INTERNAL REVENUE SERVICE

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August 3, 2000

Legend

Taxpayer =

General Partner =

Limited Partner =

Project =

State A =

District B =

Location C =

Corporation D =

Agency E =

a =

b =

c =

d =

e =

f =

g =

<u>h</u> =

<u>i</u> =

<u>j</u> =

<u>k</u> =

<u>l</u> =

<u>m</u> =

<u>n</u> =

<u>o</u> =

<u>p</u> =

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<u>v</u> =

This letter responds to your letter dated March 27, 2000, submitted on behalf of the Taxpayer, requesting a private letter ruling on issues surrounding the acquisition and rehabilitation of a residential rental property receiving low-income housing tax credits under section 42 of the Internal Revenue Code. The Taxpayer provides the following representations:

FACTS

Taxpayer was formed on <u>a</u>. Taxpayer is a State A limited partnership operating on a calendar taxable year and an accrual accounting method. The location of the IRS district office possessing examination jurisdiction over the Taxpayer's income tax returns is District B. The Taxpayer's operations to date and future business purpose consist of the following: 1) acquire the real estate project known as the Project, containing <u>b</u> residential rental units in <u>c</u> buildings situated on approximately <u>d</u> acres in Location C; and 2) rehabilitate the Project and then own, operate and manage it as a low-income housing property eligible for low-income housing tax credits under section 42.

The Project was originally constructed in e. It was developed with rental housing assistance sponsored by the U.S. Department of Housing and Urban Development ("HUD") pursuant to the section 236 Rental Assistance Program of the National Housing Act. The section 236 program provided mortgage insurance and interest reduction payments to reduce the debt service burden of the permanent mortgage.

At present, the Project has f units eligible to receive housing assistance payments pursuant to a project-based Housing Assistance Payments contract under the Section 8 program of the United States Housing Act of 1937 ("Section 8"). Another g units are occupied by tenants receiving rental assistance payments pursuant to the Section 8 tenant-based voucher program.

Taxpayer purchased the Project on h, at a cost of i, j of which was attributable to the cost of the c buildings. With other costs capitalized as part of the costs of acquisition, the adjusted basis of the acquired buildings prior to commencement of rehabilitation (for purposes of the minimum expenditure test of section 42(e)(3)(A)(ii)(I)) was approximately k.

At the time of purchase, the Project was l occupied. With the exception of tenant turnover caused by the relocation of over-income households and the temporary displacement of tenants to accommodate construction activity, the Project remained fully occupied through the rehabilitation period. Within a week of acquiring the Project, Taxpayer commenced the process of certifying the income of each of the m households then in occupancy (n units were set-aside for resident managers; o units were vacant or being vacated). Most of the existing tenants were month-to-month tenants, possessing a history of long term residency in the Project of between 3 and 25 years. Under State A law, in general, if a landlord sells his property during an unexpired leasehold term, the purchaser becomes the landlord by operation of law, and the tenant becomes a tenant of the purchaser.

Of the total cost of the Project (acquisition and rehabilitation), p was financed with proceeds of a mortgage loan made to Taxpayer by Corporation D. This loan is insured by HUD pursuant to section 221(d)(4) of the National Housing Act. q of the mortgage loan was funded with proceeds of multifamily housing revenue bonds issued by Agency E. The balance of the mortgage loan (r) was raised with proceeds obtained from the sale of GNMA securities by Corporation D. Approximately s of the Project's costs is being funded by capital contributions of the Limited Partner.

The General Partner represents that (i) 50 percent or more of the Project's aggregate basis will be financed with section 103 tax-exempt bonds in a manner satisfying the requirements of section 42(h)(4)(B) and (ii) the rehabilitation expenditures with respect to each building satisfy the requirements of section 147(d)(2). Because of the tax-exempt financing, the Project will be treated as federally subsidized within the meaning of section 42(i)(2).

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The Project's rehabilitation work was undertaken in stages, and a certificate of substantial completion for the final stage of the rehabilitation work was issued on t. The Taxpayer did not make an election concerning the applicable percentage concerning either a binding commitment with the state housing finance agency under section 42(b)(2)(A)(ii)(I) or in regard to the issuance of the tax-exempt financing under section 42(b)(2)(A)(ii)(II).

