Internal Revenue Service
Revenue Ruling 91-38

(Low Income Housing Credit Questions and Answers)

Rev. Rul. 91-38

PURPOSE

This revenue ruling answers certain questions about the low-income housing credit provided for in section 42 of the Internal Revenue Code.

LAW

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

Section 42(a) of the Code, added by section 252 of the Tax Reform Act of 1986 (the "1986 Act"), 1986-3 (Vol. 1) C.B. 106, provides that, for purposes of section 38, the amount of the low-income housing credit determined under section 42 for any tax year in the credit period shall be an amount equal to the "applicable percentage" of the qualified basis of each qualified low-income building.

Credit Period

Section 42(f)(1) of the Code, as amended by section 1002(1)(2)(B) of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), 1988-3 C.B. 1, 34, defines the credit period of any building as the period of 10 tax years beginning with the tax year in which the building is placed in service, or at the taxpayer's irrevocable election, the succeeding tax year, but in either case only if the building is qualified low-income building as of the close of the first year of the credit period.

For purposes of calculating the credit allowable for the first tax year of the credit period, section 42(f)(2) of the Code reduces the credit by applying the following first-year convention: the fraction used to determine qualified basis at the end of the first year is the sum of applicable fractions determined at the end of each full month the building was in service during that year, divided by 12. In the first tax year following the credit period, a taxpayer may recover any reduction in credit caused by applying the first-year convention during the first year of the credit period.

Applicable Percentage

In the case of any qualified low-income building placed in service by the taxpayer after 1987, section 42(b)(2)(A) of the Code provides that the term "applicable percentage" 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 the housing credit agency enter into an agreement with respect to the building (which is binding on the agency, the taxpayer, and all successors in interest) as to the housing credit dollar amount to be allocated to the 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. 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, in the case of new buildings that are not federally subsidized for the tax year (70 percent present value credit), and (ii) 30 percent of the qualified basis, in the case of new buildings that are federally subsidized for the tax year and existing buildings (30 percent present value credit). The appropriate credit percentages for each month are published monthly in the revenue ruling containing the applicable federal rates.

Section 42(i)(2)(A) of the Code provides, in part, that for purposes of section 42(b)(1), a new building shall be treated as federally subsidized for any tax year if, at any time during the tax year or any prior tax year, there is or was outstanding any obligation the interest on which is exempt from tax under section 103, or any below market federal loan (as defined in section 42(i)(2)(D)), the proceeds of which are or were used (directly or indirectly) with respect to the building or its operation.

Under section 42(b)(1) of the Code, for any qualified low-income building placed in service by the taxpayer during 1987, the applicable percentage for new buildings not federally subsidized is 9 percent and the applicable percentage for existing or federally subsidized buildings is 4 percent.

After calendar year 1989, existing buildings that receive moderate rehabilitation assistance under section 8(e)(2) of the United States Housing Act of 1937, 42 U.S.C. 1437f (1988), at any time during the credit period, generally are not eligible for an allocation of credit. See section 7108(h)(5) of the Revenue Reconciliation Act of 1989 (the "1989 Act"), 1990-1 C.B. 214, 222. The provisions of the 1989 Act generally are effective for buildings allocated housing credit dollar amounts after calendar year 1989. If no allocation is necessary by reason of section 42(h)(4) of the Code because the building is substantially financed with certain tax- exempt obligations, the

provisions are generally effective for buildings placed in service after December 31, 1989.

The Revenue Reconciliation Act of 1990 (the "1990 Act"), (Pub. L. No. 101-508), provides a limited exception from the exclusion of buildings receiving moderate rehabilitation assistance under section 8(e)(2) of the United States Housing Act of 1937. Beginning with allocations made after 1990, buildings receiving assistance under the Stewart B. McKinney Homeless Assistance Act of 1988 (as in effect on the date of enactment of the 1990 Act) may be eligible for an allocation of credit.

Rehabilitation Expenditures

Under section 42(e)(3)(A) of the Code as in effect prior to the 1989 Act, rehabilitation expenditures paid incurred by the taxpayer with respect to any building could be treated as a separate new building only if the qualified basis attributable to rehabilitation expenditures incurred during any 24-month period, when divided by the number of low-income units in the building, was $2,000 or more. For calendar years after 1989, rehabilitation expenditures with respect to 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 benefit 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, 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), as in effect both before and after the 1989 Act, the term "rehabilitation expenditures" does not include the cost of acquisition of any building.

Former section 42(d)(5)(C) of the Code, which was added by TAMRA, and which is now section 42(d)(5)(B), provides that the eligible basis of any building shall not include any portion of the building's adjusted basis attributable to amounts with respect to which an election is made under section 167(k). The election under section 167(k) is an election to depreciate rehabilitation expenditures incurred with respect to low-income rental housing after July 24, 1969, and before January 1, 1987, under a straight line method using a useful life of 60 months. If no election is made under section 167(k), rehabilitation expenditures incurred by a taxpayer with respect to a low-income rental housing building may be included in the building's eligible basis. Section 1.167(k)- 1(b)(1) of the Income Tax Regulations provides rules governing when a taxpayer will be treated as having paid or incurred rehabilitation expenditures.

