Private Letter Ruling 9101006, IRC Section 42

Date: October 2, 1990

Dear ***

This is in response to your March 1, 1990, letter and subsequent correspondence submitted on behalf of Partnership and Developer. In your March 1, 1990, letter you requested a ruling concerning the placed in service date for certain units of the Condominium for purposes 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 partnership maintaining its principal place of business in City B. Partnership files its federal income tax returns with the Internal Revenue Service Center, City C, and is under the audit jurisdiction of the District Director in City B.

Developer is a State A trust established under a declaration of trust dated a, by Individual as Settlor and Trustee. Developer maintains its principal place of business in City D. Developer files its federal income tax returns with the Internal Revenue Service Center, City C, and is under the audit jurisdiction of the District Director in City B.

The activities of Partnership include the development and operation of low-income housing both inside and outside the Northeast. Partnership intends, either directly or through a related partnership of which it or an affiliate will be general partner, to acquire end convert to low-income housing rental use the Condominium. Partnership intends to own and manage the Condominium such that it will qualify for the low-income housing credit provided by section 42 of the Code.

The Condominium originally was developed by Developer, an unrelated real estate developer, for sale as condominium units. Construction of the Condominium was completed in early b, and a Certificate of Occupancy for the building was issued by the Department and dated c. The Condominium was established by a master deed dated d. No individual unit Certificates of Occupancy are issued by the Department for condominium units.

Prior to and after completion of the Condominium, condominium units were advertised for sale in various newspapers in the metropolitan area of City B. Units were offered for outright sale and, in appropriate instances, the newspaper advertising stated that units would be rented to otherwise qualified purchasers with an option to purchase. In the case of units rented to qualified buyers with an Option to purchase, a portion of rentals would be credited toward the purchase price.

All of the condominium units were held for sale, and it was the stated intent of Developer to sell all units. However, the area real estate market was sluggish, and Developer determined that it was necessary to rent some of the less desirable units to defray carrying costs during the sales period. By a written notice dated e, to all brokers and sales associates involved in the sale of the condominium units, the Trustee of Developer, Individual, stated that "[c]ommencing on the above date [e], [Developer] will entertain one year rental application for floors one (1) and (2) ONLY, because these are the least desirable units, at [the Condominium]." These units also continued to be offered for sale into f.

As of g, leases had been executed for the Rented Units in the Condominium. Of these Rented Units, approximately One-half involved leases to tenants under rental/purchase options. The Rented Units ultimately included units on floors in addition to floors one and two. As of the end of f, all leasing activity was halted in anticipation of a sale to Partnership.

In f, Developer entered into negotiations with Partnership for the sale of the Condominium. As noted above, Partnership intends to acquire the Condominium for use as low-income housing, and to qualify it for the low-income housing credit of section 42 of the Code.

Tax counsel to Partnership advised it that Developer's holding out for and rental of certain of the condominium units (the Rented Units) may preclude Partnership from receiving a credit allocation. Counsel was not certain whether all of the condominium units had been placed in service within the meaning of section 42(d)(2)(B)(ii) of the Code so as to prevent it from qualifying for the low-income credit after acquisition by Partnership. Based on the advice of tax counsel, Partnership intends to enter into a purchase and sale agreement to acquire the Condominium contingent upon the receipt of a favorable ruling from the Internal Revenue Service that the unrented condominium units (the Condominium less the Rented Units are referred to as the "Project") had not been placed in service.

Partnership and Developer represent that because of the complexities imposed by local law and local tax and operating considerations, the construction of a building that is divided into separate condominium units through the filing of a master condominium deed generally is not an appropriate method for constructing and holding rental property. Rather, if it is intended that multi-unit residential buildings be held by the developer/owner, unitary ownership is more appropriate.

Partnership and Developer represent that under State A law, each condominium unit is considered to be a separate property consisting of the particular unit and an undivided interest in the common areas. Since each condominium unit is a separate interest that may be held by separate owners, State A law imposes detailed requirements for the creation of condominiums and for defining the relationship between the various unit holders. Specifically, a master deed must be filed and a condominium association created. Management and maintenance must be defined, as well as the method of assessing unit holdings for incurred expenses.

Partnership and Developer further represent that for purposes of local real property taxes within State A, each condominium unit is considered to be a separate assessable property. Each condominium unit is assessed at its fair market value, based either on sales price or on appraisal. Historically, within State A this has resulted, according to Partnership and Developer, in higher overall property taxes being imposed on a structure comprised of condominium units when compared to the taxes that would be assessed if the same building were considered a unitary structure.

Partnership end Developer represent that because of the increased complexity and operating costs resulting from the condominium form of ownership, it makes little economic sense for a developer to convert a unitary building to condominium units if it intends to hold the property as a rental property.

Partnership and Developer represent that in unusual instances, properties may be converted to condominiums without regard to these factors. This could occur where a municipality intends to impose a moratorium on conversion to condominiums and, while the owner intends to continue to hold the property for rent it wishes to preserve future flexibility to sell units as condominiums. It may also occur in certain subsidized mixed-income housing projects where a developer/property owner is required to maintain a certain percentage of units as low-income housing, but wishes to sell a portion of the remaining units to investors or owner/occupants, and the condominium form of ownership facilities [sic] that division.

Partnership and Developer represent that neither of these factors was a consideration in the instant situation since the Department has not imposed a moratorium. Also, Developer and Partnership represent that Developer did not intend to hold units as rentals.

Construction financing for Developer was obtained from Bank, a State A bank. The pro forma submitted by Developer to Bank with the loan application and supporting materials indicate that Developer was constructing the Condominium for sale as condominium units and that unit sales would be the source of repayment of Bank.