REQUESTED RULINGS

The Taxpayer has requested the following rulings:

1) in the present case, the applicable percentage for substantial rehabilitation expenditures treated as a separate new building under section 42(e)(1) is the figure announced for the month in which the substantial rehabilitation expenditures of the Project were completed;

2) the first year applicable fraction for the Project's substantial rehabilitation expenditures is based upon the month-end applicable fraction for each of the u full months (v) during which the Project being rehabilitated was in service;

3) substantial rehabilitation expenditures treated as a separate new building under section 42(e)(1) do not require new tenant income certifications at the time the Project's rehabilitation work was completed and placed in service;

4) the Taxpayer may rely on the rental histories of existing tenants renting on a month-by-month basis provided by the former owner of the building to establish that the low-income units in the Project are used other than on a transient basis under the requirements of section 42(i)(3)(B)(i); and

5) for purposes of determining the first year applicable fraction under section 42(f)(2)(A), the applicable fraction as of the close of the first full month during which the Project is in service may include all low-income units occupied by section 8 tenants for which the public housing authority has provided a statement to the taxpayer declaring that the incomes of such tenants do not exceed the applicable income limit under section 42(g). In addition, annual recertifications for the Project thereafter may also rely on such statements from the public housing authority with respect to the tenants receiving section 8 housing assistance.

LAW

Section 38 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 tax credit determined under section 42(a). The low-income housing tax credit that may be claimed in any year is subject to the general business tax credit limitation of section 38(c).

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 a 10-year credit period shall be the amount equal to the “applicable percentage” of the qualified basis of each qualified low-income building.

Section 42(b)(2)(A) provides that in the case of any qualified low-income building placed in service by the taxpayer after 1987, the term “applicable percentage” means the appropriate percentage prescribed by the Secretary for the earlier of–
(i) the month in which such building is placed in service, or (ii) at the election of the taxpayer–(I) the month in which the taxpayer and the housing credit agency enter into 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. A month may be elected under clause (ii) only if the election is made not later than the 5^{th} day after the close of such month. Such election, once made, shall be irrevocable.

Section 42(b)(2)(B) provides that the percentages prescribed by the Secretary for any month shall be the 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 taxable 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 taxable year (30-percent present value credit).

Section 42(c) provides that the qualified basis of any qualified low-income building for any taxable year is an amount equal to (i) the applicable fraction (determined as of the close of such taxable year) of (ii) the eligible basis of such building (determined under section 42(d)(5)). Under section 42(c)(1)(B), the “applicable fraction” is the smaller of the unit fraction (the number of low-income units divided by the number of all residential rental units) or the floor space fraction (the floor space of the low-income units divided by the floor space of all residential rental units).

In general, the eligible basis of a building under section 42(d) is its adjusted basis at the close of the first taxable year of the credit period. However, a number of limitations apply. For example, under section 42(e)(5), rehabilitation expenditures that a taxpayer elects to treat as a separate new building under section 42(e) may not be considered part of the eligible basis of an existing building under section 42(d).

Under section 42(e)(1), rehabilitation expenditures paid or incurred by the taxpayer for any building are treated as a new building. For calendar years after 1989, rehabilitation expenditures for a building may be treated as a separate new building eligible for the credit under section 42(e)(3)(A) only if (i) the expenditures are allocable to one or more low-income units or substantially benefits such units, and (ii) the amount of such expenditures during any 24-month period meets the greater of the following requirements: (I) the amount is not less than 10 percent of the adjusted basis of the building (determined as of the 1st day of such period and without regard to section 1016(a) (2) and (3)), or (II) the qualified basis attributable to such expenditures, when divided by the number of low-income units in the building, is $3,000 or more. Under section 42(e)(2)(B), the term “rehabilitation expenditures” does not include the cost of acquisition of any building.

Under section 42(e)(3)(A), a taxpayer may aggregate all rehabilitation expenditures incurred during any 24-month period to meet the minimum expenditure requirement of section 42(e)(3)(A). Rev. Rul. 91-38, 1991-2 C.B. 3, 10, provides that if the rehabilitation of a low-income housing building is completed and the minimum expenditure requirement of section 42(e)(3)(A) is met in less than 24 months, the expenditures may be treated as placed in service at the close of that period; however, in no event may the aggregation exceed 24 months. Therefore, rehabilitation expenditures are treated as placed in service at the close of the 24-month or shorter aggregation period in which the rehabilitation is completed and the expenditures requirement of section 42(e)(3)(A) is met.

