Private Letter Ruling 9001046, IRC Section 42

Date: October 11, 1989

Dear ***

This is in response to your letter dated January 23, 1989, and subsequent correspondence submitted on behalf of General Partner and Partnership as their authorized representative, requesting a ruling regarding whether certain new buildings will be treated as "federally subsidized" under section 42(i)(2)(A) of the Internal Revenue Code. The represented facts as they pertain to the request for a ruling are set forth below.

General Partner is a not-for-profit corporation organized under the laws of State X and qualifies as an organization exempt from tax under section 501(c)(3) of the Code. Association is a State X not- for-profit corporation that is comprised of the owners of *** condominium units located in City Y known as Building. According to General Partner, Building was constructed as a "barrier-free condominium complex designed to provide independent living opportunities for people who are physically disabled and their households." In *** General Partner transferred ownership of *** low-income units and, thus, the low-income housing credits to Partnership, as part of a private offering to a limited group of investors which General Partner anticipates to be under *** in number. General Partner is a general partner in Partnership.

General Partner built Building at a total cost of approximately *** million. Of this amount, *** million was financed by a Economic Development Revenue Bond issued by City Y (the "Bond"). The Bond, which General Partner represents is a tax-exempt obligation under section 103 of the Code, is reflected in two notes. One note is in the amount of *** with a year term and the other note is in the amount of *** with a year term. The remaining sum of approximately *** million was financed by private grants from various corporate and individual donors, and by a loan of *** from Bank B. The loan proceeds were used for additional development costs and is to be secured by a mortgage on the *** units which General Partner claims have not been financed by the Bond proceeds. Except for the Bond, General Partner represents that no "below market Federal loan" was used to finance Building.

General Partner contends that not all of Building's units were financed by the Bond. Rather, only *** of Building's units were financed by the Bond and the remaining *** units were financed with separate funds. General Partner further argues that the *** low-income units are part of the *** units financed by the separate funds. To support its argument, General Partner points to a Memorandum of Agreement dated *** (the "Agreement"), between City Y (the "Issuer") and General Partner (the "Borrower"). Section 1(b) of the Agreement states "that the proceeds of the sale of the revenue bonds of the Issuer will be made available to it to finance the costs of constructing and equipping *** multi-family units. . . ." A Public Notice dated *** published on *** by City Y's Corporate Counsel that advertised a Public hearing that was held *** states that

"the proceeds thereof [are] to be used to finance the costs of acquisition of a site for and the construction of *** units for handicapped persons. . . "

Although the actual Loan Agreement and the Mortgage dated *** do not make reference to the fact that the Bond is to finance construction of *** units with General Partner financing the remaining *** units, General Partner represents that this is the understanding it has with City Y. The Building description attached to the Loan Agreement as Exhibit A refers to the sale of *** units and retention of *** units. In addition, the equipment description in Exhibit C also states that Building is divided into a group of *** units which are subject to the mortgage.

In a letter dated *** from Bank A to General Partner, Bank A states that it approved the first morgage on the building. Bank A describes the loan as being used to construct *** units in a *** unit condominium building. *** units were to be sold and isolated in one wing of the building. *** of these units were to be pre-sold prior to funding. The remaining *** units were to be owned by General Partner.

According to General Partner, the sale of *** units was necessitated by the *** note that was repayable upon the earlier of (1) *** from the date of commencement of construction or (2) *** . As these units were sold, Bank A which holds the Bond, issued partial mortgage releases. General Partner expects that the *** note will be fully paid by ***. The number of units to be sold is the same number, *** as the number of units financed by General Partner. General Partner represents that the Bond documents were prepared before construction plans were complete and unit numbers assigned. Therefore, the Bond documents are silent as to which units are in the group of *** and which units are in the group of *** and which units are in the group of ***. Following consultation with the Bond counsel for Building, and subsequent to completion of construction, Bank A has informally agreed to allow General Partner to designate which units are within the *** and which units are in the *** As further evidence of Bank A's understanding and agreement that the Bond proceeds were available to finance only the *** units, Bank A has, without the necessity of any additional consideration, released the *** low-income units from the mortgage securing the Bond. Bank A and General Partner agree that the *** low-income units are in the *** and General Partner expects that in the future, upon its request and without the need for additional consideration, Bank A will release the remaining *** units from the Bond mortgage. Partnership has relied on this designation to claim the low-income housing credit.

In a letter dated ***, Bond Counsel states that at the time of the closing and the recording of the mortgage, the project consisted of vacant land. For this reason the mortgage was recorded against all of the property. However, Bond Counsel claims that it was always intended and understood by the parties that the mortgage would be enforceable against only *** units.

