Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FSH:BOS:TL-N-5997-00
PColleran

date: MAY - 1 2001

to: Director, LMSB Field Specialists
Attn: Engineer Albert Knasas

from: Associate Area Counsel
(Financial Services and Health Care: Boston)

subject: [redacted]
Rehabilitation Credit (I.R.C. § 47)
Taxable Year Ended [redacted]
U.I.L. No. 47.02-02

This memorandum responds to your memorandum dated October 17, 2000. This memorandum should not be cited as precedent. You request our assistance in determining whether specified expenditures incurred by the [redacted] in connection with the rehabilitation of the [redacted] may be treated as qualified rehabilitation expenditures pursuant to I.R.C. § 47.[1] The advice rendered in this memorandum is conditioned on the accuracy of the facts presented to us.

ISSUE

Whether the taxpayer's expenditures in rehabilitating and enlarging a post-1936 addition to a pre-1936 building are qualified rehabilitation expenditures eligible for the rehabilitation credit.

CONCLUSION

The taxpayer's expenditures in rehabilitating and enlarging a post-1936 addition to a pre-1936 building do not constitute qualified rehabilitation expenditures eligible for the rehabilitation credit.

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[1]All references to "section" are to the Internal Revenue Code of 1986, as amended.

FACTS

The [redacted] owns and operates the [redacted]. The [redacted] was acquired in [redacted] by [redacted] who transferred the [redacted] to the [redacted] (taxpayer). The [redacted] is described in detail on the [redacted]'s web page located at [redacted]. The [redacted] consists of [redacted] guest buildings - [redacted], originally known as the [redacted] was designed by architect [redacted] and completed in [redacted]. In [redacted] a new wing consisting of [redacted] rooms was added to the [redacted].

The [redacted] claimed $[redacted] in qualified rehabilitation expenditures attributable to the rehabilitation of a pre-1936 building eligible for the 10% rehabilitation credit on Form 3468, Investment Credit, attached to its Form 1065, U.S. Partnership Return of Income for the taxable year ended [redacted]. The partnership did not attach a statement to the Form 3468, as specified in the instructions to Form 3468 and required by Treasury Regulation section 1.48-12(b)(2)(viii) showing: (1) the beginning and ending dates of the 24 or 60 month period selected for the substantial rehabilitation test: (2) the adjusted basis of the building as of the later of the beginning of the 24 or 60 month period or the first day of the holding period; and (3) the amount of qualified rehabilitation expenditures incurred, or treated as incurred, during the 24 or 60 month period.

You have determined that the [redacted] of the [redacted].

You have determined that the qualified rehabilitation expenditures of $[redacted] claimed on the Partnership return relate to the rehabilitation and expansion of the wing which was added to the [redacted] during [redacted]. You have disallowed the investment credit claimed by the taxpayer on the ground that the [redacted] addition to the [redacted] and its expansion do not satisfy the definition of a "qualified rehabilitated building" as set forth in section 47(c) and Treasury Regulation sections 1.48-12(b)(4)(ii) and 1.48-12(c)(10)(i).

LAW AND ANALYSIS

Section 47 allows taxpayers an investment tax credit for a portion of the expenditures they make in rehabilitating a

qualified building. The rehabilitation credit equals the sums of two amounts: (1) 20% of the qualified rehabilitation expenditures with respect to any certified historic building; and (2) 10% of the qualified rehabilitation expenditures with respect to any other qualified rehabilitated building. Section 47(a). Qualified rehabilitation expenditures with respect to a qualified rehabilitated building are taken into account for the taxable year in which the building is placed in service as a qualified rehabilitated building. Section 47(b)(2).

Qualified rehabilitation expenditures must satisfy four conditions: (1) the expenditure is properly chargeable to a capital account; (2) the expenditure is for property for which depreciation deductions are allowable; (3) the expenditure is for property which meets the property type requirements; and (4) the expenditure is made in connection with the rehabilitation of a qualified rehabilitated building. Section 47(c)(2).

Qualified Rehabilitated Building

A qualified rehabilitated building for non certified historic structures[2] is any building and its structural components which meet the following five conditions: (1) the building has been substantially rehabilitated; (2) the building was first placed in service before the beginning of the rehabilitation; (3) the retention requirements are met; (4) depreciation or amortization is allowable with respect to the building; and (5) the building was first placed in service before 1936. Section 47(c)(1)(A).

