

MEMORANDUM

TO: Review Attorneys and Paralegals DATE: 5/15/90

FROM: Gary Brown

RE: Allocation of Shares to Professional Apartments
(Replaces memo of April 24, 1986 "Allocating Shares and
Proprietary Leases to Professional Offices")

Attached please find a copy of Revenue Ruling 90-35 ("REV. RUL. 90-35") issued by the Internal Revenue Service on April 23, 1990. As you will see, REV. RUL. 90-35 establishes circumstances under which the allocation of shares to professional apartments will not disqualify a cooperative under Internal Revenue Code §216.

The Department of Law has previously required sponsors to obtain a private letter ruling from the IRS before shares allocated to professional apartments could be sold. Private letter rulings, by their terms, cannot be cited as precedent in another case. Thus, although the IRS had granted private letter rulings in a series of cases, it was necessary to obtain a ruling in each case to ensure that the cooperative would qualify under IRC §216, and not be disqualified because shares had been allocated to non-dwelling units.

Revenue Rulings, unlike private letter rulings, can be cited as precedent. Accordingly, a private letter ruling will no longer be required if the facts are consistent with those discussed in REV. RUL. 90-35, and the sponsor's Attorney Income Tax Opinion Letter states that REV. RUL. 90-35 is applicable.

The following is a summary of the criteria established by REV. RUL. 90-35 for the allocation of shares to a professional apartment:

- the shareholder must be entitled to add sleeping and cooking facilities to the unit solely by reason of ownership of shares in the corporation;
- the unit must contain one or more rooms equipped with sanitation facilities normally found in a dwelling unit, and it must be "reasonable" to add sleeping and cooking facilities, with the cost of doing so being approximately 20% or less of the fair market value the unit would have if sold as a residential unit;

-- there must be no substantial legal impediment to the conversion of the unit to residential use, such as a zoning restriction that would require a variance.

REV. RUL. 90-35 also points out that the existence of a long-term commercial lease on a professional apartment will not disqualify the co-op if shares are sold to a third party (not the current occupant), so long as the aforementioned requirements are met. The long-term lease discussed in the ruling had one year to run until termination.

Attachment

scription contained in the ruling application were not accurate. The Service was never informed that a sale of the assets was contemplated.

In *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), a shareholder sale of distributed property was attributed to the corporation because the corporation had negotiated the sale of the property which was transferred without any business purpose just prior to an ostensible shareholder sale. The Supreme Court stated that "A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalism, would seriously impair the effective administration of the tax policies of Congress."

SEC. 2038—REVOCABLE TRANSFERS.

• *Transfers of property, made within three years of the date of A's death, from the revocable trust described, are includable in her gross estate under Sections 2038 and 2035(a).* DOC. 9016002.

In 1973, A created a revocable trust and amended it in 1974 and 1976. The governing instrument gave the settlor the right to withdraw assets.

Gifts of stock and cash were made by the corporate trustees at the settlor's direction between July 1984 and July 1987. A died on July 21, 1987.

The trust assets were reported on the estate tax return as includable in the gross estate. However, the gifts were not included in the gross estate for federal estate tax purposes.

The issue is whether the transfers of property, made within three years of A's death, from the revocable trust, are includable in A's gross estate under Sections 2038 and 2035(a).

The Service ruled that the transfers of property, made within three years of the date of A's death, from the revocable trust, are includable in her gross estate under Sections 2038 and 2035(a).

The Service said the facts presented require that the transfers to the several donees be viewed as gifts of trust corpus to third parties not as withdrawals of trust corpus by A for her own benefit, followed by a gift of the property to the several donees.

INTERNAL REVENUE BULLETIN

The following items are from Internal Revenue Bulletin No. 1990-17, dated April 23, 1990. The summaries of revenue rulings, revenue procedures, notices, and other announcements are followed by their full texts, except for items that because of their unusual length can only be run in partial text. The full texts of these items can be purchased from BNA PLUS toll-free (800) 452-7773 nationwide; (202) 452-4323 in Washington, D.C.

Revenue rulings represent the conclusions of the Internal Revenue Service on the application of the law to the stated facts. They apply retroactively unless otherwise indicated. Revenue procedures are published in the Bulletin if they affect the rights and duties of taxpayers, but not if they relate solely to matters of internal management. Rulings and procedures reported in the Bulletin do not have the

force and effect of Treasury Department Regulations, but they may be used as precedents.

SEC. 216—COOPERATIVE HOUSING CORPORATION

• *Examples illustrate circumstances under which allocation of shares to units used as professional offices will not cause disqualification as cooperative housing corporation.* REV. RUL. 90-35

Facts: In Situation 1, a cooperative housing corporation owns a multistory building containing residential apartments, except for three units on the ground floor that are leased for use as professional offices. All of the corporation's issued and outstanding shares are allocated to the residential apartments.