Under section 1.167(k)-1(b)(1) of the regulations, a taxpayer generally is treated as having paid or incurred rehabilitation expenditures if the rehabilitation is performed by or for the taxpayer or in accordance with the taxpayer's specifications, or if the taxpayer acquires the property attributable to the expenditures (or an interest therein) before the property is placed in service. Section 1.167(k)-1(b)(2) provides that the amount of rehabilitation expenditures treated as paid or incurred by the taxpayer is the lesser of (i) the rehabilitation expenditures paid or incurred before the date on which the taxpayer acquired an interest in the property attributable to the expenditures, or (ii) the taxpayer's cost or other basis for the property attributable to the rehabilitation expenditures paid or incurred before such date. Rehabilitation expenditures treated as having been paid or incurred by the taxpayer are deemed to have been paid or incurred on the date on which the expenditures were actually paid or incurred, determined in accordance with the method of accounting used by the person that actually paid or incurred the expenditures.

A taxpayer acquiring a building from a governmental unit may elect, under section 42(e)(3)(B) of the Code, to meet only the requirement that the qualified basis attributable to the rehabilitation expenditures incurred with respect to the building will be $3,000 or more when divided by the number of low-income units in the building. A taxpayer making this election may claim only the 30 percent present value credit on those expenditures.

Section 42(e)(4)(A) of the Code 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. According to section 42(e)(4)(B), the applicable fraction for the rehabilitation expenditures is the applicable fraction for the building with respect to which the expenditures were incurred.

Qualified Basis

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 (i) the "applicable fraction" (determined as of the close of the tax year) of (ii) the eligible basis of the building (determined under section 42(d)). 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) of the Code is its adjusted basis at the close of the first tax year of the credit period. However, a number of limitations apply. For example, if an existing building does not meet the requirements of section 42(d)(2)(B) (as described below), its eligible basis is zero under section 42(d)(2)(A)(ii). In addition, 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)(2)(A)(i).

Requirements for Existing Buildings

Section 42(d)(2)(A) and (B) of the Code provides that the eligible basis of an existing building will be zero unless the building meets the following requirements: (i) the building is acquired by purchase (as defined in section 179(d)(2)); (ii) there is a period of at least 10 years between the date of the building's acquisition by the taxpayer and the later of (I) the date the building was last placed in service, or (II) the date of the building's most recent nonqualified substantial improvement (as defined in section 42(d)(2)(D)(i)); and (iii) the building was not previously placed in service by the taxpayer or by any person who was a related person with respect to the taxpayer as of the time the building was previously placed in service. Furthermore, existing buildings are eligible for a credit allocation after calendar year 1989 only if a credit is allowable by reason of substantial rehabilitation of the building under section 42(e).

In determining when a building was last placed in service for purposes of satisfying the requirement in section 42(d)(2)(B)(ii) of the Code, section 42(d)(2)(D)(ii) provides that certain placements in service are not taken into account. The 1990 Act provides that as of November 5, 1990 (the date of its enactment), any placement in service of a single-family residence by any individual who owned and used the residence for no other purpose than as a principal residence is not taken into account for purposes of determining whether the 10- year requirement is met. See section 42(d)(2)(D)(ii)(V).

Transfers During the Compliance Period

Section 42(d)(7)(A) and (B) of the Code provides, in general, that the requirements of section 42(d)(2)(B) do not apply if a taxpayer acquires an existing building (or interest therein) for which a credit was allowed to any prior owner under section 42(a) and the taxpayer acquires the building (or interest therein) before the end of the building's compliance period. In that case, section 42(d)(7)(A)(ii) provides that the credit allowable to the taxpayer for any period after the acquisition is equal to the amount of credit that would have been allowable for that period to the prior owner had the owner not disposed of the building (or interest therein).

In general, a transfer of the property results in a new placed in service date if, on the date of the transfer the property is ready and available for its intended purpose. See 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-91 (1986), 1986-3 (Vol. 4) C.B. 91. However, if section 42(d)(7) of the Code applies to a transfer of the property, the fact that the transfer results in a new placed in service date does not jeopardize the purchaser's eligibility to claim the low-income housing credit, because the requirements of section 42(d)(2)(B) do not apply. According to section 42(f)(4), the credit will be allocated among the parties on the basis of the number of days the building (or interest) was held by each.

Definition of a Qualified Low-Income Housing Project

Under section 42(g)(1) of the Code, a "qualified low-income housing project" is any project for residential rental use that meets one of the following requirements: (A) 20 percent or more of the residential units in the project are both rent-restricted and occupied by individuals whose income is 50 percent or less of area median gross income, as adjusted for family size, or (B) 40 percent or more of the residential units in the project are both rent- restricted and occupied by individuals whose income is 60 percent or less of area median gross income, as adjusted for family size. Once the taxpayer elects which requirement the project will meet, the election is irrevocable.

For buildings not subject to the amendments of 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.

Under section 42(i)(3)(B) of the Code, low-income units must be suitable for occupancy and used other than on a transient basis. Additionally, section 42(i)(3)(C) provides that no unit in a building that has four or fewer residential rental units shall be treated as a low-income unit if the owner of the units is (i) the occupant of a residential unit in the building, or (ii) is related to an occupant of a unit (as "related" is defined in section 42(d)(2)(D)(iii)). However, for calendar years after 1989, if a building is acquired or rehabilitated under a development plan of action sponsored by a State or local government or a qualified nonprofit organization (as defined in section 42(h)(5)(C)), the owner-occupant restriction of section 42(i)(3)(C) is inapplicable. In this case, the applicable fraction shall not exceed 80 percent of the unit fraction and any unit that is not rented for 90 days or more shall be treated as occupied by the owner of the building as of the 1st day it is not rented.