Additions to Pre-1936 Buildings

Section 47(c)(1)(B) provides the age requirement for a qualified rehabilitated building other than a certified historic structure. Section 47(c)(1)(B) provides: "Building must be first placed in service before 1936. In the case of a building other than a certified historic structure, a building shall not be a qualified rehabilitated building unless the building was first placed in service before 1936."

Treasury Regulation section 1.48-12(b)(4)(ii) provides that a building first placed in service before 1936 will not be disqualified because additions to such building have been added

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[2] [redacted]

since 1936. Such additions, however, shall not be treated as part of the qualified rehabilitated building. The term "addition" is defined by the regulation as any construction that resulted in any portion of an external wall becoming an internal wall, that resulted in an increase in the height of the building, or that increased the volume of the building.

The [redacted] addition to the [redacted] was added after 1936 and increased the volume of the [redacted] thus, it is considered an addition within the meaning of the regulation. As such the [redacted] addition is not considered part of the qualified building and any expenditures related to its rehabilitation do not constitute qualified rehabilitation expenditures eligible for the rehabilitation credit.

Enlargement Expenditures Excluded

Expenditures attributable to the enlargement of an existing building are specifically excluded by statute from the definition of "qualified rehabilitation expenditures." Section 47(c)(2)(B)(iii). The regulations define enlargement as an increase to the total volume of the building. Treasury Regulation section 1.48-12(c)(10)(i). The total volume of a building is generally equal to the product of the floor area of the base of the building and the height from the underside of the lowest floor to the average height of the finished roof. Treasury Regulation section 1.48-12(c)(10)(i). A portion of the taxpayer's claimed rehabilitation expenditures relate to the enlargement of the [redacted] addition to the [redacted] that increased the total volume of the [redacted]. You have correctly determined that these expenditures are not qualified rehabilitation expenditures eligible for the rehabilitation credit.

The Instructions to Form 3468

The taxpayer contends that the Service has been inconsistent in its interpretation of the prohibition of post 1936 additions to pre-1936 buildings from qualifying as part of the qualified rehabilitated building. The taxpayer alleges that the Service neglected to include a statement in the instructions to the Form 3468 prohibiting post 1936 additions to pre-1936 properties from qualifying as part of the qualified rehabilitated building. The taxpayer argues the Service by prohibiting post 1936 additions to pre-1936 buildings from qualifying in the regulations but not reiterating this prohibition in the instructions to the Form 3468 created an "'ambiguity' that has the effect of creating confusion." The taxpayer contends that as a result of this ambiguity and confusion in the Service's interpretation of rehabilitation credit, courts may find that the taxpayer is

entitled to the rehabilitation credit for the costs attributable to the rehabilitation and expansion of the [redacted] addition to the [redacted].

The instructions to Form 3468 for [redacted] provide in pertinent part:

> To be a qualified building, your building must meet all of the following requirements:
>
> 1. The building was originally placed in service before 1936 or it is a certified historic structure. . . .
>
> 2. The building must be substantially rehabilitated. . . .
>
> . . .
>
> To be qualified rehabilitation expenditures, your expenditures must meet all of the following requirements:
>
> 1. The expenditures must be for (a)nonresidential rental property, (b) residential rental property (but only if a certified historic structure - see Regulations section 1.48-1(h)) . . .
>
> 2. The expenditures must be incurred in connection with the rehabilitation of a qualified rehabilitated building. . . .
>
> . . .
>
> 4. The expenditures cannot include the costs of acquiring or enlarging any building.

We find the instructions to the Form 3468 to be consistent with the statute and regulations in the interpretation of the prohibition on post 1936 additions to pre-1936 buildings from qualifying as part of the qualified rehabilitated building. The instructions clearly state that qualified rehabilitation expenditures do not include the costs of enlarging any building. This would have put the taxpayer on notice that the cost of enlarging the [redacted] addition to the [redacted] would not be a qualified rehabilitation expenditure. The instructions also provide that to be a qualified rehabilitated building for other than historic structures the building must have been originally placed in service before 1936. This would have put the taxpayer

on notice that the [redacted] addition to the [redacted] would not qualify as part of the qualified rehabilitated building. Indeed, the instructions to the Form 3468 direct the reader to the regulations.