Section 42(e)(4)(A) provides, in part, that expenditures treated as a separate new building under section 42(e) are considered placed in service at the close of the 24-month period during which the expenditures were incurred. Section 42(e)(4)(B) provides that the applicable fraction under subsection (c)(1) for the rehabilitation expenditures is the applicable fraction for the building (without regard to paragraph (1)) for which expenditures were incurred.

Section 42(e)(5) provides that rehabilitation expenditures may, at the election of the taxpayer, be taken into account under section 42(e) or section 42(d)(2)(A)(i) (i.e., existing building basis) but not under both subsections.

Section 42(f)(1) defines the “credit period” for a low-income housing tax credit building as the period of 10 taxable years beginning with (A) the taxable year in which the building is placed in service or (B) at the election of the taxpayer, the succeeding taxable year, but only if the building is a qualified low-income building as of the close of the first year of such period.

Section 42(f)(2)(A) provides a special rule for the first year of the credit period. Specifically, the credit allowable under section 42(a) with respect to any buildings for the first taxable year of the credit period shall be determined by substituting for the applicable fraction under section 42(c)(1) the fraction–

(i) the numerator of which is the sum of the applicable fractions determined under section 42(c)(1) as of the close of each full month of such year during which such building was in service, and

(ii) the denominator of which is 12.

Section 42(f)(2)(B) provides that any reduction by reason of section 42(f)(2)(A) in the credit allowable (without regard to section 42(f)(2)(A)) for the first taxable year of the credit period shall be allowable under section 42(a) for the first taxable year following the credit period.

Section 42(g)(1) provides the term “qualified low-income housing project” means any project for residential rental property if the project meets the requirements of section 42(g)(1) (A) or (B) whichever is elected by the taxpayer: (A) the project meets the requirements of this subparagraph if 20 percent or more of the residential units in such project are both rent-restricted and occupied by individuals whose income is 50 percent or less of area median gross income; (B) the project meets the requirements of this subparagraph if 40 percent or more of the residential units in such project are both rent-restricted and occupied by individuals whose income is 60 percent or less of area median gross income. An election under this paragraph, once made, shall be irrevocable.

Section 42(g)(2)(A) provides that a residential rental unit is rent-restricted if the gross rent with respect to such unit does not exceed 30 percent of the imputed income limitation (discussed in section 42(g)(2)(C)).

Section 42(i)(3)(A) defines a “low-income unit” as any unit in a building if– (i) such unit is rent-restricted (as defined in section 42(g)(2)), and (ii) the individuals occupying such unit meet the income limitation applicable under section 42(g)(1) to the project of which such building is a part. Section 42(i)(3)(B)(i) provides that a unit shall not be treated as low-income unit unless the unit is suitable for occupancy and used other than on a transient basis.

Section 1.42-5(c)(1)(iii) of the Income Tax Regulations requires the owner of a low-income housing project to certify at least annually to the state housing finance agency that, for the preceding 12-month period the owner has received an annual income certification from each low-income tenant, and documentation to support that certification; or, in the case of a tenant receiving section 8 housing assistance payments, the statement from a public housing authority to the building owner declaring that the tenant’s income does not exceed the applicable income limit under section 42(g). Section 1.42-5(c)(1)(v) requires the owner to certify at least annually that all units in the project were for use by the general public and used on a nontransient basis (except for transitional housing for the homeless provided under section 42(i)(3)(B)(iii)). Generally, a unit is considered to be used on a nontransient basis if the initial lease term is 6 months or greater. See H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-95 (1986), 1986-3 (Vol. 4) C.B. 95.

DISCUSSION

Concerning the Taxpayer's first requested ruling about the appropriate applicable percentage for the Project's rehabilitation expenditures, we note that section 42(e)(1) treats rehabilitation expenditures paid or incurred by the taxpayer with respect to any building as a separate building. Rev. Rul. 91-38, 1991-2 C.B. 3, 10, provides that although section 42(e)(4)(A) treats the expenditures aggregated under section 42(e)(3)(A) as placed in service at the close of the 24-month period permitted for aggregating such expenditures, if the rehabilitation is completed and the minimum expenditures requirement of section 42(e)(3)(A) is met in less than 24 months, the rehabilitation expenditures can be placed in service at the close of that shorter period of time.

