

Office of Chief Counsel
Internal Revenue Service
Memorandum

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subject: POSTN-120761-11

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE:

How are the recapture provisions of § 42(j)(1) applied when the Service adjusts a building's eligible basis under § 42(d) as the result of an audit of a tax year subsequent to the first year of the credit period for which the period for assessment has expired (closed taxable year), considering Bentley Court II Limited Partnership v. Commissioner, T.C. Memo. 2006-113 (Bentley)?

CONCLUSION:

The recapture provisions of § 42(j)(1) apply if the Service's adjustment of a building's eligible basis under § 42(d) as a result of an audit of a taxable year subsequent to a closed taxable year results in a decrease in the qualified basis used to compute the credit. The Service may rely on the qualified basis as reported in a closed taxable year when applying the recapture provisions of § 42(j)(1). The Service may also recalculate the qualified basis in a closed taxable year in appropriate circumstances.

LAW AND ANALYSIS:

Section 42(c)(1)(A) provides the qualified basis of any qualified low-income building for any taxable year is an amount equal to the applicable fraction of the eligible basis.

Section 42(d) defines eligible basis of a new building as its adjusted basis as of the close of the first year of the credit period. Section 42(e)(1) provides rehabilitation expenditures paid or incurred by the taxpayer with respect to any building are treated as a separate new building. Section 42(f)(1) defines the credit period as the period of ten years beginning with the taxable year in which the building is placed in service, or, at the election of the taxpayer, the succeeding taxable year. Section 42(i)(1) defines the compliance period with respect to any building as the period of fifteen taxable years beginning with the first taxable year of the credit period. Section 42(j)(1) provides that if as of the close of any taxable year in the compliance period, the amount of the qualified basis of any building with respect to the taxpayer is less than the amount of such basis as of the close of the preceding taxable year, then the taxpayer's tax for the taxable year shall be increased by the credit recapture amount.

In Bentley the issue was whether the recapture provisions of § 42(j)(1) applied to a taxpayer. The taxpayer claimed § 42 credits for six years, 1990 through 1995. The Service audited the 1993, 1994, and 1995 tax returns for which the period of assessments had not expired (open taxable years) and determined that the applicable fraction was zero, thus qualified basis was zero, and the entire credit claimed for the three years under audit was disallowed. The Service applied § 42(j)(1) to recapture 1/3 of the credit claimed in the three closed taxable years (i.e., 1990, 1991, and 1992) as part of the adjustment to the 1993 tax return. The taxpayer protested imposition of recapture, arguing that its qualified basis for the entire six-year period was zero, and therefore there was no difference between the qualified basis in 1992 and 1993 and no recapture. The court held that because taxpayer represented on its returns that it was entitled to § 42 credits in a closed taxable year that taxpayer was estopped under the duty of consistency doctrine to deny that it had the reported qualified basis at the end of that closed taxable year. The court explained that this doctrine is intended to prevent a taxpayer from taking a position in an earlier year and a contrary position in a later year after the limitations period has run on the earlier year. The court upheld the Service's position (and taxpayer's concession) that qualified basis at the close of 1993 (the first open taxable year) was zero, and that the taxpayer was subject to recapture under § 42(j)(1) because the qualified basis for 1993 was less than the qualified basis taxpayer reported at the end of 1992 (i.e., the prior, closed taxable year).

Bentley makes clear that when applying the recapture provisions of § 42(j)(1) the Service may rely on a taxpayer's qualified basis as reported by that taxpayer for a closed taxable year. Since eligible basis is a component of qualified basis, Bentley suggests that, notwithstanding § 42(d)(1), the Service is not required to adjust a taxpayer's eligible basis in preceding closed taxable years. Accordingly, the Service may accept the taxpayer's reported qualified basis (including eligible basis) in a closed taxable year for purposes of applying the recapture provisions of § 42(j)(1).

While the court's opinion in Bentley is clear that the Service is not required to recalculate qualified basis in a closed taxable year, the court does not restrict the Service from recalculating a taxpayer's qualified basis in a closed taxable year for

purposes of making a determination in a taxpayer's open taxable year. Thus, the Service may, in its discretion, recalculate a taxpayer's qualified basis in closed taxable years for purposes of making a determination in an open taxable year.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call James Holmes or Chris Wilson at (202) 622-3040 if you have any further questions.