Developer and Partnership represent that the express terms of the financing documents are consistent with the development of condominium units for resale rather than for holding the building as rental property. First, the financing was of limited duration and was due and payable in all events on h. Secondly, Developer had no commitment for permanent financing. Thus, the financing documents indicate that the condominium units were constructed for resale and not for holding as rental property.

Partnership and Developer represent that advertisements run in the Newspaper and local papers indicate that the units were held for the primary purpose of sale and not for rental. These advertisements generally were run from i through f.

Developer represents that it has not claimed any depreciation deductions with respect to the condominium units.

Partnership and Developer represent that the economics of the Condominium also indicate that it was not constructed as rental property but only primarily for sale. Construction financing on the Condominium was approximately $j, bearing a k percent interest rate. Assuming that Developer were to obtain permanent financing in that amount and at the same interest rate for a 25-year term, debt service payments would have been approximately $1 per month or $m per year, assuming a direct reduction mortgage. Even without regard to local real estate taxes and other operating costs, this would have required an average monthly rental of $n from each of the units (which varied in desirability). Partnership and Developer represent that this amount is far in excess of the rentals that could be obtained in the local area and it could not be anticipated that the units could be so rented. It was believed, however, that the units were attractively priced for a purchaser/occupant.

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).

Section 42(a) of the Code provides that the amount of the low- credit period shall be an amount equal to the applicable percentage of the qualified basis of each qualified low-income building. Section 42(b)(2)(A) provides that the term applicable percentage, for any qualified low-income building placed in service by the taxpayer after 1987, means 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(h)(1)(A) of the Code provides that the amount of the credit determined under section 42 for any building for any tax year shall not exceed the housing credit dollar amount allocated to such building. A taxpayer is required to 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 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 4(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.

Section 42(i)(4) of the Code provides that the term "new building" means a building the original use of which begins with the taxpayer.

The Service issued guidance on what constitutes a qualified low- income building in IRS Notice 88-91, 1988-26 I.R.B. 28. Notice 88-91 states that final regulations will provide that the term "qualified low-income building" includes residential rental property that is either an apartment building, a single family dwelling, a townhouse, a rowhouse, a duplex, or a condominium. 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. Accordingly, each condominium unit meeting the requirements of section 42 of the Code constitutes a separate qualified low-income building with its separate placed-in-service date.

The Service also issued guidance on what constitutes placing a building in service in IRS Notice 88-116, 1988-2 C.B. 449. Notice 88- 116 provides that the term "placed in service" has two definitions -- one for buildings and one for rehabilitation expenditures that are treated as a separate new building (section 42(e)(4)(A)). 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. In general, a transfer of the building results in a new placed-in-service date if, on the date of transfer, the building is occupied or ready for occupancy.

For further guidance on the term "placed in service" for qualified low-income buildings under section 42 of the Code, the Service looks to the placed-in-service rules in the Income Tax Regulations for both depreciation deductions for real property and investment tax credit under sections 167 and 46 of the Code.

Section 1.167(a)-2 of the regulations provides that the depreciation allowance in the case of tangible property applies only to that part of the property that is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence. The allowance does not apply to inventories or stock in trade, or to land apart from the improvements of physical development added to it.

Section 1.167(a)-10(b) of the regulations provides that the period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service.

Section 1.167(a)-11(e)(1)(i) of the regulations provides that the term "first placed in service" refers to the time the property is first placed in service. Property is first placed in Service when first 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.

Similarly, under section 1.46-3(d) of the regulations, 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 regulations, only depreciable property may be placed in service for purposes of claiming depreciation deductions. Under section 1.167(a)-1(a) of the regulations, depreciable tangible property is property used in the trade or business of a taxpayer or property held by a taxpayer for the production of income. Property held either as inventory or primarily for sale to customers in the ordinary course of a taxpayer's trade or business is not property for which depreciation deductions are allowed pursuant to section 1.167(a)-2 of the regulations.

Under the facts of this case, Developer was involved in both the sale and the rental of the condominium units it constructed. Having engaged in some rental activity during the sales period, Developer represents that it did not intend to hold condominium units as rental units. Only the Rented Units were actually leased to tenants, approximately one-half of whom had rental/purchase options. Thus, for purposes of this letter ruling, we assume, without so ruling, that Developer was holding the condominium units of the Project (the Condominium less the Rented Units) primarily for sale to customers in the ordinary course of Developer's trade or business.

Assuming the Project was held by Developer primarily for sale of its units to customers in the ordinary course of its business, we also assume that the Project was not property for which depreciation deductions were allowed under section 167 of the Code. As stated above, the Service looks to section 1.167 of the regulations for guidance on placement in service as it pertains to the low-income housing credit under section 42. Developer represents that no depreciation deductions were taken on the Condominium. The Certificate of Occupancy issued by Department to Developer for the Condominium evidences availability for occupancy under local law, but is not of itself determinative under the facts of whether the Project was placed in service under section 42. Developer attempted to sell individual condominium units of the Project, and did not enter into leases for any units of the Project. Developer was presumably holding the Project for purposes for which no depreciation is allowed. Therefore, under the above assumptions we conclude that no placement in service has occurred for the condominium units of the Project held by Developer for purposes of the low-income housing credit under section 42.

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 the Project has not been placed in service by Developer, each condominium unit of the Project will constitute a separate new building under section 42(i)(4) when originally placed in service by Partnership.

Based upon the above facts and assumptions, we rule as follows:

Under section 42 of the Code, the condominium units of the Project are not considered placed in service by Developer and will be considered new buildings when acquired by Partnership.

This ruling is directed only to the taxpayer on whose behalf it was requested. 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 letter have not been adopted. Therefore, this ruling letter may be modified or revoked 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, 26. However, when the criteria in section 8.01 of Rev. Proc. 90-1 are satisfied, a ruling is not revoked or modified 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)