Private Letter Ruling 9330013, IRC Section 42

Date: April 29, 1993

Dear ***

This letter responds to your letter of October 21, 1992, submitted on behalf of Taxpayer, requesting rulings on various issues under section 42 of the Internal Revenue Code.

Subsequently, on behalf of Taxpayer you withdrew a request for rulings on ruling request (F) and (G) in your October 21, 1992 letter. With respect to ruling request (B) in that letter, the Service is still considering whether that ruling can be issued. If it is determined that ruling request (B) can be issued, that ruling will be issued in a supplemental letter ruling.

Taxpayer has made the following representations.

Taxpayer is a diversified electric utility company originally incorporated in State X in t1 and in State Y as of t2. Taxpayer is the common parent of an affiliated group as defined in section 1504 of the Code (Affiliated Group), and owns 100 percent of the stock of Corp A, formerly Corp B, which owns 100 percent of the stock of Corp C. The Affiliated Group is subject to the audit jurisdiction of the District Director of City X.

Corp C was incorporated in State Y in t3 and is primarily a holding company. Corp C was acquired by Corp A in t4 and was formerly known as Corp E and Corp F upon acquisition in t4. Corp C owns 100 percent of the Stock of Corp D. Corp D was incorporated in State Z in t5.

Through Corp D and Corp D's controlled affiliates, Taxpayer owns a low-income housing credit projects (the Projects) with approximately b units in ten states throughout the country. Three of the a projects have non- section 42 units; the other properties exclusively provide section 42 units.

The Project A, Project B, Project C, Project D, Project E, Project F, and Project G projects are each owned by a special purpose subsidiary of Corp D. The Project H and Project I projects are held by limited partnerships, all of the partnership interests in which are held by Corp D affiliates. The Project J, Project K, Project L, and Project M projects are held by limited partnerships in which c% of the partnership interests are held by Corp D affiliates. The Project N project is held by a limited partnership in which d% of the partnership interests are held by Corp D affiliates.

Issue 1: Whether application fees are gross rent under section 42(g)(2) of the Code?

Taxpayer charges an application fee at ten of the a projects. Application fees are charged to cover the cost of checking a prospective tenant's income, credit history, and landlord references. The costs vary from project to project, as different credit checking service

companies charge different prices. The fee is intended to recoup only actual out-of-pocket costs of checking credit and landlord references. The fees charged are comparable to those charged in the geographic area surrounding the particular project. In all cases, no amount is charged in excess of the average expected out-of- pocket costs of checking tenant qualification at each project. For example, at the Project M, Project F and Project K projects, the application fee charged is the actual cost of the third party credit checks and is paid directly by the applicant to such third party. The collection of application fees is standard industry practice in the apartment management business.

Analysis and Ruling:

For buildings not subject to the amendments of the Revenue Reconciliation Act of 1989 (the 1989 Act), section 42(g)(2)(A) of the Code provides that a 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 limits applicable to the occupants under section 42(g)(1). For buildings subject to the amendments of the 1989 Act, a residential rental unit is rent-restricted if the gross rent with respect to the unit does not exceed 30 percent of the imputed income limitation applicable to the unit under section 42(g)(2)(C). Furthermore, section 42(g)(2)(A) provides that for buildings subject to the amendments of the 1989 Act, the amount of the income limitation for any period shall not be less than the limitation applicable for the earliest period the building (which contains the unit) was included in the determination of whether the project is a qualified low-income housing project.

Rent in the context of section 42 of the Code is a periodic charge for the right to occupy or use someone else's property. Thus, Taxpayer's one-time application fee that reimburses their out-of- pocket expenses for checking credit, and landlord references is not rent under section 42 (g)(2).

Issue 2: Whether a free rental period is included in calculating a tenants's initial lease term when determining whether a unit is being used on a transient basis under section 42(i)(3)(B)(i) of the Code?

Taxpayer represents that free rent is occasionally offered to tenants of projects that sign an initial six-month or longer lease when competing projects offer such concessions or when a market has turned "soft" (i.e. when vacancy rates increase). The amount of the rent concession is usually 1/2 to one month's free rent, depending on the rental rate of the unit and the level of competitive pressure. The rent concession never exceeds one month's free rent and is comparable to the amount generally offered to tenants in the particular geographic area. On occasion a rent concession has been offered at some of the projects during rent-up in a soft market or when a decline-in occupancy has occurred.

Analysis and Ruling:

Under section 42(i)(3)(B)(i) of the Code a unit is not a low- income unit unless the unit is suitable for occupancy and used other than on a transient basis. Generally, a unit is

considered not to be used on a nontransient basis if the initial lease term is six months or greater. H.R. Rep. No. 841, 99th Cong, 2d Sess. II-95 (1986).

Taxpayer's free rental period of one month or less that is part of a 6-month or longer lease is included in the calculation of the initial lease term's length.

Issue 3: How should Taxpayer treat a maintenance personnel unit and a model unit.

A rent-free unit is provided to certain employees who are required to live on-site and are on-call around the clock. This usually involves a project manager and maintenance person. These employees are responsible for the operation of the property and the security and safety of the residents. Because on average 500 residents live at each project, the on-call employees must deal with a multitude of emergencies and disturbances which occur at any time of the day or night. The maintenance person performs important services such as emergency repairs, maintenance, upkeep and cleaning. Taxpayer has also found that the continuous presence of these employees on-site tends to reduce the level of disturbances at the project.