Recapture of Credit

According to section 42(j)(1) and (2) of the Code, if at the close of any tax year in the compliance period the building's qualified basis with respect to the taxpayer is less than the basis as of the close of the preceding tax year, then the taxpayer is liable for additional tax in an amount equal to the accelerated portion of credits allowed in earlier years with respect to the reduction in qualified basis, plus interest. The accelerated portion of the credit under section 42(j)(3) is the excess of (A) the aggregate credit allowed for those years for that basis, over (B) the aggregate credit that would be allowable for those years for that basis if the aggregate credit that would have been allowable for the entire compliance period were allowable ratably over 15 years, rather than 10 years.

If a building fails to remain part of a qualified low-income housing project (for example, because of non-compliance with the minimum set-aside requirement or the rent restrictions or other requirements imposed on the units constituting the set-aside) during the building's 15-year compliance period, the taxpayer or taxpayers that owned the building (or interests therein) must repay the entire accelerated portion of the credit, with interest, for all prior years. Generally, any change in ownership of a building during the building's compliance period is also a recapture event. See 2 H.R. Conf. Rep. No. 841, at II-96.

Section 42(j)(6) of the Code permits the taxpayer to avoid recapture upon disposition of the building or an interest therein by furnishing a bond to the Secretary in an amount satisfactory to the Secretary and for the period required by the Secretary, if the building is reasonably expected to continue to be operated as a qualified low-income building. Furthermore, for partnerships consisting of 35 or more partners, unless the partnership elects otherwise, no change in ownership will be deemed to occur if within a 12-month period at least 50 percent (in value) of the original ownership is unchanged. See 2 H.R. Conf. Rep. No. 841, at II-96, and H.R. Conf. Rep. No. 1104, 100th Cong., 2d Sess. II-83 (1988), 1988-3 C.B. 473, 573. A de minimis rule may apply to certain dispositions of interests in partnerships (other than large partnerships described in section 42(j)(5)) that own buildings for which a credit was claimed. See Rev. Rul. 90-60, 1990-2 C.B. 3, for additional information.

Allocation of Credit by Housing Credit Agencies

Under section 42(h)(1) of the Code, a taxpayer may not claim a credit on a qualified low-income building in excess of the housing credit dollar amount allocated to the building by the state or local housing agency in whose jurisdiction the building is located. However, under section 42(h)(4) a taxpayer need not obtain a credit allocation for the portion of a building's eligible basis financed by an obligation which is subject to the volume cap of section 146 and the interest on which is exempt from tax under section 103. Prior to the 1989 Act, if such an obligation financed 70 percent or more of the aggregate basis of the building and the land on which it was located, the entire building was exempt from the limits of section 42(h)(1). Under the 1989 Act, buildings placed in service after calendar year 1989 are exempt from the limits of section 42(h)(1) if 50 percent or more of the aggregate basis of the building and the land on which it is located are financed with such tax-exempt obligations.

Section 42(h)(2)(A) of the Code provides that the housing credit dollar amount allocated to a building for any calendar year applies to the building for all tax years in its compliance period that end during or after the year of allocation. However, under section 42(h)(1)(B), as amended by TAMRA, an allocation is taken into account only if it occurs not later than the close of the calendar year in which the building is placed in service, unless one of the exceptions in section 42(h)(1)(C), (D), (E), or (F) apply. Under section 42(h)(2)(B), the allocation reduces the credit agency's allocable housing credit dollar amount only for the year of the allocation.

QUESTIONS AND ANSWERS

A. *DETERMINATION OF CREDIT PERIOD ISSUES*

QUESTION 1.

How do taxpayers make the election under section 42(f)(1) of the Code to defer the start of the credit period?

ANSWER 1.

The building owner may elect under section 42(f)(1) of the Code to begin the credit period (and the compliance period) the year after the building is placed in service by checking the appropriate box on line 5a in Part II of Form 8609, Low-Income Housing Credit Allocation Certification. Form 8609 must be attached to the owner's federal income tax return for each year of the 15-year compliance period, which begins with the first year of the credit period. If the owner does not claim a low-income housing credit on its timely filed federal income tax return (taking any extensions into account) for the year in which the building is placed in service, or fails to timely file its federal income tax return for that year, the owner is deemed to have made the irrevocable election to begin the credit period (and the compliance period) the succeeding tax year. In the case of buildings held by flow-through entities, only the entity may file a Form 8609 to make the election under section 42(f)(1). Only one election may be made per building. If there are multiple owners that are not members of a flow-through entity, and each owner files a Form 8609 with respect to a building, all of the Form 8609s for that building must be consistent with regard to whether the election is made. Unless all the owners of a particular building make the section 42(f)(1) election, the credit period and compliance period for that building will begin with the year in which the building is placed in service. Once made, an election under section 42(f)(1) is binding on the owner and all successors in interest.

QUESTION 2.

X, a calendar year corporation, was created on June 1, 1987. On July 1, 1987, X placed in service a qualified low-income building. If X chooses not to defer the beginning of the credit period under section 42(f)(1) of the Code, when does the credit period for the building begin?

ANSWER 2.

