Internal Revenue Service

Number: **200046033**
Release Date: 11/17/2000
Index No.: 42.10-00

Department of the Treasury

P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:5 — PLR-108861-00
Date:
August 23, 2000

Legend:

Taxpayer =

District =

State =

Partnership =

Gen Partner =

Member A =

Member B =

Agency =

a =

b =

c =

d =

e =

f =

g =

h =

Dear :

This letter responds to your letter dated April 13, 2000, and subsequent correspondence, submitted on behalf of Taxpayer, requesting a private letter ruling under § 42(j)(1) of the Internal Revenue Code. The Internal Revenue Service District Office that will have jurisdiction over all returns filed by Taxpayer is District.

Taxpayer represents that the facts are as follows:

FACTS:

Taxpayer was formed under State law on a. Taxpayer is in the business of owning investments in rental real estate, including residential units and office buildings. Taxpayer was initially treated as a partnership for federal tax purposes. On b, Taxpayer intended to file Form 8832, Entity Classification Election, to elect to be treated as a C corporation for federal tax purposes, effective c. However, Taxpayer failed to file timely the election. Upon discovery of the mistake, Taxpayer promptly filed on d, Form 8832 and sought relief under § 301.9100-3 of the Procedure and Administration Regulations which is the subject of a separate ruling request. Taxpayer's members before and after the election remained unchanged.

Partnership, a State limited partnership, owns residential rental property (Project) that qualifies for the low-income housing credit under § 42. Taxpayer owns a e percent limited partner interest in Partnership. The remaining f percent interest in Partnership is owned by Gen Partner, a State limited liability company, as the general partner. The Project was placed in service in g and the § 42(f)(1) election was made to defer the beginning of the credit period until the succeeding year pursuant to § 42(f)(1). Agency allocated low-income housing tax credits under § 42 to the Project in g.

RULINGS REQUESTED:

1. Taxpayer's election to be taxed as a C corporation will not constitute a recapture event under § 42(j) for the low-income housing tax credit allocable to Taxpayer.

2. Taxpayer's election to be taxed as a C corporation will not constitute a recapture event under § 42(j) for the low-income housing tax credit allocable to Partnership.

3. Member A and Member B may claim their allocable portion of the low-income housing tax credit for the period in the taxable year h in which Taxpayer was taxed as a partnership for federal tax purposes and that Taxpayer may claim its

allocable portion of the credit for the period it is taxed as a corporation for federal tax purposes in accordance with § 42(f)(4).

LAW AND ANALYSIS:

Section 38(a) 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 credit determined under § 42(a).

Section 42(a) provides that, for purposes of section 38, the amount of the low-income housing credit determined under § 42 for any taxable year in a 10-year credit period shall be an amount equal to the applicable percentage of 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, § 42(b) provides, in part, that the term "applicable percentage" means the appropriate percentage prescribed by the Secretary for the month applicable under § 42(b)(2)(A)(i) or (ii). 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 taxable year, and (ii) 30 percent of the qualified basis of existing buildings, and of new buildings that are federally subsidized for the taxable year.

Section 42(c) provides that the qualified basis of any qualified low-income building for any taxable year is an amount equal to the applicable fraction (defined in § 42(c)(1)(B)) of the eligible basis of such building. In general, under § 42(d) the eligible basis of a new building is its adjusted basis as of the close of the first taxable year of the credit period.

Section 42(f)(1) provides that the term "credit period" means, with respect to any building, the period of 10 taxable years beginning with the taxable year in which the building is placed in service, or 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. The election under § 42(f)(1)(B), once made, shall be irrevocable.

Section 42(f)(4) provides that if a building (or an interest therein) is disposed of during any year for which credit is allowable under § 42(a), such credit shall be allocated between the parties on the basis of the number of days during such year the building (or interest) was held by each. In any case, proper adjustments shall be made in the application of § 42(j). See Rev. Rul. 91-38, 1991-2 C.B. 3.

Under § 42(j)(1), if at the close of any taxable year in the compliance period, the amount of the qualified basis of any building with respect to the taxpayer is less than the amount of such basis as of the close of the preceding taxable year, the taxpayer's tax for the taxable year will be increased by the credit recapture amount. The credit recapture amount is determined under § 42(j)(2) and § 42(j)(3).

The legislative history to § 42 provides that, generally, any change in ownership of a low-income building during the compliance period is a recapture event and that all dispositions of ownership interests in buildings are treated as transfers for purposes of recapture. See 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess., II-96 and II-102 (1986), 1986-3 (Vol.4) C.B. 1, 96, 102. Under § 42(j)(6), however, no recapture will be imposed on a disposition of a low-income building (or an interest therein) if the taxpayer furnishes to the Secretary a bond, and it is reasonably expected that the building will continue to be operated as a qualified low-income building through the end of the compliance period. A taxpayer may satisfy the bond posting requirement of § 42(j)(6) by completing a portion of Form 8693, Low-Income Housing Credit Disposition Bond, and having it approved by the Internal Revenue Service.