Taxpayer represents that model units are maintained primarily during a project's rent-up period to show prospective tenants the desirability of the project's units. If the project maintains full occupancy thereafter, the model is usually dismantled and the unit rented out because model units do not generate tenant income for a project owner. However, at a large apartment complex, it is standard industry practice to continuously maintain a model unit that can be shown to prospective tenants for marketing purposes and to be competitive. The use of model units increases the likelihood of renting available units. Projects that do not have model units, but compete against projects with model units, are disadvantaged competitively. By increasing competitiveness, model units contribute to the economic viability of low-income projects. Model units also enable the owners to avoid disturbing tenants who live at the property and delays resulting from providing notice to tenants before obtaining access to occupied apartments. Model units currently exist at *** of the a projects.

Analysis and Ruling:

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 the applicable fraction, determined as of the close of the tax year, of the eligible basis of the building, determined under section 42 (d)(5).

Section 42 (c)(1)(B) of the Code defines the applicable fraction as the smaller of the unit fraction or the floor space fraction. Section 42(c)(1)(B) defines the unit fraction as the fraction the numerator of which is the number of low-income units in the building and the denominator of which is the number of residential rental units, whether or not occupied, in the building. Section 42(c)(1)(D) defines the floor space fraction as the fraction the numerator of which is the total floor space of the low- income units in the building and the denominator of which is the total floor space of the residential rental units, whether or

not occupied, in the building. In general, under section 42(i)(3)(A), a low-income unit is any unit that is rent-restricted and occupied by individuals meeting the income limitation applicable to the building.

Section 42 (d)(1) of the Code provides that the eligible basis of a new building is its adjusted basis as of the close of the first tax year of the credit period. Section 42(d)(4)(A) provides that, except as provided in section 42(d)(4)(B), the adjusted basis of any building is determined without regard to the adjusted basis of any property that is not residential rental property. Section 42(d)(4)(B) provides that the adjusted basis of any building includes the adjusted basis of property of a character subject to the allowance for depreciation used in common areas or provided as comparable amenities to all residential rental units in the building.

The legislative history of section 42 of the Code states that residential rental property, for low-income housing credit purposes, has the same meaning as residential rental property within section 103. The legislative history also states that residential rental property includes residential rental units, facilities for use by the tenants, and other facilities reasonably required by the project. H.R.Conf.Rep. No. 841, 99th Cong., 2d Sess. II-89 (1986), 1986-3 (Vol. 4) C.B. 89. Under section 1.103-8(b)(4) of the Income Tax Regulations, facilities that are functionally related and subordinate to residential rental units are considered residential rental property. Section 1.103-8(b)(4)(iii) of the regulations provides that facilities functionally related and subordinate to residential rental units include facilities for use by the tenants, such as swimming pools and similar recreational facilities, parking areas, and other facilities reasonably required for the project. The examples given by section 1.103-8(b)(4)(iii) of facilities reasonably required for a project specifically include units for resident managers or maintenance personnel.

Rev. Rul. 92-61, 1992-32 I.R.B. 4, holds that the adjusted basis of a unit occupied by a full-time resident manager is included in the eligible basis of a qualified low-income building under section 42(d)(1) of the Code, but the unit is excluded from the applicable fraction under section 42(c)(1)(B) for purposes of determining the building's qualified basis.

A unit occupied by full-time maintenance personnel should be treated like a unit occupied by a full-time resident manager. Thus, the adjusted basis of the full-time, maintenance personnel unit is included in eligible basis under section 42(d)(1) of the Code, but the unit is excluded from the applicable fraction when determining qualified basis under section 42(c)(1)(B).

However, a model unit is a residential rental unit under section 42 of the Code. Therefore, a model unit's cost is included in the building's eligible basis under section 42(d)(1), and is included in the denominator of the applicable fraction when determining a building's qualified basis under section 42(c)(1)(B)

Issue 4: In the year of a transfer of an interest in a low-income housing project, may the applicable credit be allocated between buyer and seller based on the number of days in such year that the project is held by each party?

Interests in the Project M, Project G and Project I project are expected to be sold through limited partnership interests this year.

Analysis and Ruling:

Rev. Rul 91-38, 1991-2 C.B. 3, provides, in part, that under section 42(f)(4) of the Code, the owner who has held the property for the longest period during the month in which a transfer occurs is deemed to have held the property for the entire month and may claim a credit accordingly. In cases in which the transferor and transferee have held the property for the same amount of time during the month of the transfer, the transferor is deemed to have held the property for the entire month and the transferee's ownership of the property is deemed to begin the first day of the following month.

Under Rev. Rul. 91-38 the party that held the property the longest in a given month is considered to have owned the property for all the days in that month. Thus, the Taxpayer may not allocate the credit based on the ACTUAL number of days each party owns the property.

No opinion is expressed or implied regarding the application of any other provisions of the Code or regulations. No opinion is expressed whether the projects otherwise qualify for the low-income housing credit under section 42 of the Code.

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 of final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling may be modified or revoked if the adopted temporary or final regulations are inconsistent with any conclusion of this ruling. See section 11.04 Rev. Proc. 93-1, 1993-1 I.R.B. 10, 39. However, when the criteria in section 11.05 of Rev. Proc. 93-1 are satisfied, a ruling is not revoked or modified 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 Taxpayer.

Sincerely yours,

James Ranson

Chief, Branch 5

Office of the Assistant Chief Counsel

(Passthroughs and Special Industries)