A building's credit period is the period of 10 years (120 months) beginning with the first day of the tax year in which the building is placed in service, or the succeeding tax year if the election under section 42(f)(1) of the Code is made. The tax year that a building is placed in service is determined, at the time of placement in service, by the tax year of the owner who placed the building in service and is not affected by subsequent changes in the tax year of that owner or by the introduction of subsequent owners with different tax years.

Each building has only one credit period. For purposes of section 42(f) of the Code, when the first tax year of the credit period is a short tax year, the credit period begins 12 months before the end of the short tax year. In other words, the credit period begins on what would have been the first day of the tax year, had the tax year not been a short tax year.

Because X came into existence on June 1, 1987, X had a short tax year for calendar year 1987. Because X did not elect to defer the start of the credit period to the succeeding year, which would have been its first full tax year, the building's credit period began 12 months before the end of X's short tax year. Therefore, the credit period began January 1, 1987, rather than the first day of the short tax year, June 1, 1987. The credit for the first year of the credit period is computed according to the first-year convention in section 42(f)(2) of the Code.

B. *CREDIT COMPUTATION ISSUES*

QUESTION 3.

X, a calendar year corporation, placed a newly constructed qualified low-income building in service on February 1, 1987. X received a $90,000 housing credit allocation for 1987 from the state Y housing credit agency based upon the 9 percent applicable credit percentage and had a qualified basis in the building as of December 31, 1987, of $1,000,000. X did not elect to defer the start of the credit period under section 42(f)(1) of the Code. For calendar year 1987, X claimed a credit using the first-year convention of section 42(f)(2).

During calendar year 1988 (the second year of the credit period), because of a change in annual accounting period permitted under section 442 of the Code, X made a short-period return for the 8-month period beginning January 1, 1988, and ending August 31, 1988. May X claim any low-income housing credit on its short-period return?

ANSWER 3.

Yes. As Answer 2 explains, the building's credit period is determined, at the time of placement in service, by reference to the tax year of the owner who placed the building in service, and is not affected by subsequent changes in the owner's tax year. The amount of credit that a particular owner may claim on its return for a tax year is determined on the last day of that owner's tax year. Because X was a calendar year taxpayer and did not elect to defer the start of the credit period, the building's credit period begins

January 1, 1987, and ends December 31, 1996.

In accordance with section 42(a) of the Code, the amount of credit that X may claim on the short-period return is an amount equal to the product of the applicable percentage of 9 percent and 8/12 of the building's qualified basis as of August 31, 1988. X is entitled to only 8/12 of the applicable percentage of the qualified basis on the last day of the short-period tax year because the short period includes only 8 months. If the qualified basis was $1,000,000 on August 31, 1988, X would be allowed to claim a credit on its short- period return of $60,000 [(.09) x (8/12 x $1,000,000)]. Assuming X retains ownership of the building, continues to comply with the requirements of section 42 of the Code and remains on an August 31 tax year, for each succeeding tax year in the credit period the credit is based upon the qualified basis as of August 3l of that tax year. If the qualified basis on August 31, 1989, is $1,000,000, X may claim a credit of $90,000 [(the applicable percentage, .09) x ($1,000,000)] on its federal income tax return for the tax year ending August 31, 1989.

The last 4 months in the credit period (September 1996 through December 1996) are included in X's tax year beginning September 1, 1996, and ending August 31, 1997. The credit for those 4 months is based upon 4/12 of the qualified basis as of August 31, 1997. The credit for X's tax year ending August 31, 1997, consists of the credit for the last 4 months of the credit period plus the disallowed first year credit amount that is carried over to the 11th year under section 42(f)(2)(B) of the Code. See Question and Answer 5 below.

C. *AVAILABILITY OF CREDIT TO SUBSEQUENT PURCHASERS*

QUESTION 4.

What is the meaning of the word "allowed" as used in section 42(d)(7)(B)(i) of the Code, which permits a subsequent owner to step into the shoes of a prior owner and claim a credit on a qualified low-income building, but only if the credit was "allowed" to a prior owner?

ANSWER 4.

For purposes of section 42(d)(7)(B)(i) of the Code, the term "allowed" may also mean "allowable." If a qualified low-income building is acquired during the building's compliance period, section 42(d)(7)(B)(i) requires that a credit must have been allowed to a prior owner of the building if the new owner is to continue claiming the credit. In this manner, credits may be transferred to the new purchaser of a building (or interest therein) during the period for which the property is eligible to receive the credit, with the new purchaser "stepping into the shoes" of the seller as to credit percentage, basis, and liability for compliance and recapture. See 2 H.R. Conf. Rep. No. 841, at II-87. The purchaser's basis upon acquisition of the building (or interest therein) for section 42 purposes equals the eligible basis of the building (or interest therein) whether the purchase price is greater or less than that basis.

A credit need not actually have been claimed by a prior owner in order for a subsequent owner to claim the credit under section 42(d)(7) of the Code. If a taxpayer transfers a qualified low-income building (or an interest therein) before actually claiming a credit, but after having received an allocation or having qualified for the credit without an allocation (as provided in this ruling) under section 42(h)(4)(B), the credit will be considered allowed to the prior owner for purposes of section 42(d)(7)(B)(i). However, in order to be treated as having been allowed a credit, a prior owner must have actually received a low-income housing credit allocation for the building from a state housing credit agency before the transfer or must have actually qualified for the credit under section 42(h)(4)(B).

