Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:5 — PLR-114317-99
Date: February 17, 2000

Legend:

Company =

Parent =

Unrelated Corporation =

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X District

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Dear :

This letter responds to your authorized representative's letter dated August 9, 1999, and subsequent correspondence, on behalf of Company requesting that Company not be required to recapture low-income housing tax credits under § 42(j)(1) of the Internal Revenue Code if Company reduces (or, in two instances, eliminates) the amount of bonds by the bonded amount attributable to credit previously claimed by certain Company subsidiaries. The Internal Revenue Service District Office that will have examination jurisdiction over all returns filed by Company is the X District.

The relevant facts as represented in your submission are set forth below.

FACTS:

Company, Parent, and the a Company subsidiaries subject to this ruling request (the "Relevant Corporations") are accrual basis, calendar-year taxpayers.

Company is an indirectly owned subsidiary of Parent, a State corporation. Parent is the common parent of an affiliated group of corporations that files a consolidated federal income tax return.

Before b, Company invested in c low-income housing projects qualifying for low-income housing tax credits under § 42. Several projects were owned by corporations wholly owned by Company. Other projects were owned by limited partnerships some or all of the interests of which were held by corporations wholly owned by Company. Unrelated parties also held direct or indirect interests in many of the limited partnerships.

Pursuant to a purchase and sale agreement dated d, by and between Unrelated Corporation as buyer and Company as seller, Company sold its interests in e of the c projects to Unrelated Corporation. Company sold the other project to a corporation unrelated to Company or Unrelated Corporation pursuant to a right of first refusal that

the purchaser had for the project. The sales to Unrelated Corporation involved transfers of stock and partnership interests that occurred at three separate closings: as of b, g, and h.

In i, Company filed Forms 8693, Low-Income Housing Credit Disposition Bond, for the j projects for which tax credits had been claimed in k and earlier years and/or was anticipated to be claimed in l. The other o projects were in various stages of development and did not generate tax credits before those projects were sold. The Internal Revenue Service approved all of the Forms 8693 in m.

As part of the sales to Unrelated Corporation, Company sold all of the stock in n corporations. Unrelated Corporation and Company, or their affiliates, made elections pursuant to § 338(h)(10) for o of the n corporations. In addition, p of the corporations acquired by Unrelated Corporation owned interests in projects that did not generate credits before the sale to Unrelated Corporation, and r other corporations held project interests that were transferred shortly before the sale to Unrelated Corporation. Only a Relevant Corporations (i.e., the corporations that claimed credit before the sale and for which no transfer shortly before sale occurred and no § 338(h)(10) election was made) are the subject of this ruling request. (The names and taxpayer identification numbers of the a Relevant Corporations are listed in Attachment A and are incorporated by reference into this ruling.)

In connection with the sale by Company to Unrelated Corporation, some of the partnerships owned by u of the Relevant Corporations terminated under § 708(b)(1)(B). These partnerships owned § 42 projects.

Company specifically represents that:

1. The purchase and sale agreement pursuant to which the interests in all the § 42 projects were sold to Unrelated Corporation require Unrelated Corporation to continue to operate the projects as qualified low-income housing projects under § 42 (and to the best knowledge of the Company, all of the projects have been so operated).

2. For a partnership terminating under § 708(b)(1)(B), each Relevant Corporation owning a direct or indirect interest in the partnership immediately before the partnership's termination continued to own the same direct or indirect interest in the deemed new partnership after the termination.

3. With respect to the Relevant Corporations, § 1.47-1 of the Income Tax Regulations would not have applied to any section 38 property that is subject to recapture due to its being held by a partnership terminated under § 708(b)(1)(B) because the Relevant Corporations would have satisfied the "mere change in form" exception of § 1.47-3(f).

4. Section 42(j)(5)(B) did not apply to any of the partnerships owning § 42 projects in which the Relevant Corporations owned direct or indirect interests.

5. For each year beginning with the year the Relevant Corporations first owned an interest in § 42 property upon which credits were taken (or intended to be taken in 1998) up until the time of Company's sale of the Relevant Corporations to Unrelated Corporation, the Parent, Company and Relevant Corporations have filed a consolidated return.

RULING REQUESTED:

Company requests the Service to rule that Company will not be subject to recapture of low-income housing credits under § 42(j)(1) if the Company reduces the amount of its bonds by the bonded amount previously attributable to credit previously claimed by the a Relevant Corporations.

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.

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. Similarly, § 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.

The consolidated return regulations provide guidance regarding direct and indirect transfers of ITC property, both within and out of the consolidated group. Section 1.1502-3(f)(2)(i) provides generally that during a consolidated return year a transfer of section 38 property (which includes ITC property) from one member of an affiliated group to another member of the group during a consolidated return year is not treated as a disposition within the meaning of former § 47(a)(1). Further, an example in those regulations provides that no recapture applies when a corporation holding ITC property is sold to a member outside the group. Example 5 of § 1.1502-3(f)(3) (which incorporates the facts of Example 1) pertains to a situation in which corporations P, S, and T file a consolidated return for calendar year 1967. In such year S places in service section 38 property having an estimated useful life of more than 8 years. In 1968, P, S, and T file a consolidated return and in such year S sells such property to T. Then, in 1969, P sells all the stock of T to a third party. Example 5 concludes that the sale of T's stock to the third party "will not cause section 47(a)(1) to apply."

