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Washington, DC 20224

**Person to Contact:**

**Telephone Number:**

Refer Reply To:

CC:PSI:7 / PLR-100652-00

Date:

March 15, 2001

Legend:

Corporation

State

Bank

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Dear

We received your letter requesting rulings under §§ 216, 305, 311, 721, 722, and 723 of the Internal Revenue Code. This letter responds to your request.

Corporation is a cooperative housing corporation organized under the laws of State. Corporation owns a building, which consists of a residential units and a ground floor that previously contained b nonresidential units. Currently, c shares of common stock of Corporation are issued and outstanding. All the outstanding common stock has been allocated to the residential units. No stock has been allocated to the nonresidential space on the ground floor.

Corporation entered into a proprietary lease with Bank for the entire nonresidential space. The lease provides that upon expiration of the lease term, Bank

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will remove all bank specific improvements from the premises.

The local zoning law and building code regulations currently permit modification of the nonresidential space from its commercial use to residential use as a matter of right. The size and location of the nonresidential space is such that, with certain modifications, it could be reasonably converted into residential units comparable to the existing residential units in the building.

Corporation proposes to issue d shares of its authorized but unissued stock allocable to the nonresidential space. The proprietary lease will entitle the owner of the stock allocated to the nonresidential space, as against Corporation, to occupy the nonresidential space for dwelling purposes solely by reason of the ownership of such shares.

Corporation further proposes to distribute to its current tenant-stockholders the d shares of stock that will be allocated to the nonresidential space. The tenant-stockholders then plan, but are not required, to contribute the shares of stock allocated to the nonresidential space to a limited liability company (LLC) in exchange for e% of the membership interests in the LLC. The rest, f%, of the membership interests in the LLC, will be owned by an investor that is not a tenant-stockholder. The LLC will perform certain activities in connection with its ownership of the shares of stock allocated to the nonresidential space.

You requested the following rulings:

1. The allocation of the d shares of Corporation stock to the nonresidential space will not affect the status of Corporation as a cooperative housing corporation within the meaning of § 216(b)(1).

2. For purposes of § 216(b)(1)(D), the income Corporation receives from the LLC pursuant to stockholder assessments made by Corporation will be income derived from tenant-stockholders provided that the fully paid-up requirement of § 216(b)(2) is met.

3. The proposed stock distribution by Corporation will not be treated as a distribution to the tenant-stockholders to which § 310 applies by reason of §§ 305(b) and 305(c) but will constitute a distribution to which § 305(a) applies. Thus, the distribution will not result in taxable income to any tenant-stockholder.

4. No gain or loss will be recognized to Corporation upon the distribution of stock pursuant to § 311 (a).

5. The cost or other basis of the stock in Corporation held by a tenant-

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stockholder immediately prior to the stock dividend distribution will be allocated between the stock held immediately prior to the stock dividend distribution and stock received in the distribution in proportion to the fair market value of the shares of each immediately after the distribution by reason of §§ 307(a) and 1.307-1(a).

6. The contribution by the tenant-stockholders of the shares of stock allocated to the nonresidential space to the LLC in exchange for e% of the LLC membership interests will not be taxable to the tenant-stockholders nor to the LLC pursuant to § 721(a).

7. The basis in the LLC membership interest received by each tenant-stockholder will be the same as the basis the tenant-stockholder had in the Corporation shares allocated to the nonresidential space contributed to the LLC pursuant to § 722.

8. The basis in the Corporation shares received by the LLC from the tenant-stockholders will be the cumulative bases that the tenant-stockholders had in the shares prior to their contribution to the LLC by reason of § 723.

#### Ruling Requests 1 and 2

Section 216(a) provides that in the case of a tenant-stockholder (as defined in subsection (b)(2)), there shall be allowed as a deduction amounts (not otherwise deductible) paid or accrued to a cooperative housing corporation within the taxable year, but only to the extent that such amounts represent the tenant-stockholder's proportionate share of –

(1) the real estate taxes allowable as a deduction to the corporation under § 164 which are paid or incurred by the corporation on the house or apartment building and on the land on which such houses (or building) are situated, or

(2) the interest allowable as a deduction to the corporation under § 163 which is paid or incurred by the corporation on its indebtedness contracted –

(A) in the acquisition, construction, alteration, rehabilitation, or maintenance of the houses or apartment building, or

(B) in the acquisition of the land on which the houses (or apartment building) are situated.