A state credit agency makes an allocation after reviewing the application submitted by the building owner and determining that the building will probably qualify as a qualified low-income building. A state credit agency may issue a reservation of a credit amount or a binding commitment to allocate credit in a later year as a preliminary step to issuing a credit allocation but, unlike a credit allocation, a reservation or a binding commitment may be revoked (for example, if specified conditions are not met by the building owner). Therefore, if a taxpayer transfers a qualified low-income building (or an interest therein) after the state agency reserves a low-income credit for that building but before the agency actually allocates that credit to that building, the credit will not be considered allowed to the prior owner within the meaning of section 42(d)(7)(B)(i) of the Code. If the credit is not considered allowed to the prior owner but the building has not been placed in service so that there is no violation of the 10-year rule in section 42(d)(2)(B)(ii) (and if the requirements of section 42 are otherwise met), the purchaser may apply to the state housing credit agency for an allocation of credit.

If a taxpayer receives an allocation with respect to a new building during the construction period of the building, as may be the case where the taxpayer expects to use the 10 percent carryover allocation rule in section 42(h)(1)(E) of the Code, and transfers the building (or an interest therein) before the building is

placed in service, the purchaser will take an eligible basis in the building (or interest therein) equal to the transferor's eligible basis in the building (or interest) at the time of transfer, whether the purchase price is greater or less than that basis. Because the property has not yet been placed in service, the eligible basis of the building has not yet been determined. The purchaser's eligible basis is determined at the end of the first tax year of the credit period. That eligible basis consists of both the transferor's eligible basis at the time of transfer and any additional costs incurred by the purchaser after the transfer, to the extent includible in eligible basis.

In the case of buildings placed in service after 1989 and financed with tax-exempt bonds issued after 1989, if a credit allocation is not necessary because the building meets the requirements of section 42(h)(4)(B) of the Code, the credit will be considered allowed to the prior owner for purposes of section 42(d)(7)(B)(i) when the following conditions are met: (1) the tax-exempt obligations have been issued; (2) the building has met the requirements for allocation of a housing credit dollar amount under the qualified allocation plan applicable to the area in which the project is located as required by section 42(m)(1)(D); (3) the governmental unit issuing the bonds has determined the credit dollar amount necessary for the financial feasibility of the project and its viability as a qualified low-income housing project throughout the credit period as required by section 42(m)(2)(D); and (4) the state housing credit agency has assigned a building identification number (B.I.N.) to the building as is customarily done when an allocation of credit is made by the state housing credit agency.

In the case of buildings financed with tax-exempt bonds issued before 1990, if a credit allocation is not necessary because the building meets the requirements of section 42(h)(4)(B) of the Code, the credit will be considered allowed to the prior owner for purposes of section 42(d)(7)(B)(i) when the following conditions are met: (1) the tax-exempt obligations have been issued; and (2) the state housing credit agency has assigned a B.I.N. to the building as is customarily done when an allocation of credit is made by the state housing credit agency.

Rev. Rul. 91-38, Table 1

Month	Number of occupied low-income units	Total number of units
March	2	10
April	2	10
May	2	10
June	2	10
July	4	10
August	6	10
September	7	10
October	9	10
November	10	10
December	10	10

QUESTION 5.

On March 1, 1987, developer D, a calendar-year taxpayer, placed in service a newly completed qualified low-income building. The building consisted of 10 units, all of which were expected to be occupied by low-income tenants. The qualified basis of the building was $100,000. D received a $9,000 housing credit dollar amount allocation for 1987 from the state housing credit agency based upon the 9 percent applicable percentage for newly constructed non-federally-subsidized buildings. D chose not to make the election under section 42(f)(1) of the Code to defer the start of the credit period. On July 20, 1987, D sold the building to T, whose tax year ends August 31. At the time of sale, D had not yet claimed any credit with respect to the building for the period preceding the transfer. Table 1 shows the number of units in the building that were occupied by low-income tenants at the close of each full month between March 1, 1987, and December 31, 1987, the close of the tax year during which the building was placed in service.

Is T eligible for the low-income housing credit under section 42 of the Code?

ANSWER 5.

Yes. Although D had not claimed any of the low-income housing credit prior to the transfer, D received a housing credit dollar amount allocation before the sale of the property, and D would have been allowed to claim a credit if D had retained ownership of the property and had complied with the requirements of section 42 of the Code. Therefore, under section 42(d)(7), T may "step into the shoes" of D and may claim the tax credit that would have been allowable to D for the period after the acquisition, provided that T complies with the requirements of section 42. See Question and Answer 4.

The building's credit period is determined by reference to the tax year (at the time of placement in service) of D, the owner who

placed the building in service, and is not affected by differing tax years of succeeding owners. However, the amount of credit that a particular owner may claim on a return for a tax year is determined on the last day of that owner's tax year. Had D, a calendar-year taxpayer, chosen to make the election under section 42(f)(1) of the Code to defer the start of the credit period, T would have calculated the credit as of January 1, 1988, the first day of the first year of the building's credit period, even though T owned the building prior to the start of the credit period.

For purposes of 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. In this example, for purposes of calculating the credit that T is entitled to claim, T does not immediately "step into the shoes" of D when the transfer occurs on July 20, 1987. Instead, because D held the property for more than half of the month of July, T may not begin claiming the credit that would have been allowable to D until August 1, 1987. Thereafter, T may claim the credit that would have been allowable to D until the end of the credit period (assuming T retains ownership of the property and the requirements of section 42 of the Code are otherwise met).