We find that there is no ambiguity or confusion in the Service's position that the costs of rehabilitating and enlarging a post 1936 addition to a pre-1936 building are not qualified rehabilitation expenditures. The taxpayer's argument is not only unpersuasive but beside the point, since the authoritative sources of Federal tax law are in the statutes, regulations, and judicial decisions not in instructions to an IRS form. Adler v. Commissioner, 330 F2d 91, 93 (9th Cir. 1964); Zimmerman v. Commissioner, 71 T.C. 367, 370 (1978) affd. without published opinion 614 F.2d 1294 (2d Cir. 1979); Green v. Commissioner, 59 T.C. 456, 458 (1972); Aldridge v. Commissioner, 51 T.C. 475, 482 (1968). In other words, reliance on an informal IRS publication may not be used to justify a reporting position that is inconsistent with the operative law. See, e.g., Johnson v. Commissioner, 620 F.2d 153, 155 (7th Cir. 1980), aff'g T.C. Memo. 1978-426; Jones v. Commissioner, T.C. Memo. 1993-358. Here, the statute and regulations are clear that qualified rehabilitation expenditures do not include the costs of enlarging or rehabilitating a post 1936 addition to a pre-1936 building.

Validity of Treasury Regulation Section 1.48-12(b)(4)(ii)

The taxpayer relying on National Muffler Dealers' Ass'n v. United States, 440 U.S. 472 (1979), contends that the Treasury Regulation section 1.48-12(b)(4)(ii)does not reflect congressional intent and is thus invalid to the extent that it excludes post 1936 additions to pre-1936 buildings as part of the qualified rehabilitated building.

Section 47(c)(1)(B) provides the age requirement for a qualified rehabilitated building other than a certified historic structure. Section 47(c)(1)(B) provides: "Building must be first placed in service before 1936. In the case of a building other than a certified historic structure, a building shall not be a qualified rehabilitated building unless the building was first placed in service before 1936."

Treasury Regulation section 1.48-12(b)(4)(ii) provides that a building first placed in service before 1936 will not be disqualified because additions to such building have been added since 1936. Such additions, however, shall not be treated as part of the qualified rehabilitated building. Treasury Regulation section 1.48-12(b)(4)(ii). The term "addition" is

defined by the regulation as any construction that resulted in any portion of an external wall becoming an internal wall, that resulted in an increase in the height of the building, or that increased the volume of the building. Treasury Regulation section 1.48-12(b)(4)(ii).

The rehabilitation credit statute does not contain a specific grant of authority to the Secretary of the Treasury to promulgate regulations under the rehabilitation credit statute. Because the Secretary of Treasury lacked a specific grant of authority to promulgate regulations under the rehabilitation credit statute, the regulations issued with respect to the rehabilitation credit were issued under the general grant of authority provided in section 7805(a)[3]. Such interpretive regulations are entitled to "substantial weight" according to the Supreme Court in Lykes v. United States, 343 U.S. 118, 127 (1952).

The Secretary of the Treasury has broad authority to promulgate all needful regulations. Section 7805(a); United States v. Correll, 389 U.S. 299, 306-307(1967). It is well settled that Treasury regulations "must be sustained unless unreasonable and plainly inconsistent with the revenue statutes." Commissioner v. South Texas Lumber Co., 333 U.S. 496, 501 (1948); accord Commissioner v. Portland Cement Co. of Utah, 450 U.S. 156, 169 (1981). Because they constitute contemporaneous constructions by those charged with administration of these statutes, they "should not be overruled except for weighty reasons." Bingler v. Johnson, 394 U.S. 741, 750 (1969); Commissioner v. South Texas Lumber Co., supra at 501.

A regulation is not a reasonable statutory interpretation unless it harmonizes with the plain language of the statute, its origins, and its purpose. United States v. Vogel Fertilizer Co., 455 U.S. 16 (1982); National Muffler Dealers Association v. United States, 440 U.S. 472, 477 (1979).

Consistent with the foregoing, we examine the historical development of the rehabilitation credit and determine whether the regulation in question implements the congressional mandate in a reasonable manner.

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[3] Section 7805(a) provides, in pertinent part, that "the Secretary [of the Treasury] shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue."