Section 216(b)(1) provides that the term “cooperative housing corporation” means a corporation –

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(A) having one and only one class of stock outstanding,

(B) each of the stockholders of which is entitled, solely by reason of his ownership of stock in the corporation, to occupy for dwelling purposes a house, or an apartment in a building, owned or leased by such corporation,

(C) no stockholder of which is entitled (either conditionally or unconditionally) to receive any distribution not out of earnings and profits of the corporation except on a complete or partial liquidation of the corporation, and

(D) 80 percent or more of the gross income of which for the taxable year in which the taxes and interest described in § 216(a) are paid or incurred is derived from tenant-stockholders.

Section 216(b)(2) provides that the term “tenant-stockholder” means a person who is a stockholder in a cooperative housing corporation, and whose stock is fully paid-up in an amount not less than an amount shown to the satisfaction of the Secretary as bearing a reasonable relationship to the portion of the value of the corporation’s equity in the houses or apartment building and the land on which situated which is attributable to the house or apartment which such person is entitled to occupy.

Section 1.216-1(e)(2) provides in part that in order to qualify as a “cooperative housing corporation” under § 216, each stockholder of the corporation, whether or not the stockholder qualifies as a tenant-stockholder under §§ 216(b)(2) and 1.216-1(f), must be entitled to occupy for dwelling purposes an apartment in a building or a unit in a housing development owned or leased by such corporation. The stockholder is not required to occupy the premises. The right as against the corporation to occupy the premises is sufficient. Such right must be conferred on each stockholder solely by reasons of his or her ownership of stock in the corporation. That is, the stock must entitle the owner thereof either to occupy the premises or to a lease of the premises. The fact that the right to continue to occupy the premises is dependent upon the payment of charges to the corporation in the nature of rentals or assessments is immaterial.

Situation 2 of Rev. Rul. 90-35, 1990-1 C.B. 48, provides as follows:

X Corporation is a cooperative housing corporation, as defined in § 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.

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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.

The 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.

The purchaser of shares attributable to the one unit [of the professional offices] 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 § 216(b)(1)(B).

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 § 216 of the Code provided that the unit is capable of conversion as provided and the purchaser of the shares has the right to occupy the unit as provided in § 1.216-1(d)(2) of the regulations.

Based on the information submitted and representations made, we conclude that 1) the allocation of the d shares of Corporation stock to the nonresidential space will not affect the status of Corporation as a cooperative housing corporation within the meaning of § 216(b)(1) and 2) for purposes of § 216(b)(1)(D), the income Corporation

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receives from the LLC pursuant to stockholder assessments made by Corporation will be income derived from tenant-stockholders provided that the fully paid-up requirement of § 216(b)(2) is met.

#### Ruling Requests 3, 4, and 5

Under § 305(a), except as otherwise provided in this section, gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock. However, under § 305(b), distributions in lieu of money, disproportionate distributions, distributions of preferred stock on common stock, distributions of preferred stock and distributions of convertible preferred stock are treated as § 301 distributions of property.

In addition, under § 305(c) the Secretary shall prescribe regulations under which a change in conversion ratio, a change in redemption price, a difference between redemption price and issue price, a redemption which is treated as a distribution to which § 301 applies, or any transaction having a similar effect on the interest of any shareholder shall be treated as a distribution with respect to any shareholder whose proportionate interest in the earnings and profits or assets of the corporation is increased by such change, difference, redemption, or similar transaction.

Under § 311(a), except as otherwise provided in § 311(b), no gain or loss shall be recognized by a corporation on the distribution (not in complete liquidation) with respect to its stock of its stock, or property. However, under § 311(b), gain is recognized by a corporation if it distributes property to a shareholder and the fair market value of such property exceeds its adjusted basis.

Under §§ 307(a) and 1.307-1(a), if a shareholder receives stock as a distribution on stock previously held and under § 305 such distribution is not includible in gross income then, the basis of the stock with respect to which the distribution was made shall be allocated between the old and the new stocks in proportion to the fair market values of each on the date of the distribution.

The distribution of d shares of Corporation stock to the tenant-stockholders of Corporation is in substance a formalization or certification of what the current tenant-stockholders already own in Corporation. None of the exceptions under § 305(b) apply because the distribution is akin to a distribution of common stock on common stock. Additionally, § 305(c) and the regulations thereunder do not apply. As a result, the distribution of the shares is not taxable under § 305(a).

The distribution of the shares will not be taxable to Corporation under § 311(a) because it is a distribution of Corporation's stock with respect to the shareholders' stock ownership in Corporation and not a distribution of property.

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The basis of the shares will be calculated in accordance with § 307(a) and § 1.307-1(a).