Little guidance is available to illustrate when, under § 42(j), a reduction in qualified basis of a building with respect to the taxpayer has occurred or when there has been a disposition that requires the taxpayer to post a bond to avoid recapture. However, analogous provisions concerning recapture of investment tax credit (ITC) property provide relevant guidance for determining recapture under § 42(j).

Under § 50(a)(1), if during any taxable year ITC property is disposed of or otherwise ceases to be ITC property with respect to the taxpayer before the close of the recapture period, the tax for such taxable year shall be increased. Currently, there are no regulations under § 50. However, for property placed in service before January 1, 1991, former § 47(a)(1) (and the regulations thereunder) contained a similar ITC recapture rule. The regulations under former § 47 (which are still effective) mirror the general recapture rule of former § 47 that a disposition or cessation of ITC property before the close of the estimated useful life of the property that was taken into account in computing the taxpayer's qualified investment will result in ITC recapture. However, there are a number of exceptions to the general rule concerning the recapture of ITC. For example, § 1.47-6(a)(2) provides a de minimis rule that permits a partner to dispose of up to 33-1/3 percent of its proportionate interests in the general profits of a partnership (or in a particular item of section 38 property) before ITC recapture applies. Rev. Rul. 90-60, 1990-2 C.B. 6, adopts a similar de minimis rule for purposes of § 42(j) whereby no bond is required to avoid or defer recapture for any disposition by a partner of its interest in a low-income building held through a partnership (to which § 42(j)(5)(B) does not apply) until the partner has disposed of more than 33-1/3 percent of its greatest total interest in the building held through the partnership. Also § 1.47-3(f)(1) (reflected now, in part, in § 50(a)(4)) provides an exception to ITC recapture in the case of a mere change in form of conducting a trade or business. To qualify for the

§ 1.47-3(f)(1) exception, the following requirements must be met:

> (1) the ITC property must be retained as ITC property in the same trade or business;
>
> (2) the transferor (or in the case where the transferor is a partnership, the partner) of the ITC property must retain a substantial interest in the trade or business,
>
> (3) substantially all the assets (whether or not ITC property) necessary to operate the trade or business must be transferred to the transferee to whom the ITC property is transferred, and
>
> (4) the basis of the ITC property in the hands of the transferee is determined in whole or in part by reference to the basis of the ITC property in the hands of the transferor.

Section 1.47-3(f)(2) provides that a transferor is considered as having retained a substantial interest in a trade or business only if, after the change in form, the transferor's retained interest in the trade or business is substantial in relation to the total interest of all persons or is equal to or greater than the transferor's interest prior to the change in form.

Section 362(a) provides, in part, that if property is received by a corporation in connection with a transaction to which § 351 applies, then the basis of the property will be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on the transfer.

Section 723 provides that a partnership's basis of property contributed to the partnership by a partner is the adjusted basis to the contributing partner at the time of the contribution, increased by the amount of gain recognized by the contributing partner on the transfer.

Section 301.7701-3(a) of the Income Tax Regulations provides, in part, that a business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes as provided in § 301.7701-3(a). An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under § 301.7701-2(b)(2)) or a partnership.

Section 301.7701-3(g)(1)(i) provides that if an eligible entity classified as a partnership elects under § 301.7701(c)(1)(i) to be classified as an association, the partnership is deemed to contribute all of its assets and liabilities to the association in

exchange for stock in the association, and immediately thereafter, the partnership liquidates by distributing the stock of the association to its partners.

Rev. Rul. 84-111, 1984-2 C.B. 88, provides, in part, that where a partnership transferred all of its assets to a newly-formed corporation in exchange for all the outstanding stock of the newly-formed corporation and the assumption by the newly-formed corporation of the partnership's liabilities, followed by the partnership's termination by distributing all the stock of the newly-formed corporation to the partnership's partners in proportion to their partnership interests, § 351 applies. Accordingly, the newly-formed corporation's basis in the assets received from the partnership equals their basis to the partnership immediately before their transfer to the newly-formed corporation under § 362(a).

Section 708(a) provides that a partnership shall be considered as continuing if it is not terminated. Section 708(b)(1)(B) provides that, for purposes of § 708(a), a partnership shall be considered terminated if within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

Final regulations published in the Federal Register on May 9, 1997 (62 Fed. Reg. 25498, T.D. 8717) amend previous regulations under § 708(b)(1)(B). The final regulations provide, in part, that if a partnership is terminated by a sale or exchange of an interest, the following is deemed to occur: the partnership contributes all of it assets and liabilities to a new partnership in exchange for an interest in the new partnership; and, immediately thereafter, the partnership liquidates by distributing interests in the new partnership to the purchaser and the remaining partners, followed by the continuation of the business by the new partnership or its dissolution and winding up. Under § 723, the new partnership takes a basis in the old partnership's property equal to the adjusted basis such property had in the hands of the old partnership (i.e., carryover basis).