In 1978, Congress extended the investment credit for rehabilitation expenditures to non-historical, non-residential buildings. Revenue Act of 1978, Pub. L. 95-600, section 315, 92 Stat. 2763, 2828. This was achieved by the newly enacted section 48(g) which provided that the portion of the basis of a qualified rehabilitated building attributable to qualified rehabilitation expenditures would be treated as section 38 property. Under section 48(g)(1)(B), the rehabilitated building was required to be at least 20 years old prior to its rehabilitation.

Three years later, section 48(g) was revised under the Economic Recovery Tax Act of 1981 (ERTA), Pub. L. 97-34, section 212(a) and (b), 95 Stat. 172, 235-236, which replaced the 10-percent credit with a three-tier credit system. Effective as to expenditures incurred after December 31, 1981, section 46(a)(2) was amended to provide for an increase in the amount of the credit for rehabilitation expenditures to 15, 20, and 25 percent of the qualified rehabilitation expenditures incurred on 30-year buildings, 40-year buildings, and certified historic structures, respectively.

ERTA also included an amendment of section 48(g)(1)(B) to provide that a qualified rehabilitated building, other than a certified historic structure, was required to be at least 30-years old. Notably, however, the basic definition of a qualified rehabilitated building as set forth in section 48(g)(1)(A) remained unchanged

The regulation in question, Treasury Regulation section 1.48-12, was published in proposed form in 50 Fed. Reg. 26797 (June 28, 1985) 1985-2 C.B. 777. The notice of proposed rulemaking stated that the amendments would be effective generally for rehabilitation expenditures incurred after December 31, 1981. Proposed Treasury Regulation section 1.48-12(b)(4)(ii),, provided:

> Additions. A building that was first placed in service at least 30 years before physical work on the rehabilitation began will not be disqualified because additions to such building are less than 30 years old. Additions to the building that are less than 30 years old, however, shall not be treated as part of the qualified rehabilitated building. The term "addition" means any construction that resulted in any portion of an exterior wall becoming an internal wall, that resulted in an increase in the height of the building , or that increased the volume of the building.

Following the publication of the proposed regulations, the

definition of a qualified rehabilitated building was again amended under the Tax Reform Act of 1986, Pub. L. 99-514, section 251(a) and (b), 100 Stat. 2085, 2183. In short, the 1986 Act reduced the amount of the investment credit to 10 percent for buildings first placed in service before 1936 and to 20 percent for certified historic structures. The Revenue Reconciliation Act of 1990 redesignated section 48(g) as section 47.

Treasury Regulation section 1.48-12, was adopted as a final regulation on October 7, 1988. See T.D. 8233, 1988-2 C.B. 11. Although additional language was added to Treasury Regulation section 1.48-12(b)(4)(ii),, to reflect changes provided in the Tax Reform Act of 1986, the essence of the regulation remained the same. Treasury Regulation section 1.48-12(b)(4)(ii) provides in pertinent part:

> Additions. A building that was first placed in service before 1936 in the case described in paragraph (b)(4)(i)(A) of this section [property placed in service after December 31, 1986] . . . will not be disqualified because additions to such building have been added since 1936 . . . . Such additions, however, shall not be treated as part of the qualified rehabilitated building. The term "addition" means any construction that resulted in any portion of an external wall becoming an internal wall, that resulted in an increase in the height of the building, or that increased the volume of the building.

With the foregoing as background, we return to the question of whether Treasury Regulation section 1.48-12(b)(4)(ii) carries out the congressional mandate underlying the rehabilitation credit statute. We conclude that the regulations harmonizes with congressional intent.

Treasury Regulation section 1.48-12(b)(4)(ii)requires that any addition to a qualified building must itself meet the statutory age requirement of section 47(c)(1)(B) in order to be considered part of the qualified rehabilitated building. Requiring all additions to a structure satisfy the statutory age requirements to be considered part of the qualified rehabilitated building is a reasonable interpretation of the statute.

Adopting the taxpayer's interpretation that any addition to a pre-1936 building should be a part of the qualified building eligible for the credit would render the intent of the statute meaningless. This would result in taxpayers being allowed the rehabilitation credit on any addition to a pre-1936 structure, no matter what year the addition was added. Under the taxpayer's

theory an addition made in the year 2000 to a pre-1936 building would qualify as part of the qualified building eligible for the rehabilitation credit. Clearly this is not what Congress had in mind when it enacted the rehabilitation credit.

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By:_____
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