Based on the forgoing, we conclude that: 1) The proposed distribution by Corporation of the shares will not be treated as a distribution to Corporation shareholders to which § 301 applies by reason of §§ 305(b) and 305(c) but will constitute a distribution to which § 305(a) applies. Thus, the distribution will not result in taxable income to any Corporation shareholders; 2) No gain or loss will be recognized to Corporation upon the distribution of the shares; 3) The cost or other basis of the stock in Corporation held by a shareholder immediately prior to the distribution of the shares will be allocated between the stock immediately prior to the distribution of the shares and the shares received in the distribution in proportion to the fair market value of the stocks of each immediately after the distribution; and 4) The distribution of the shares will not diminish the earnings and profits of Corporation available for later dividend distributions within the meaning of §§ 316, 1.312-11(b) and (c).

#### Rulings Request 6, 7, and 8

Section 721(a) provides that no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

Section 721(b) provides that § 721(a) shall not apply to gain realized on a transfer of property to a partnership which would be treated as an investment company (within the meaning of § 351) if the partnership was incorporated.

Section 351(a) provides that no gain or loss will be recognized if one or more persons transfer property to a corporation solely in exchange for stock in the corporation and immediately after the exchange the transferors are in control (as defined in § 368(c)) of the corporation. Section 351(e)(1) provides that § 351(a) will not apply to a transfer of property to an investment company.

Section 1.351-1(c)(1) of the Income Tax Regulations provides, in part, that a transfer of property will be considered to be a "transfer to an investment company" if (1) the transfer results, directly or indirectly, in diversification of the transferors' interests, and (2) the transferee is (a) a regulated investment company, (b) a real estate investment trust, or (c) a corporation more than 80 percent of the value of whose assets are held for investment and are readily marketable stocks and securities, or interests in regulated investment companies or real estate investment trusts.

Section 1.351-1(c)(3) indicates that stocks and securities will be considered readily marketable if (and only if) they are part of a class of stock or securities which is traded on a securities exchange or traded or quoted regularly in the over-the-counter market. For purposes of § 1.351-1(c)(1)(ii)(c), the term "readily marketable stocks or

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securities” includes convertible debentures, convertible preferred stock, warrants, and other stock rights if the stock for which they may be converted or exchanged is readily marketable. Stocks and securities will be considered to be held for investment unless they are (i) held primarily for sale to customers in the ordinary course of business, or (ii) used in the trade or business of banking, insurance, brokerage, or a similar trade or business.

In the present situation, the shares allocable to the commercial units are not interests in regulated investment companies, interests in real estate investment trusts, or part of a class of stock which is traded on a securities exchange or traded or quoted regularly in the over-the-counter market. Because the current tenant-stockholders will be contributing nonmarketable securities in exchange for 80 percent of the interest in the LLC, the LLC will not constitute an investment company within the meaning of § 1.351-1(c)(1). Thus, the exception of § 721(b) will be inapplicable and the contribution will qualify for nonrecognition under § 721(a).

Section 722 holds that the basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under § 721(b) to the contributing partner at such time. Because the tenant-stockholders are contributing only shares in Corporation, and there will be no gain under § 721(b), each tenant-stockholder will take a basis in the LLC interest that is derived from the basis of the contributed shares.

Section 723 states that the basis of property contributed to a partnership by a partner shall be the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under § 721(b) to the contributing partner at such time. Because there will be no gain under § 721(b), the partnership will take the contributed shares with the basis of those shares in the hands of the respective contributors.

Based on the representations that have been made, we hold 1) the contribution by the tenant-stockholders of the shares of stock allocated to the commercial space to the LLC in exchange for LLC membership interests will not be taxable to the tenant-stockholders nor to the LLC pursuant to § 721(a); 2) the basis in the LLC membership interest received by each tenant-stockholder will be the same as the basis the tenant-stockholder had in the Corporation shares allocated to the commercial space contributed to the LLC pursuant to § 722; and 3) the basis in the Corporation shares received by the LLC from the tenant-stockholders will be the cumulative bases that the tenant-stockholders had in the shares prior to their contribution to the LLC by reason of § 723.

This ruling is based on the facts presented and the applicable law in effect on the date of this letter. If there is a change in material fact or law (local or federal) before the

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transactions considered in this ruling take effect, the ruling will have no force or effect.

Except as specifically ruled herein, we express or imply no opinion concerning the federal tax consequences of this transaction under the cited provisions or any other provisions of the Code.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,  
Joseph H. Makurath  
Senior Technician Reviewer, Branch 7  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosure: Copy for § 6110 purposes