In a letter dated ***, General Partner represents that there has been no cross collateralization between the loans on the *** units and loans on the *** units. The units which have been collateralized by the Bond mortgage are units ***. At the end of

construction, General Partner received the proceeds from the *** short-term, unsecured loan from Bank A. Sixty thousand dollars of this loan have been repaid and the remainder is being converted to a mortgage which will be collateralized by units *** Lastly, General Partner claims that units *** were financed entirely with private funds other than the Bond.

As further evidence that the *** units were not financed by the Bond, in a letter dated *** General Partner represents that the Bond proceeds were segregated from all other funds used in development of Building. The account at Bank A was an escrow account which required both Bank A and General Partner to release money. Disbursements were allowed to be made to contractors and materialmen for costs related to construction. The escrow account insured that no disbursements could be made to or commingled with other General Partner accounts. General Partner further notes that *** percent of the payments to the general contractor for Building were from private funds and that percent of the *** units is approximately *** units.

Section 42(a) of the Code 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.

In the case of any qualified low-income building placed in service by the taxpayer after 1987, section 42(b)(2)(A) of the Code provides that the term "applicable percentage" means the appropriate percentage prescribed by the Secretary for the month in which the building is placed in service. Section 42(b)(2)(B) provides that the percentages prescribed by the Secretary for any month shall be percentages that will yield over a 10-year period amounts of credit that have a present value equal to: (i) 70 percent of the qualified basis of new buildings that are not federally subsidized for the tax- year (70 percent present value credit), and (ii) 30 percent of the qualified basis of existing buildings, and of new buildings that are federally subsidized for the tax year (30 percent present value credit). The appropriate credit percentages for each month are published in the monthly revenue ruling containing the applicable Federal rates.

Section 42(i)(2)(A) of the Code generally provides that a new building shall be treated as federally subsidized for any taxable year if, at any time during such taxable year or any prior taxable year, there is or was outstanding any obligation the interest on which is exempt from tax under section 103, or any below market Federal loan, the proceeds of which are or were used (directly or indirectly) with respect to such building or the operation thereof. Section 42(i)(2)(D) defines the term "below market Federal loan" as any loan funded in whole or in part with Federal funds if the interest 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).

Notice 88-91, 1988-36 I.R.B. 28, states that final regulations under section 42 of the Code will provide that the term "qualified low-income building" includes residential rental property that is either an apartment building, a single family dwelling, a

townhouse, a rowhouse, a duplex, or a condominium. Therefore, each individual condominium in a building that contains more than one condominium may qualify for the low-income housing credit under section 42.

General Partner is concerned that, if the Service views the Bond proceeds as financing directly or indirectly the low-income units, those units would be considered "federally subsidized" under section 42(i)(2)(A) of the Code. Under section 42(b)(2)(B)(ii), the applicable percentage for new buildings (including qualifying rehabilitation of an existing building) which are federally subsidized and which are placed in service after 1987 is determined by using the 30 percent present value test. Because the low-income housing credit is based on a multiple of the applicable percentage and the qualified basis of the qualified low-income building, a determination that a new building (or qualified rehabilitation of an existing building) is federally subsidized reduces the amount of credit which is available to the owner of a qualified low-income building.

Notice 88-91 provides that each condominium unit is considered a separate building for purposes of section 42. The determination of whether a building is federally subsidized is made under section 42(i)(2)(A) of the Code. Thus, each of Partnership's condominium units must be tested separately under section 42(i)(2)(A) to determine whether the unit is federally subsidized.

Under the facts, Bank A, as trustee for the Bond, viewed the Bond mortgage as only applying to the *** units. To this end, Bank A released the low-income units from the mortgage for no consideration. Therefore, based on General Partner and Partnership's representations and supporting documents which show that the Bond was used to finance only *** units, we conclude that Partnership's low- income condominium units are not "federally subsidized" under Section 42(i)(2)(A) 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 taxpayers 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 issue addressed in this letter ruling have not been adopted. This letter ruling is issued under the authority of Rev. Proc. 88-18, 1988-20 I.R.B. 32, that enables the Service to issue rulings for Code sections enacted or amended by the Tax Reform Act of 1986 or the Revenue Act of 1987. Therefore, this ruling may be modified or revoked by the Service. However, when the criteria in section 16.05 of Rev. Proc. 89-1, 1989- 1 I.R.B. 20 are satisfied, a ruling is not modified or revoked retroactively except in rare or unusual circumstances.

In accordance with the power of attorney on file, a copy of this letter is being sent to you as General Partner and Partnership's authorized representative.

A copy of this letter should be attached to the income tax return of Partnership for the taxable year in which the 5 low-income units were placed in service under section 42 of the Code.

Sincerely yours,

Susan Reaman

Assistant to the Chief, Branch 5

Office of the Assistant Chief Counsel

(Passthroughs and Special Industries)