Because D, the taxpayer that placed the building in service, was a calendar year taxpayer and because D chose not to make the election under section 42(f)(1) of the Code to defer the start of the credit period, the building's credit period begins the first day of calendar year 1987 (January 1, 1987) and continues for 120 months (until December 31, 1996). The first year of the building's credit period is the period from January 1, 1987, through December 31, 1987.

Under section 42(f)(2) of the Code, the applicable fraction used for determining the credit with respect to any building for the first tax year of the credit period is 1/12 of the sum of the applicable fractions determined under section 42(c)(1) as of the close of each full month of that year during which the building was in service. The sum of the applicable fractions determined under section 42(c)(1) for the period between March 1, 1987 (the date the building was placed in service), and July 31, 1987 (the date through which D is deemed to have owned the property), is 2/10 + 2/10 + 2/10 + 2/10 + 4/10, for a total of twelve-tenths (12/10), which when divided by 12, yields 1/10 or 0.1. Under section 42(f)(2), the credit amount that pertains to the portion of the tax year from March 1, 1987, to July 31, 1987, is $900 (the applicable fraction of 0.1 times the eligible basis of $100,000 times the applicable percentage of .09). Whether D may claim this credit amount will be determined under section 42(j) (relating to recapture of the credit and the posting of a bond). See Rev. Rul. 90-60, 1990-2 C.B. 3, for additional information on recapture of the credit and the posting of a bond. T is not entitled to claim this credit amount because T may claim the credit only for the period after T acquires the property. However, during the month that T owns the property during its tax year ending August 31, 1987, the applicable fraction is 6/10. Therefore, T may claim a credit on its federal income tax return for the tax year ending August 31, 1987, in the amount of $450 (the applicable fraction of 0.05 or (6/10 times 1/12) times the eligible basis of $100,000 times the applicable percentage of .09).

The credit for the first 4 months of T's succeeding tax year, which begins September 1, 1987, and ends August 31, 1988, still must be determined according to the first-year convention in section 42(f)(2) of the Code. This is because those months are still part of the first year of the building's credit period. The sum of the monthly applicable fractions determined under section 42(c)(1) for the period from September 1, 1987, to December 31, 1987, is 36/10 or 3.6, which, when divided by 12 and multiplied by the eligible basis of $100,000 and the applicable percentage of .09, yields a credit amount of $2,700.

If on August 31, 1988, in T's succeeding tax year, the applicable fraction under section 42(c)(1) of the Code is 10/10 or 1.0, then T's qualified basis at the end of that tax year is $100,000 (1.0 times $100,000 of eligible basis). The credit for the remaining 8 months in T's tax year beginning September 1, 1987, and ending August 31, 1988, is $6,000 (8/12 times $100,000 of qualified basis times the applicable percentage of .09). T's total credit amount for the tax year beginning September 1, 1987, and ending August 31, 1988, is $8,700 ($2,700 + $6,000).

For each of T's succeeding tax years in the credit period, the credit is based upon the qualified basis as of the last day of T's tax year (August 31). The last 4 months in the credit period (September 1996 through December 1996) are included in T's tax year beginning September 1, 1996, and ending August 31, 1997. The credit for those 4 months is based upon 4/12 of the qualified basis as of August 31, 1997. The credit for T's tax year ending August 31, 1997, consists of the credit for the last 4 months of

the credit period plus the disallowed first-year credit amount that is carried over to the 11th year under section 42(f)(2)(B) of the Code.

The disallowed first-year credit amount is calculated in the following manner: if the first-year convention of section 42(f)(2) of the Code had not applied to the calculation of the credit for the first year of the building's credit period, the credit amount would have been $9,000 based upon an applicable fraction for that building of 10/10 as of December 31, 1987, multiplied by the eligible basis on that date of $100,000, multiplied by the applicable percentage of .09. However, because of the first-year convention of section 42(f)(2), the allowable credit with respect to the building for the first tax year in the credit period was only $4,050 ($900 allowable to D for the period prior to T's acquisition of the building + $450 allowable to T for its tax year ending August 31, 1987, + $2,700 for the period between September 1, 1987, and December 31, 1987, allowable to T for part of its tax year ending August 31, 1988). Therefore, the carryover credit amount is $4,950 (the difference between $9,000 and $4,050).

This carryover credit is allowable for the first tax year ending after December 31, 1996, the date the credit period ends. Accordingly, for T's tax year ending August 31, 1997, T calculates the credit for the last 4 months of the credit period (the period between August 31, 1996, and December 31, 1996), and adds to this the carryover credit. For T's tax year ending August 31, 1997, T may claim $3,000 for the 4 month period between September 1, 1996, and December 31, 1996, plus the carryover amount of $4,950, for a total credit in that year of $7,950.

D. *REHABILITATION EXPENDITURES ISSUES*

QUESTION 6:

If a taxpayer begins the rehabilitation of an existing building in January 1987 and completes the rehabilitation in December 1987, less than 24 months after the rehabilitation began, must the taxpayer wait until December 1988, a 24-month period, before the rehabilitation expenditures are treated as placed in service under section 42(e)(4)(A) of the Code?

ANSWER 6.