The corporation proposes to allocate authorized but unissued shares to the professional office units and sells them to the corporate and individual occupants of those offices. The professional units are structurally similar to residential units in the building. They contain one or more rooms equipped with sanitation facilities. Although there are presently no sleeping or cooking facilities in those units, it would be reasonable to add those facilities under the facts and circumstances at a cost equal to 20 percent of the fair market value of the units if they were sold as residential units.

Ownership of the shares attributable to the office units would entitle the tenant-stockholders to install sleeping and cooking facilities and occupy the units for dwelling purposes upon approval of the board of directors. The corporation has agreed that it would not unreasonably withhold such approval and would cooperate in effecting the conversion. The building is located in an area that is zoned for residential use, except that the ground floor may have certain non-residential uses that include use as professional offices. Under local ordinances, the ground floor units could be converted from office use to residential use as a matter of right.

In Situation 2, the facts are the same as above, except that shares allocated to one of the professional offices will be sold to a third party and not the current occupant. The existing commercial lease on that unit has one year to run until it terminates. The purchaser of the shares will succeed to the lessor's rights and obligations under that lease.

In Situation 3, the facts are the same as in Situation 1, except that the building already has the maximum number of residential units permitted under the local zoning code. Converting the offices to residential units would require a zoning variance.

Holding: In Situation 1, the allocation of shares to the office units will not disqualify the corporation from treatment as a cooperative housing corporation under Section 216 because those units meet the definition of an apartment for purposes of Section 216(b)(1)(B).

In Situation 2, the existence of a long-term commercial lease on the non-residential unit will not disqualify the corporation from treatment as a cooperative housing corporation under Section 216, provided that the unit is capable of conversion as in Situation 1 and the purchaser of the shares has the right to occupy the unit as provided in Section 216-1(d)(2).

In Situation 3, the allocation of shares to non-residential units will disqualify the corporation from treatment as a cooperative housing corporation under Section 216 because there is a substantial legal impediment to occupying the

units for residential purposes as required in Section 216(b)(1)(B).

Full Text:

ISSUE

Under what circumstances will the allocation of shares of a cooperative housing corporation to nonresidential units permit the corporation to remain qualified as a cooperative housing corporation under section 216 of the Internal Revenue Code?

FACTS

Situation 1. X Corporation is a cooperative housing corporation, as defined in section 216(b)(1) of the Code, that owns land and a building thereon containing apartments. All units in the multistory building are residential apartments, except for three units on the ground floor that are leased for use as professional offices. All of X's issued and outstanding shares are allocated to the residential apartments in the building.

X proposes also to allocate authorized but unissued shares to the professional office units and sell them to the corporate or individual occupants of those offices. The professional units are structurally similar to residential units in the building. Although the offices do not contain sleeping or cooking facilities, they do contain one or more rooms that contain sanitation facilities normally found in a dwelling unit. Moreover, it would be reasonable to add sleeping and cooking facilities normally found in a dwelling unit to the office units under all the facts and circumstances. The cost of adding sleeping and cooking facilities is equal to approximately 20 percent of the fair market value the professional units would have if they were sold as residential units. Ownership of the shares attributable to the office units would entitle the tenant-stockholders to install sleeping and cooking facilities and occupy the units for dwelling purposes upon approval of the board of directors of the corporation. X has agreed that such approval would not be unreasonably withheld and that it would cooperate in effecting the conversion.

The entire building, including the professional office units, is located in an area that is zoned for residential use, except that the ground floor may have certain enumerated nonresidential uses that include use as professional offices. The ground floor units could be converted from office use to residential apartment use as a matter of right under the applicable local zoning, building, and fire codes.

Situation 2. The facts are the same as in *Situation 1*, except that shares allocated to one of the professional offices will be sold to a third party and not the current occupant. The existing commercial lease has one year to run until it terminates. If shares are allocated to the unit and sold to a third party, the third party will succeed to the lessor's rights and obligations under the existing commercial lease.

Situation 3. The facts are the same as in *Situation 1*, except that the building already has the maximum number of residential units permitted under the local zoning code. A zoning variance would have to be obtained from the local zoning authority in order to obtain permission to convert the office units to residential units.

LAW AND ANALYSIS

Section 216(a) of the Code allows a tenant-stockholder to deduct amounts paid or accrued to a cooperative housing

corporation within the taxable year to the extent that the amounts represent the tenant-stockholder's proportionate share of certain real estate taxes allowable as a deduction to the corporation under section 164, and certain interest allowable as a deduction to the corporation under section 163.

Section 216(b)(2) of the Code, in part, defines the term "tenant-stockholder" to mean a person who is a stockholder in a cooperative housing corporation.

