Private Letter Ruling 9203021, IRC Section 141

CITY'S BONDS TO FINANCE HOUSING PROGRAMS ARE NOT PRIVATE ACTIVITY BONDS.

Date: October 21, 1991

Dear ***:

This letter is our reply to your request for rulings on the Homeowner Programs and Developer Programs. Specifically, you have asked us to rule that (1) the transfers described in the Homeowner Programs and the Developer Programs are not loans within the meaning of section 141(c) of the Code, (2) any payments received under the enforcement notes and liens created under the Homeowner Programs and the Developer Programs are not payments in respect of property or borrowed money used for private business use within the meaning of section 141(b)(2), and (3) the interest on the bonds will not be includible in gross income under section 103(a) of the Internal Revenue Code.

Facts

As a result of the deterioration of much of its housing stock in low and moderate income neighborhoods, the City has developed a variety of programs to provide adequate housing. These programs include the Homeowner Programs and the Developer Programs and help to create new dwelling units or rehabilitate existing dwelling units.

Under the Homeowner Programs, the City subsidizes the purchase of housing units. Under the Developer Programs, the City sells City- owned, multifamily housing projects to developers for a below-market price or provides funds to developers for the acquisition or renovation of housing projects. The developers then must maintain below-market rental rates and other beneficial conditions for an extended period of time. In all of the programs, the City controls the activities of the homeowners and developers through a mortgage note and lien (the "Enforcement Note and Lien"). The subsidies from these programs increase home ownership and provide more affordable rental housing for low and moderate income persons and the homeless.

In order to finance these programs, the City will issue $a of bonds (the "Bonds"). The City will use $b of the proceeds for the Homeowner Programs and Developer Programs. The City will use the remaining $c on projects with no private use.

THE HOMEOWNER PROGRAMS

Under the Homeowner Programs, the City provides a subsidy that makes housing more affordable to a targeted class. The homeowner generally does not repay any part of the subsidy unless the homeowner sells the home for a profit or otherwise realizes the appreciated value of the home.

Under Program A the City sells City-owned land at its appraised value to a not-for-profit corporation (the "A-Sponsor"). The A- Sponsor pays a downpayment of $500 per unit plus a non-interest bearing, non-recourse note and mortgage for the balance of the purchase price. This balance is known as the City Land Subsidy. The A-Sponsor also contracts with a builder to build homes. The builder constructs the homes for a limited profit within a fixed budget. The A-Sponsor obtains most of the financing for construction from a bank. The City advances to the A-Sponsor the City Construction Subsidy, intended to finance a portion of the construction cost of the housing unit.

The A-Sponsor sells a unit to an income eligible homeowner for a price equal to the construction cost of the unit reduced by the City Construction Subsidy and any federal and state subsidies. The homeowner makes a downpayment and borrows the balance of the purchase price from a private lender in return for a purchase money mortgage. The homeowner executes one Enforcement Note and Lien with the City in an amount equal to the City Construction Subsidy for that unit, plus any state or federal subsidy, plus a ratable portion of the City Land Subsidy. Because the City Construction Subsidy and the City Land Subsidy are added to the Enforcement Note and Lien, they are payable by the homeowner and not by the A-Sponsor. Under Program A, the A- Sponsor may not sell more than ten percent of the units to homeowners other than income eligible homeowners. Any advances made by the City under Program A in connection with these units are repaid to the City by the A-Sponsor upon the sale of the unit.

The City has represented that the purpose of the City Construction Subsidy and the City Land Subsidy is to make housing more affordable by reducing the purchase price. The amount of the City Construction Subsidy received by each homeowner varies because the intent of the City Construction Subsidy is to reduce the carrying cost to a stated percentage of homeowner income.

Under the Enforcement Note and Lien, which are subordinate to the purchase money mortgage, neither the City Construction Subsidy nor the City Land Subsidy will ever be repaid if the following conditions are met: (1) the home is never sold by the original owner or anyone who received the home by gift, devise, or descent; (2) the home is continuously occupied as a primary residence for the required period of time; (3) the home is never sold for a profit, defined as the amount received by the homeowner less the original purchase price; or (4) no refinancing, condemnation, or destruction by fire generates proceeds exceeding those needed to satisfy the purchase money mortgage.