Rev. Rul. 82-20, 1982-1 C.B. 6, provides guidance on distributions of stock of a corporation to which ITC property was transferred. In the ruling, corporation P owns 100 percent of subsidiary corporation S, and the two filed a consolidated federal income tax return. A and B, equal owners of P, had conflicts over the running of the business and decided to divide the business into two independent corporations, one owned by A and the other owned by B. To achieve this result, P transferred all the assets of one of the businesses necessary to conduct the trade or business, including section 38 property, to S solely in exchange for additional shares in S and immediately thereafter distributed all the stock of S to A. A then surrendered all its stock in P as part of the transaction. Revenue Ruling 82-20 concludes:

> "When there is no intention at the time of transfer to keep the property within the consolidated group, the transaction should be viewed as a whole and not as separate individual transactions.
>
> * * *
>
> Because the transfer of the section 38 property from P to S is a step in the planned transfer of the property outside the group, the exception in section 1.1502-3(f)(2)(i) of the regulations does not apply. Therefore, the transfer from P to S is a disposition under section 47(a)(1) of the Code."

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, Company, as part of a larger transaction, sold all of the stock of the Relevant Corporations in a taxable transaction to Unrelated Corporation, an entity unrelated to Company or its subsidiaries. As a result of this transaction, Unrelated Corporation became the owner of the Relevant Corporations, including the assets of the Relevant Corporations. These assets include direct and indirect interests (through ownership interests in limited partnerships) in low-income housing projects upon which tax credits had been claimed in 1997 and earlier years and/or were anticipated to be claimed in 1998. Also, as a result of this transaction, the Relevant Corporations are no longer in the affiliated group that includes Parent and Company. Because it was unclear whether Company's sale of the Relevant Corporations to Unrelated Corporation resulted in a disposition of the § 42 projects that would subject the Company or the Relevant Corporations to recapture liability under § 42(j), Company filed (and the Service approved) Forms 8693 for the j projects for which tax credits had been claimed by the Relevant Corporations (in whole or in part) in 1997 and earlier years and/or was anticipated to be claimed in 1998.

Example 5 of § 1.1502-3(f)(3) describes a situation where no recapture of ITC applies when one member of an affiliated group transfers ITC property to another member of the group, then the member holding the ITC property is later sold to an entity outside the group. In accordance with this example, the sale of the Relevant Corporations' stock to Unrelated Corporation resulting in a transfer of all the Relevant Corporations' assets (including it's direct and indirect ownership interests in § 42 property) to Unrelated Corporation is not a disposition of § 42 property resulting in § 42(j) recapture.

Company represents that u of the Relevant Corporations owned interests in partnerships that terminated under § 708(b)(1)(B) as a result of sales or exchanges by other partners in the partnerships. None of these terminating partnerships were partnerships to which § 42(j)(5)(B) applies. Under § 1.708-1(b)(1)(iv), each terminating partnership will be deemed to have contributed all 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, each terminating partnership's contribution is a disposition of the § 42 property and a § 42 recapture event. Recapture liability (if any) will be the responsibility of those partners who are members of the terminating partnerships at the time of the disposition. Although the u Relevant Corporations did not contribute to the sales or exchanges that resulted in the technical termination of the terminating partnerships, they are partners in the terminating partnerships at the time these partnerships contribute their assets, including any § 42 property, to the new partnerships. Absent an exception, the Relevant Corporations would be subject to § 42(j) recapture as a result of the deemed

contribution (disposition) of § 42 property by the terminating partnerships to the new partnerships.

Company has represented that the purchase and sale agreement pursuant to which the interests in all the § 42 projects were sold to Unrelated Corporation require Unrelated Corporation to continue to operate the projects as qualified low-income housing projects under § 42 (and to the best knowledge of the Company, all of the projects have been so operated). Company has also represented that each Relevant Corporation owning a direct or indirect interest in a project partnership immediately before the partnership's termination continued to own the same direct or indirect interest in the deemed new partnership after the termination. In addition, Company has represented that, with respect to the Relevant Corporations, § 1.47-1 would not have applied to any section 38 property that is subject to recapture due to its being held by a partnership terminated under § 708(b)(1)(B) because the Relevant Corporations would have satisfied the "mere change in form" exception of § 1.47-3(f).

Assuming the requirements of § 1.47-3(f) are met, no recapture liability would have resulted from the disposition of section 38 property by the terminating partnerships; and the Relevant Corporations, who are partners in the terminating partnerships at the time of the dispositions, likewise would not be subject to ITC recapture. We believe that it appropriate in this case to analogize the § 1.47-3(f) exception for ITC recapture to the determination of recapture under § 42(j). Therefore, based on the analogous application of § 1.47-3(f), the deemed contribution of the § 42 property to the new partnerships under § 708(b)(1)(B) will not be treated as a disposition of § 42 property resulting in the recapture of § 42 credits by the u Relevant Corporations.

Accordingly, based solely on the representations and relevant law as set forth above, we rule that Company will not be subject to recapture of low-income housing credits under § 42(j)(1) if the Company reduces the amount of its bonds by the bonded amount previously attributable to credit previously claimed by the a Relevant Corporations.

No opinion is expressed or implied regarding the application of any other provisions of the Code or regulations, including §§ 50, 708, and 1502. Specifically, we express no opinion on whether Company, Relevant Corporations, or any partnership owning § 42 property in which the Relevant Corporations own a direct or indirect interest (either before or after the sale of Relevant Corporation stock to Unrelated Corporation) qualifies for the low-income housing credit under § 42, or whether any other requirement of § 42 is met. In addition, no opinion is expressed or implied regarding how much the bonded amounts are to be reduced to reflect credit previously claimed by the Relevant Corporations.

In accordance with the power of attorney, we are sending a copy of this letter ruling to the Company's 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 yours,

Harold E. Burghart
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Enclosure:
6110 copy