Private Letter Ruling 8813024, IRC Section 42

Dec. 30, 1987

This letter is in response to a letter dated December 1, 1987, and subsequent correspondence that we received from the Partnership's authorized representatives, in which they request that we issue a private letter ruling to Partnership in regard to the low-income housing credit under section 42 of the Internal Revenue Code.

The following facts and representations have been submitted for consideration:

Partnership, a State M limited partnership, was formed on a, among N, a State M corporation, as the General Partner and O, P and Q as the Limited Partners. Partnership is an accrual basis partnership with a tax year ending December 31, and both Partnership and its partners file federal income tax returns with the Internal Revenue Service Center in City R. Partnership and its partners are under the jurisdiction of the District Director, City S.

City T is a municipality of State M. The housing project owned by Partnership (the Project) is located within the boundaries of City T.

Partnership has purchased property on which it will construct the Project, a low-income housing project that is designed to meet the requirements of Section 42 of the Code. A portion of the financing for the construction of the Project is a loan in the principal amount of $b from City T to Partnership (the City T Loan). A copy of the draft promissory note that is anticipated to evidence the City T Loan (the Draft Promissory Note) is attached to your representatives' letter dated December 1, 1987, as Exhibit B.

City T will fund the City T Loan through receipt of a grant from the Department of Housing and Urban Development (HUD) in the amount of $b (the HUD grant). The HUD grant was made pursuant to HUD's Housing Development Grant Program (the HDG Program) for HUD Project c. While the HDG Program regulations, 24 CFR Part 850, require City T to enter into an agreement with Partnership that governs the disbursement of the HUD grant funds to Partnership and restricts the Project to certain low-income standards, the HDG Program imposes no restrictions upon the financial relationship between City T and Partnership. Accordingly, City T is free to make a grant to Partnership, to loan the funds at a below market interest rate, or to make a market rate loan to fund the Project. While the City T Loan was initially contemplated to bear interest at a below market rate, City T has tentatively agreed to an adjustment of the interest rate consistent with the terms of the Draft Promissory Note. The increased interest rate would take effect from the date of initial funding of the City T Loan.

The HDG Program is based on the premise that the grantee, City T, will benefit from the construction of the targeted housing project through (i) an increased number of decent, safe and sanitary housing units of modest design for families and individuals without other reasonable and affordable housing alternatives; (ii) an increase in employment

opportunities; and (iii) an increase in its property tax base. Because City T is not required to repay the HUD grant funds to HUD, the amount that it will receive from Partnership in repayment of the City T Loan will constitute, pursuant to 24 CFR 850.71, an additional source of funds which may be used by City T to invest in other low-income housing projects. In this fashion the HUD grant triggers both a current and a future benefit.

The Project will consist of d rental units, of which e units will constitute low-income housing as defined in the HUD grant. To construct the Project, Partnership received a first loan from U under the HUD Coinsurance Program in the amount of $f, bearing 9.5% interest. The City T Loan will be secured by a second deed of trust with respect to the Project.

Current payments of interest and principal are limited under the terms of the City T Loan to 80% of the "surplus cash" as that term is defined in the "Regulatory Agreement." HUD routinely requires the operators of HUD insured low-income housing projects to enter into Regulatory Agreements which control the use of the rental receipts of the project in question. Typically, surplus cash is defined as the excess funds over operating expenses, HUD required reserves for repair or improvement of the project, and, if applicable, payment of principal and interest on a first mortgage; here, the U loan. HUD may, in the appropriate circumstances, include in the Regulatory Agreement a provision which permits the owner of a low-income housing project to withdraw funds prior to the current payment of 100% of the second mortgage debt service. This type of provision has the effect of encouraging the holder of a second mortgage to agree to permit the owner of the project in question to receive some current cash flow, thus providing an incentive to the owner to operate the project efficiently and to maximize the project's cash flow. Such an arrangement is evidenced in this particular transaction by the reservation of 20% of surplus cash as an incentive to the owners to maximize cash flow.

Both Partnership and City T have agreed that they will not discriminate against prospective tenants in the Project on the basis of their eligibility for housing assistance under any federal, state, or local housing assistant program. Partnership has agreed to operate the Project in accordance with the HDG Program requirements for a period of twenty years and restrictive covenants have been recorded to enforce these requirements. Through the extension of the HDG Program funding and the City T Loan, HUD and City T have both found that the Project furthers the housing policy of the United Stated and of State M.

On the basis of the foregoing, the following rulings are requested with respect to the receipt of the City T Loan by Partnership:

1. The City T Loan does not constitute a grant within the meaning of Section 42(d)(5)(B) of the Code.

2. The City T Loan does not constitute a below market federal loan as defined in Section 42(i)(2)(C) of the Code.

Section 38(a) of the Code provides for a general business credit against tax that includes the current year business credit. Section 38(b)(5) provides that the current year business credit includes the low-income housing credit determined under section 42(a).

Section 42(a) of the Code, which was added by section 252 of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 106 (the Act), 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.

Section 42(b)(1)(A) of the Code prescribes an applicable percentage of 9 for new buildings that are placed in service in 1987 and that are not federally subsidized. Section 42(b)(1)(B) prescribes, for other buildings placed in service in 1987, an applicable percentage of 4 for new buildings that are federally subsidized and for existing buildings.

Section 42(b)(2) of the Code provides that in general, in the case of any qualified low-income building placed in service by the taxpayer after 1987, the term "applicable percentage" means the percentage appropriately prescribed by the Secretary of Treasury for the month in which the building is placed in service. The percentage thus prescribed will yield over a 10-year period amounts of credit under section 42(a) that have present value equal to (i) 70 percent of the qualified basis of a building described in section 42(b)(1)(A), and (ii) 30 percent of the qualified basis of a building described in section 42(b)(1)(B).

Section 42(c) of the Code provides that the qualified basis of any qualified low-income building for any tax year is an amount equal to the product of the eligible basis of the building times its applicable fraction. The section then defines the term "applicable fraction" for these purposes. Essentially, it is that portion of the total residential rental space in the building that is attributable to the building's low-income residential rental space. Section 42(d)(1) provides that for these purposes the eligible basis of a new building is its adjusted basis, and under section 42(d)(5)(A) the eligible basis of any building for its entire 15-year compliance period is its eligible basis on the date it is placed in service. Pursuant to the general rule of section 1011(a) and section 1012 the adjusted basis of a taxpayer's new, self-constructed building, on the date it is placed in service, is its cost.

Section 42(d)(5)(B) of the Code provides that if, during any tax year of the compliance period, a grant is made with respect to any building or the operation thereof and any portion of such grant is funded with federal funds (whether or not includable in gross income), the eligible basis of such building for such tax year and all succeeding tax years shall be reduced by the portion of such grant that is so funded.

For purposes of section 42(b)(1) of the Code, section 42(i)(A) describes the new buildings that shall be treated as federally subsidized for any tax year, and it includes any new building with respect to which there is outstanding, at any time during that tax year, any below market federal loan the proceeds of which are used (directly or indirectly) with

respect to the building or its operation. Section 42(i)(2)(C) defines the term "below market federal loan" for these purposes as any loan funded in whole or in part with federal funds if the interest rate payable on such loan is less than the applicable federal rate in effect under section 1274(d)(1) (as of the date on which the loan was made).

Two sets of Temporary Income Tax Regulations have been promulgated that provide guidance with respect to several subsections of section 42 of the Code, but they do not cover the areas of Partnership's concern. Other than the law cited above our only authority for the meaning of "grant" and "below market federal loan" for these purposes is found in the legislative history of the Act.

2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-91 (1986), 1986-3 (Vol. 4), C.B. 91, states only that a federal grant includes any grant funded in whole or in part by the federal government, to the extent funded with federal funds. It gives these examples of such grants (that may not be included in eligible basis): Community Development Block Grants, Urban Development Action Grants, Rental Rehabilitation Grants, and Housing Development Grants.

The Conference Report defines a federal subsidy as including a direct or indirect federal loan, if the interest rate on such loan is less than the applicable federal rate. A federal loan under the Farmers' Home Administration section 515 program is an example of such a federal subsidy, as is a reduced interest rate loan attributable in part to a federal grant. The determination of whether rehabilitation expenditures are federally subsidized is made without regard to the source of financing for the construction or acquisition of the building to which the rehabilitation expenditures are made.

Based on the facts presented it appears that the HUD grant to City T is an outright grant, one that City T does not have to repay to HUD. The HDG Program permits City T to lend the HUD grant funds to low-income housing developers either at market interest rates or at below market rates, or to make outright grants to such developers.