The amount of the Enforcement Note and Lien attributable to the City Construction Subsidy is ratably reduced to zero over a fifteen or twenty-five year period as long as the homeowner occupies the home as a primary residence. The portion of the Enforcement Note and Lien attributable to the City Land Subsidy in some instances remains fully payable for a period of 99 years and is then forgiven and in other instances is ratably reduced to zero over a twenty-five year period similar to the City Construction Subsidy. The Enforcement Note is nonrecourse, bears no stated interest rate, and is payable solely from any profit realized upon resale of the unit. Until the Enforcement Note is paid in full or forgiven, all subsequent owners are bound by its provisions.

Program B is similar to Program A. However, a major distinction is that the full amount of the Enforcement Note and Lien is forgiven in the 99th year.

In Program C, the not-for-profit corporation (the "C-Sponsor") transfers an apartment building built with the advance from the City to a cooperative housing association. Residents are required to sell their shares in the cooperative back to the cooperative when they leave, and the cooperative then resells the unit. To participate in Program C, the C-Sponsor and cooperative must enter into a regulatory agreement with the City. During the term of the regulatory agreement, which is at least 40 years, the cooperative must restrict the resale price of each housing unit, preventing the realization of any significant appreciation. The units may only be sold to purchasers with household income not exceeding a specified level. The housing thus remains targeted to low or moderate-income individuals well into the future.

The program and terms of the Enforcement Note and Lien, which are executed by the cooperative, are similar to those of Program A. However, the regulatory agreement effectively prohibits the cooperative from resetting the resale price of a unit to realize any significant appreciation for a period of at least 40 years. After 15 years, the Construction Subsidy will have been reduced to zero, and the Land Subsidy will be payable only if (1) appreciation is realized on the sale of the unit and (2) the unit is sold to a purchaser not meeting the specified household income limitations.

Under Program D, the City works with a nonprofit developer (the "D-Sponsor") to build single family row houses on City owned land. The City provides a maximum of $15,000 per unit to the Sponsor to write down the cost of construction. Once the D-Sponsor has constructed the houses, the City sells the land to the Sponsor for one dollar per home. The D-Sponsor then sells the home to a homeowner, who executes an Enforcement Note and Lien for the amount of the City Subsidy payable to the City. For the balance of the purchase price, the homeowner obtains a purchase money mortgage from a financial institution.

The Enforcement Note and Lien under Program D are similar to those under Program A. The Enforcement Note bears no interest, is not payable until the house is sold and appreciation is realized, is nonrecourse, and is not negotiable. The Enforcement Note and Lien are subordinate to the purchase money mortgage. However, the amount of the Enforcement Note and Lien are not ratably reduced to zero. Instead, the Enforcement Note and Lien under Program D have a term equal to the time during which the mortgagor, or the mortgagor's successors or assigns, occupy the house as a primary residence.

In Program E, City-owned vacant buildings are sold to sponsors (the "E-Sponsors") for one dollar. The E-Sponsors rehabilitate the buildings and convert them into condominiums. The City provides a subsidy (the "E-Subsidy") to each E-Sponsor equal to the difference between the E-Sponsor's development cost and the sale price to homeowners. The sale price is mandated by the City and is less than the E-Sponsor's development cost, including a 10 percent profit.

The Sponsor signs an Enforcement Note and Lien with the City in return for the E-Subsidy. The terms of the Enforcement Note and Lien are substantially similar to those of the Enforcement Note and Lien in Program D except that (1) the City is entitled to a percentage of appreciation upon resale that declines ratably to 50 percent over a 15-year period and (2) the City is entitled to liquidated damages in addition to repayment of the E-Subsidy if a unit is either sold within three years after its initial sale or sold to someone other than a natural person unrelated to the

Sponsor. The Sponsor also signs a regulatory agreement with the City, consisting of a series of covenants by the Sponsor that will run with the land. The covenants permit the City to enforce the promise by the E-Sponsor to follow the City's rules for the program.

The condominium units are sold to homeowners at prices set by the City. The E-Sponsor is in effect either penalized or rewarded for selling to homeowners above or below the City's income guidelines by either an acceleration of part of the Sponsor's Enforcement Note and Lien or an increase of the Subsidy, which increases the proceeds received by the Sponsor from the Enforcement Note and Lien. