations in which a partnership or other flow-through entity is applying for a credit allocation under section 42(h)(1)(E) of the Code. In such situations, it is the applying partnership or other flow-through entity to which the above 4 rules apply for purposes of the 10-Percent-Carryover-Credit Exception. The applying partnership or other flow-through entity, as building owner, must satisfy the 10 percent basis threshold under section 42(h)(1)(E). Thus, the applying partnership or other flow-through entity that meets the requirements of Notice 89-1 is the taxpayer for purposes of section 42(h)(1)(E).

Notice 89-1 also provides, generally, that an allocation is made when a State housing credit agency issues a Form 8609 to the taxpayer. However, an allocation pursuant to section 42(h)(1)(E) of the Code is an exception to this general rule. When an allocation is made pursuant to section 42(h)(1)(E), a Form 8609 is not issued by the State housing credit agency until the calendar year in which the building is placed in service.

Finally, Notice 89-1 provides that an allocation pursuant to section 42(h)(1)(E) of the Code is made when an allocation document containing the following information is completed: (1) the address of the building, or if none exists, a specific description of its location; (2) the name, address, and taxpayer identification number of the building owner receiving the allocation; (3) the name and address of the housing credit agency; (4) the taxpayer identification number of the agency; (5) the date of the allocation; (6) the housing credit dollar amount allocated to the building; (7) the taxpayer's total reasonably expected basis in the project; (8) the taxpayer's basis in the project as of the close of the calendar year in which the allocation is made and the percentage such basis bears to the reasonably expected basis in the project; (9) the expected date that the building will be placed in service; and, (10) the Building Identification Number (B.I.N.) to be assigned to the building when the building is placed in service. The B.I.N. should reflect the year the allocation is made, rather than the year the building is placed in service, unless the building is placed in service during the allocation year.

Under section 42(e)(1) of the Code, rehabilitation expenditures paid or incurred by the taxpayer with respect to any building shall be treated for purposes of section 42 as a separate new building. Section 42(e)(2)(A) provides that the term "rehabilitation expenditures" means amounts chargeable to capital account and incurred for property (or additions or improvements to property) of a character subject to allowance for depreciation in connection with the rehabilitation of a building. The term does not include the cost of acquiring any building (or interest therein) or any amount not permitted to be taken into account under sections 42(d)(3) and 42(d)(4).

Section 42(e)(3)(A) of the Code provides that section 42(e)(1) applies to rehabilitation expenditures with respect to any building only if (i) the expenditures are allocable to 1 or more low-income units or substantially benefit such units, and (ii) the amount of such expenditures during any 24-month period meets the requirements of whichever of the following subclauses requires the greater amount of such expenditures: (I) the requirement of this subclause is met if such amount is not less than 10 percent of the adjusted basis of the building (determined as of the first day of such period and without regard to paragraphs (2) and (3) of section 1016(a)); or (II) the requirement of this subclause is met if the qualified basis attributable to such amount, when divided by the low-income units in the building, is $3000 or more ($2000 for allocations received prior to January 1, 1990). Pursuant to section 42(e)(3)(C), the determination under section 42(e)(3)(A) shall be made as of the close of the first tax year in the credit period with respect to such expenditures.

Section 42(e)(4) of the Code provides that for purposes of applying section 42 with respect to expenditures that are treated as a separate building by reason of section 42(e) -- (A) such expenditures shall be treated as placed in service at the close of the 24-month period referred to in section 42(e)(3)(A), and (B) the applicable fraction for the building (without regard to paragraph 1)) with respect to which the expenditures were incurred. Nothing in section 42(d)(2) shall prevent a credit from being allowed by reason of section 42(e).

As represented in the foregoing facts, Partnership received the 1989 Carryover Allocation of $o from the State A State Housing Finance Commission pursuant to section 42(h)(1)(E) of the Code. The Carryover Allocation constitutes an actual allocation from the State A 1989 housing credit ceiling for rehabilitation expenditures expected to qualify under section 42(e). Documentation for the Carryover Allocation, in complying with Notice 89-1, names Partnership as the owner of Project to whom the credits were allocated. For purposes of this ruling letter we assume both that Partnership, as named owner of Project, paid or incurred costs at the time of the Carryover Allocation to give it a basis of more than 10 percent of the reasonably expected basis for Project and that the Carryover Allocation to Partnership was a valid allocation.

Also as represented in the foregoing facts, Partnership intends to admit an Investor Limited Partner as the sole limited partner, at which time the Initial Limited Partner will withdraw from Partnership. For purposes of this ruling, we assume, without ruling, that Partnership will not terminate pursuant to section 708(b)(1)(B) of the Code as a result of the transaction considered herein. Thus, Partnership will remain owner of Project to which the Carryover Allocation was initially issued.

Based on the foregoing facts, law, and assumptions we rule that Partnership, as named owner in the Carryover Allocation, is the taxpayer for purposes of the 10-Percent-Carryover-Credit Exception of section 42(h)(1)(E) of the Code pursuant to which the Carryover Allocation was issued.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the above-described facts under any other provisions of the Code or regulations. We direct this ruling letter only to the taxpayer on whose behalf it was requested. Section 6110(j)(3) of the Code provides that this ruling letter may not be used or cited as precedent. Temporary or final regulations pertaining to one or more of the issues addressed in this ruling letter have not been adopted. Therefore, we may modify or revoke this ruling letter if the adopted temporary or final regulations are inconsistent with any conclusion herein. See section 8.01 of Rev. Proc. 90-1, 1990-1 I.R.B. 8,25. However, when the criteria in section 8.01 of Rev. Proc. 90-1 are satisfied, we will not revoke or modify a ruling letter retroactively, except in rare or unusual circumstances.

A copy of this letter should be attached to the appropriate federal income tax returns for the year in which the transactions are consummated.

Sincerely yours,

James Ranson

Chief, Branch 5

Office of the Assistant Chief Counsel

(Passthroughs and Special Industries)