No. Under section 42(e)(3)(A) of the Code, a taxpayer may aggregate all rehabilitation expenditures incurred during any 24- month period for purposes of meeting the minimum expenditures requirement of section 42(e)(3)(A). 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 expenditures may be treated as placed in service at the close of that period; however, in no event may the aggregation period 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. Only those rehabilitation expenditures subject to the amendments made by section 201(a) of the 1986 Act (requiring 27.5 year depreciation of residential rental property) are eligible for the low-income housing credit under section 42. Expenditures incurred prior to 1987 and not placed in service prior to 1987 may be eligible for the credit, if the expenditures are subject to the amendments made by section 201(a) of the 1986 Act. See section 42(c)(2)(B).

QUESTION 7.

During the period from March 1, 1987, through December 31, 1987, A, the owner of an existing building, incurred substantial rehabilitation expenditures in amounts that met or exceeded the minimum expenditures requirement of section 42(e)(3)(A) of the Code. These expenditures were not federally subsidized. On January 1, 1988, A sold the building to B. On that date, the building did not meet the requirements for an existing building under section 42(d)(2)(B) (in particular, the 10-year requirement of section 42(d)(2)(B)(ii)); however, B bought the property before the rehabilitation expenditures were placed in service. May B receive a housing credit dollar amount in 1988 based upon the 9 percent applicable percentage (the 70 percent present value credit) for the rehabilitation expenditures?

ANSWER 7.

Yes. Because A had not received a housing credit dollar amount allocation for the rehabilitation expenditures A had incurred before selling the property to B, no credit was "allowed" to A as a prior owner and, therefore, the rules of section 42(d)(7) of the Code do not apply. See Question and Answer 4. However, section 1.167(k)- 1(b)(1) of the regulations provides rules governing when a taxpayer is treated as having paid or incurred rehabilitation expenditures. Although the election under section 167(k) of the Code may no longer be made with respect to rehabilitation expenditures on a low-income rental housing building, rules similar to those of section 1.167(k)-1(b)(1) will generally still apply in determining when rehabilitation

expenditures are treated as paid or incurred by the taxpayer under section 42. Because B acquired the property attributable to the rehabilitation expenditures before such property was placed in service, section 1.167(k)-1(b)(1) treats B as having paid or incurred the expenditures to the extent of the lesser of the rehabilitation expenditures paid or incurred before B's acquisition or B's cost or other basis attributable to the rehabilitation expenditures. Accordingly, for purposes of section 42, B's basis in the rehabilitation expenditures is the lesser of A's basis in the rehabilitation expenditures at the time of transfer (in general, A's actual cost paid or incurred for the rehabilitation expenses prior to January 1, 1988), or B's cost or other basis for the property attributable to the rehabilitation expenditures paid or incurred before that date. When B places the rehabilitated property in service, that property's original use is considered to begin with B.

If A had placed the rehabilitation expenditures in service for depreciation purposes before selling the building to B, B would not be treated as having paid or incurred the expenditures under section 42 of the Code or section 1.167(k)-1(b)(1) of the regulations because B would have acquired the the property attributable to the rehabilitation expenditures after that property was placed in service. In order for B to be eligible to receive a housing credit dollar amount for the cost of acquiring the building, the building would have to meet the requirements for an existing building under section 42(d)(2)(B) of the Code (including the requirement that there be a period of at least 10 years between the date of the building's acquisition and the later of (I) the date the building was last placed in service, or (II) the date of the most recent nonqualified substantial improvement of the building as defined in section 42(d)(2)(D)).

QUESTION 8.

Assume the same facts as in Question 7, except that A incurred rehabilitation expenditures that did not equal or exceed the minimum prescribed by section 42(e)(3)(A) of the Code. Is B eligible to receive an allocation of credit with regard to the rehabilitation expenditures that A incurred?

ANSWER 8.

Yes. Section 1.167(k)-1(b)(1) of the regulations treats B as having paid or incurred the expenditures, and a similar rule will be applied for purposes of section 42 of the Code. Under section 42(e)(5), B may elect to treat A's expenditures either as (a) part of the eligible basis of an existing building that meets the requirements of section 42(d)(2)(B), or (b) part of a series of expenditures treated as a separate new building under section 42(e).

(a) If the existing building that B purchased met the requirements of section 42(d)(2)(B) of the Code, B could include the rehabilitation expenditures in the building's eligible basis under section 42(d)(2)(A)(i) but only to the extent the cost of the expenditures is not already reflected in the purchase price for the building. B would be eligible to receive an allocation of credit, based upon the 30 percent present value credit for existing buildings, with respect to the building's entire eligible basis. However, see Note, below.

(b) Alternatively, regardless of whether the building meets the requirements of section 42(d)(2)(B) of the Code, B may continue to make rehabilitation expenditures and may count the expenditures made by A toward the amount prescribed by section 42(e)(3). Because the expenditures were not federally subsidized, once the aggregate rehabilitation expenditures meet the requirements of section 42(e), B would be eligible to receive an allocation of credit, based upon the 70 percent present value credit for new buildings, with respect to the eligible basis attributable to the aggregate rehabilitation expenditures.

NOTE: Under section 7108(d)(1) of the 1989 Act, generally effective for allocations of credit after December 31, 1989, an existing building is not eligible for the credit unless an allocation of credit is allowable by reason of substantial rehabilitation of the building under section 42(e) of the Code. Therefore, the rehabilitation expenditures would have to equal at least the minimum amount prescribed by section 42(e)(3)(A) if the building is to be eligible for any credit.