Evidently, the two-step character of a federal grant (to a local governmental unit) followed by a grant or loan (from that unit to a building owner) must be recognized and respected for purposes of both section 42(d)(5) and section 42(i)(2) of the Code. First, it seems clear from section 42(d)(5)(B) that although federal funds are involved, a grantor (of a federal grant to which this subsection applies) is not necessarily the federal government nor is the grant funds necessarily all federal funds, since the eligible basis of the building must be reduced only by the portion of the grant that is funded with federal funds. Second, it seems clear that a first step grantee is not necessarily a second step grantor of the federal funds based on the language in the Conference Report that is used in giving an example of a federal subsidy: ". . . . a reduced interest rate loan attributable in part to a federal grant." A grantee of federal funds, in certain cases, apparently, is free to make a grant or extend a loan to a building owner using only those federal funds, or those funds plus funds from non-federal sources; and section 42(i) indicates that if it is a loan, it may or may not be at the market interest rate.

We have concluded that we should look only to the proposed financial arrangement between City T and Partnership to determine whether funds will be granted or loaned, and that we should make that determination without regard to the source of the funds or the terms under which they were received by City T. After making that determination the source of the funds becomes relevant for purposes of sections 42(d)(5) and 42(i)(2) of the Code.

We conclude that the City T Loan is not a grant of any classification because the amount extended by City T to Partnership, $b, will have to be repaid in full, with interest. Section 42(d)(5)(B) of the Code does not apply to require a reduction in the eligible basis of the Project.

The City T Loan is a loan the proceeds of which are to be used directly or indirectly for construction of the Project. It is a loan funded wholly with federal funds. Whether or not such a loan is a below market federal loan, within the meaning of section 42(i)(2)(C) of the Code, ordinarily would depend solely on the interest rate payable on the loan. We have concluded in this case, however, that in order to ensure that it is not a below market federal loan (and the Project is not federally subsidized) FOR ANY OF THE TAX

YEARS DURING THE PROJECT'S 15-YEAR COMPLIANCE PERIOD, a modification of the Draft Promissory Note is required.

Therefore, this ruling will be based, in part, on the following revisions to the Draft Promissory Note to which the Partnership has agreed:

(A) Paragraph 1(b) will be revised to make it clear that the interest rate payable on the Loan is the applicable federal rate in effect UNDER SECTION 1274(D)(1) OF THE CODE (as of the date on which the loan is made).

(B) Paragraph 1(c) will be revised to read: REPAYMENT. During the construction period, interest shall accrue on all Loan disbursements and shall be deferred until completion of construction, and shall be added to the principal of the Loan to form a new principal balance. Commencing upon completion of construction, but in no event later than December 1, 1988, monthly installments of interest and principal (computed on the basis of a 360-day year of twelve 30-day months) shall be paid on the first day of each succeeding month until the entire indebtedness has been paid; however, payments due under this Note shall be limited to 100% of the surplus cash, as defined in the Regulatory Agreement between U and the Maker, until Jaunary 1, 2005, and 80% of the surplus cash at all times on or after January 1, 2005. Any accrued interest and unpaid principal shall be paid as a balloon payment at the end of the fortieth year from the date of the Loan.

Based on the representations in the letter dated December 1, 1987, and subsequent correspondence, and on the above revisions being made to the Draft Promissory Note, when executed by the parties, we rule as follows:

1. The City T Loan will not constitute a grant within the meaning of section 42(d)(5)(B) of the Code.

2. The City T Loan will not constitute a below market federal loan as defined in section 42(i)(2)(C) of the Code.

No opinion is expressed or implied regarding the application of any other provisions of the Code or regulations. This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

Temporary or final regulations pertaining to the issues addressed in this ruling have not been adopted. This ruling is issued under the authority of Rev. Proc. 87-7, 1987-2 I.R.B. 15, that enables the Service to issue rulings that previously would have been precluded by the provisions of section 5.07(2) of Rev. Proc. 87-1, 1987-1 I.R.B. 7. Therefore, this ruling may be modified or revoked by the Service. However, when the criteria in section 16.05 of Rev. Proc. 87-1 are satisfied, a ruling is not modified or revoked retroactively, except in rare or unusual circumstances.

Copies of this letter are being sent to the persons you have designated to receive it in accordance with the Power of Attorney on file in this office.

A copy of this letter should be filed with the income tax return of each partner in Partnership for the taxable year in which the transaction covered by this ruling is consummated.