The term "cooperative housing corporation" is defined in section 216(b)(1) of the Code to mean a corporation (A) that has only one class of stock outstanding; (B) each stockholder of which is entitled, solely by reason of stock ownership in the corporation, to occupy for dwelling purposes a house or an apartment in a building leased or owned by the corporation; (C) no stockholder of which is entitled to receive any distribution not out of earnings and profits except on a complete or partial liquidation of the corporation; and (D) that derives 80 percent or more of its gross income from tenant-stockholders.

Section 1.216-1(d)(2) of the Income Tax Regulations provides that, in order for the corporation to qualify as a cooperative housing corporation, must be entitled to occupy for dwelling purposes an apartment in a building or a unit in a housing development owned or leased by the corporation. The stockholder is not required to occupy the premises. The right as against the corporation to occupy the premises is sufficient if conferred on each stockholder solely by reason of ownership of stock in the corporation. That is, ownership of the stock must entitle the owner either to occupy the premises or to lease the premises.

Rev. Rul. 80-299, 1980-2 C.B. 82, holds that actual occupancy of certain apartment units by stockholders of a corporation is not required for purposes of satisfying section 216(b)(1)(B) of the Code when those units are occupied by non-stockholder tenants protected under rent control laws.

Rev. Rul. 74-241, 1974-1 C.B. 68, provides that, for purposes of section 216(b)(1)(B) of the Code, the term "apartment in a building" means an independent housekeeping unit consisting of one or more rooms that contain facilities for cooking, sleeping, and sanitation normally found in a principal residence.

Rev. Rul. 74-241 does not require, however, that a unit presently contain all the facilities normally found in a principal residence in order to constitute an apartment in a building for purposes of section 216(b)(1)(B) of the Code. Accordingly, a unit will be treated as meeting that definition if (1) the stockholder is entitled to convert the unit to an apartment, as defined in Rev. Rul. 74-241, solely by reason of ownership of stock in the cooperative housing corporation; (2) the conversion of the unit would be reasonable under all the facts and circumstances, including structural feasibility and cost; and (3) the applicable local zoning, building, and fire codes permit both the conversion referred to in (1) and residential use of the unit as a matter of right.

Whether conversion of a unit to residential use is reasonable will depend on all the facts and circumstances. Generally, conversion will be reasonable where the unit is structurally similar to existing residential units in the buildings, has ready access to plumbing and utility sources, and the cost of converting the unit to residential use is not disproportionate to the fair market value the unit would have if the unit were sold as a residence.

Under the facts in *Situation 1*, (1) the stockholders are entitled to add sleeping and cooking facilities to convert the office units to dwelling units solely by reason of their ownership of stock in the corporation, (2) the addition of

these facilities to the office units would be reasonable under all the facts and circumstances, including structural feasibility and cost, and (3) the applicable local zoning, building, and fire codes permit addition of those facilities and residential apartment use as a matter of right.

In *Situation 2*, the purchaser of shares attributable to the one unit is temporarily barred from occupancy by the existing commercial lease. Nevertheless, ownership of stock confers occupancy rights upon the stockholder as against the corporation and the fact that a current occupant has the right to remain in possession of the unit under a pre-existing lease is immaterial for purposes of section 216(b)(1)(B). See Rev. Rul. 80-299.

In *Situation 3*, the zoning restriction precludes the conversion of the units to residential use without obtaining a zoning variance, which may or may not be granted. The zoning restriction is a substantial legal impediment to the conversion of the office units to residential use.

HOLDINGS

In *Situation 1*, the allocation of shares to nonresidential units will not disqualify the corporation from treatment as a cooperative housing corporation under section 216 of the Code because those units meet the definition of an apartment for purposes of section 216(b)(1)(B).

In *Situation 2*, the existence of a long term commercial lease on the nonresidential unit will not disqualify the corporation from treatment as a cooperative housing corporation under section 216 of the Code provided that the unit is capable of conversion as provided in *Situation 1* and the purchaser of the shares has the right to occupy the unit as provided in section 1.216-1(d)(2) of the regulations.

In *Situation 3*, the allocation of shares to nonresidential units will disqualify the corporation from treatment as a cooperative housing corporation under section 216 of the Code because there is a substantial legal impediment to occupying the units for residential purposes as required in section 216(b)(1)(B).

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 58-421, 1958-2 C.B. 112, which holds that the sale of commercial space in a cooperative apartment building will not prevent the corporation from being classified as a cooperative housing corporation under section 216(b)(1)(B), is modified to include the conditions set forth in this revenue ruling. In addition, as a result of the Tax Reform Act of 1986, the holding of the revenue ruling that income derived from stockholders who are not individuals cannot be included as income from tenant-stockholders is obsolete. As modified, Rev. Rul. 58-421 is superseded.

Rev. Rul. 74-241 is amplified.

DRAFTING INFORMATION

The principal author of this revenue ruling is David L. Click of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling contact David Click on (202) 566-4821 (not a toll-free call).