E. *10-YEAR OWNERSHIP REQUIREMENT FOR EXISTING BUILDINGS*

QUESTION 9.

Section 42(d)(2)(B)(ii)(I) of the Code requires that there be a minimum of 10 years between the date a taxpayer acquires an existing building and the date the building was last placed in service. Does this requirement apply only if the building was last placed in service as residential rental property?

ANSWER 9.

No. Except as provided in section 42(d)(2)(D)(ii) of the Code, for purposes of section 42(d)(2)(B)(ii)(I), there must be a minimum of 10 years between the date a taxpayer acquires an existing building and the date the building was last placed in service for any purpose, whether in a trade or business, in the production of income, in a tax-exempt activity, or in a personal activity.

F. QUALIFIED RESIDENTIAL RENTAL PROPERTY

QUESTION 10.

If a taxpayer owned a home and used it as a personal residence can the taxpayer in 1987 convert the property into residential rental property for low-income housing and claim a tax credit for an existing building under section 42(d) of the Code without substantially rehabilitating the building as described in section 42(e)?

ANSWER 10.

No. In this situation, the taxpayer previously placed the building in service as a personal residence. Under section 42(d)(2)(A)(ii) and (B)(iii) of the Code, an existing building has an eligible basis of zero if it was previously placed in service by the taxpayer or by any person who was a related person (as defined in section 42(d)(2)(D)(iii)) with regard to the taxpayer as of the time the building was previously placed in service. This is the case regardless of whether the taxpayer placed the building in service as a personal residence more than 10 years ago (i.e., regardless of whether the 10-year requirement of section 42(d)(2)(B)(ii) is met).

However, if the taxpayer converts the property into residential rental property for low-income housing and, in so doing, incurs substantial rehabilitation expenditures in the amount prescribed by section 42(e)(3) of the Code, the taxpayer may treat the rehabilitation expenditures as a separate new building under section 42(e)(1). Because the requirements of section 42(d)(2)(B) do not apply to new buildings, the taxpayer would be eligible for a low- income housing credit allocation based on the qualified basis attributable to the aggregate rehabilitation expenditures.

QUESTION 11.

Taxpayer A bought a newly-constructed, single-family home in 1979 and placed it in service as residential rental property. The property was residential rental property from 1979 to 1985, when A sold the property to B who used it solely as a personal residence from 1985 to 1991. In 1991, if C purchases the property, substantially rehabilitates the property, and converts it into residential rental property for low-income housing, may C receive a tax credit for acquisition and rehabilitation of an existing building under section 42(d) of the Code?

ANSWER 11.

Yes. Although there has only been a period of 6 years between the date C acquired the property and the date the property was last placed in service by B, section 42(d)(2)(D)(ii)(V) of the Code, as added by the 1990 Act, provides that for allocations of credit made after 1990, there shall not be taken into account, in determining when a building was last placed in service, any placement in service of a single-family residence by any individual who owned and used such residence for no other purpose than as a principal residence. Under this provision, B's placement in service is not taken into account for purposes of the 10-year requirement of section 42(d)(2)(B)(ii). Therefore, there has been at least 10 years between the date C acquired the property in 1991, and the date the building was last placed in service by A in 1979 as residential rental property. Assuming the building meets the other requirements of section 42(d)(2)(B) applicable to existing buildings (including the requirement that a credit is allowable to the building for substantial rehabilitation under section 42(e), unless the exception in section 42(f)(5)(B) applies), C may be eligible to receive a housing credit dollar amount for acquisition and rehabilitation of the single-family home.

G. *RENT-RESTRICTED RESIDENTIAL RENTAL UNIT*

QUESTION 12.

Must the cost of meals provided in a common dining facility of a low-income project be included in gross rent under section 42(g)(2)(A) of the Code?

ANSWER 12.

Section 42(g)(2)(A) of the Code provides that a residential rental 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 tenants under section 42(g)(1).

Notice 89-6, 1989-1 C.B. 625, provides that the furnishing of services other than housing (whether or not such services are significant) will not prevent property from qualifying as residential rental property. However, any charges for services that are not optional to low-income tenants must be included in gross rent for purposes of section 42(g)(2)(A) of the Code. A service is optional if payment for the service is not required as a condition of occupancy.

In the case of a qualified low-income building with a common dining facility, if a practical alternative exists for tenants to obtain meals other than from the dining facility, and if payment for the meals in the facility is not required as a condition of occupancy, the cost of the meals will not be included in gross rent for purposes of section 42(g)(2)(A) of the Code.

The requirement that a practical alternative exists for tenants to obtain meals other than from the dining facility shall apply to projects receiving allocations of housing credit dollar amounts after

calendar year 1991, and for projects not subject to the allocation limits, the requirement shall apply to projects placed in service after calendar year 1991.

EFFECTIVE DATE

The Internal Revenue Service may issue regulations addressing some of the points covered by this ruling. To the extent the regulations are inconsistent with the guidance provided by this ruling, the regulations will have prospective effect. Taxpayers may therefore rely on the provisions of this ruling until further guidance is published.

DRAFTING INFORMATION

The principal author of this revenue ruling is Donna Young of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling contact Ms. Young on (202) 377-6349 (not a toll-free call).