Under prior § 708(b)(1)(B) regulations, basis in the old partnership's property did not carryover to the new partnership. As a result, one of the conditions for satisfying the mere-change-in-form exception to ITC recapture under § 1.47-3(f)(1) was not satisfied. This condition, found in § 1.47-3(f)(1)(ii)*(d)*, provides that the basis of ITC property in the hands of the transferee be determined in whole or in part by reference to the basis of the ITC property in the hands of the transferor. Because under the new § 708(b)(1))(B) regulations basis in the old partnership's property carries over to the new partnership, the condition in § 1.47-3(f)(1)(ii)*(d)* is now satisfied.

In the present case, Taxpayer elected under § 301.7701-3(g)(1)(i) to be treated as a C corporation for federal tax purposes. As a result of this election, Taxpayer was deemed to contribute all of its assets and liabilities to a newly-formed corporation in exchange for stock in the corporation, and immediately thereafter, Taxpayer liquidated by distributing the stock of the corporation to Member A and Member B.

Taxpayer's election will also cause a termination of Partnership under § 708(b)(1)(B). Under § 1.708-1(b)(1)(iv), Partnership will be deemed to have contributed all of its assets, including any § 42 property, to a new partnership in return for an interest in the new partnership.

Under the general rule of § 42 that any change of ownership (e.g., transfer) of a building during the compliance period is a recapture event and that all dispositions of ownership interests in buildings are treated as transfers for purposes of recapture, the deemed contribution of Taxpayer's assets under § 301.7701-1(g)(1)(i) is a disposition of an interest in § 42 property and a § 42 recapture event. Recapture liability (if any) will be the responsibility of those members who are members of Taxpayer at the time of the disposition. Member A and Member B were members of Taxpayer at the time Taxpayer made the election under § 301.7701-3(g)(1)(i) and was deemed, in part, to contribute its assets, including an interest in § 42 property, to a newly-formed corporation. Absent an exception, Member A and Member B would be subject to § 42(j) recapture as a result of the deemed contribution (disposition) of an interest in § 42 property by Taxpayer to the newly-formed corporation.

Similarly, the deemed contribution of Partnership's assets under § 1.708-1(b)(1)(iv) is a disposition of § 42 property and a § 42 recapture event. Partnership's partners, Taxpayer and Gen Partner, were partners of Partnership at the time of the disposition. Absent an exception, Gen Partner and Taxpayer would be subject to § 42(j) recapture as a result of the deemed contribution (disposition) of § 42 property by Partnership to the new partnership.

Taxpayer represents that as a result of Taxpayer's election and Partnership's termination, the Project will continue to be used as a low-income housing project that qualifies for the credit under § 42. Further, Taxpayer represents that the interests held by the members of Taxpayer prior to the election will equal the interests held by the members following the election. The interests held by Partnership's partners prior to Partnership's termination will equal the interests held by the partners following the termination. All of Partnership's assets will be deemed transferred to the new partnership under § 1.708-1(b)(1)(iv). Taxpayer also represents that all of Taxpayer's assets will be deemed transferred to the newly-formed corporation upon the election under § 301.7701-3(g)(1)(i). In addition, Taxpayer represents under the election as well as under the partnership termination that the basis of the assets in the hands of the transferee will equal the basis in the hands of the transferor.

We believe that it is appropriate in this case to analogize the § 1.47-3(f) exception for ITC recapture to the determination of recapture under § 42(j). Therefore, Taxpayer's deemed contribution of its interest in the § 42 property to the newly-formed corporation under § 301.7701-3(g)(1)(i) and Partnership's deemed contribution of the

§ 42 property to the new partnership will not be treated as dispositions of § 42 property resulting in recapture of § 42 credits by Member A and Member B, or Taxpayer and Gen Partner.

Accordingly, based solely on the representations and relevant law as set forth above, we rule that no recapture of low-income housing credits under § 42(j)(1) will occur as a result of Taxpayer's election to be treated as a C corporation under § 301.7701-3(g)(1)(i). Further, we rule that no recapture of low-income housing credits under § 42(j)(1) will occur as a result of Partnership's termination under § 708(b)(1)(B).

We also rule that Member A and Member B may claim their allocable portion of the low-income housing tax credit for the period in the taxable year h in which Taxpayer was taxed as a partnership for federal tax purposes and that Taxpayer may claim its allocable portion of the credit for the period it is taxed as a corporation for federal tax purposes in accordance with § 42(f)(4). See Rev. Rul. 91-38, 1991-2 C.B. 3.

No opinion is expressed or implied regarding the application of any other provisions of the Code or regulations, including §§ 50, 708, 7701, and 301.9100. Specifically, we express no opinion on whether Taxpayer, Partnership, or Gen Partner owns a direct or indirect interest that qualifies for the low-income housing tax credit under § 42, the Project otherwise qualifies for the low-income housing tax credit, or whether any other requirement of § 42 is met.

In accordance with the power of attorney, we are sending a copy of this letter ruling to Taxpayer.

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 yours,
Susan J. Reaman, Chief, Branch 5
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure: 6110 copy