In the present case, the minimum expenditures test has been fulfilled for the Project and the rehabilitation work was completed on t. Thus, this date can serve as the placed-in-service date for the rehabilitation work. Section 42(b)(2)(A)(i) provides that the applicable percentage means the appropriate percentage announced by the Secretary for the month in which the building is placed-in-service. Thus, we conclude that the Project can permissibly utilize the applicable percentage for t, the placed-in-service date for the rehabilitation expenditures treated as a separate building.

In regard to Taxpayer's second requested ruling and the first year applicable fraction for the rehabilitation expenditures for the Project, section 42(e)(4)(B) provides that for purposes of applying section 42 with respect to rehabilitation expenditures which are treated as a separate building by reason of section 42(e), the applicable fraction under section 42(c)(1) shall be the applicable fraction for the building (without regard to section 42(e)(1)) with respect to which the expenditures were incurred. We also note that the Conference Committee Report accompanying the Tax Reform Act of 1986 expressed: "Qualified basis [for rehabilitation expenditures] is determined in the same fractional manner as for new construction or acquisition costs even if all rehabilitation expenditures are made only to low-income units." See H.R. Conf. Rep. No. 841, 99th Cong., 2nd Sess. II-90 (1986), 1986-3 (Vol. 4) C.B. 90. Accordingly, the first year applicable fraction rule of section 42(f)(2) is applicable to rehabilitation expenditures treated as a separate new building under section 42(e), and thus the Project's first year applicable fraction is based upon the month-end applicable fraction for each of the u full months (v) during which the Project was in service.

The Taxpayer's third requested ruling is that substantial rehabilitation expenditures treated as a new building under section 42(e) do not need a separate tenant income certification at the time the Project's rehabilitation work is placed in service. We agree. As noted previously, section 42(e)(4)(B) provides that rehabilitation expenditures treated as a separate building utilize the same applicable fraction for the building with respect to which the expenditures were incurred. Quite simply, we do not believe there is a statutory mandate in section 42 for the Taxpayer to engage in a second round of tenant income certifications after performing this task at the time of acquisition of the Project and throughout the rehabilitation process as new tenants are admitted.

In regard to the Taxpayer's fourth requested ruling concerning the establishment of the use of the low-income units in the Project on other than a transient basis, we believe that the requirement of section 42(i)(3)(B)(i) must be evaluated in light of the facts and circumstances unique to the Project. In this case, Taxpayer stepped into the shoes of the prior owner with respect to existing leaseholds. Generally, a lease term of six months or greater for the tenants would indicate that the units were used on other than a transient basis. See, H.R. Conf. Rep. No. 841, supra, at II-95. The Project possessed a very stable tenant population at the time of acquisition, with considerable tenant rental histories in certain units. Indeed, on Taxpayer's acquisition of the Project the majority of the tenants had resided in the units for a minimum of 3 years and some up to 25 years, even though most of the tenants at the time were month-to-month tenants. In light of this stable tenant population, we believe that the Taxpayer's effort to document a tenant's prior longstanding rental history in the Project represents a sufficient means to demonstrate the rental of certain of the low-income units on other than a transient basis, without the necessity of executing new tenant leases. We expressly condition this ruling on the fact that the tenants at the time of acquisition had initial leasehold terms of 6 months or longer with the prior owner of the Project and that Taxpayer did not plan to change use of the units.

The Taxpayer's final requested ruling concerns the issue of utilizing statements from the public housing authority concerning section 8 voucher holders to establish the first year applicable fraction under section 42(f)(2)(A), and thereafter for purposes of meeting the annual tenant income certification requirement under section 1.42-5(c)(iii). We believe that section 1.42-5(c)(iii) provides authority for the Taxpayer to permissibly utilize the statement from the public housing authority not only to initially determine in the first year of the credit period whether the income levels of tenant section 8 voucher holders fulfill the minimum set-aside requirements of section 42(g), but also the subsequent annual tenant income certification requirements throughout the remainder of the compliance period.

No opinion is expressed or implied regarding the application of any other provision of the Code or regulations, including whether the Project qualifies for credit under section 42. In accordance with the power of attorney, we are sending copies of this letter to your authorized representatives.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,
Harold E. Burghart
Assistant to the Branch Chief, Branch 5
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure: 6110 copy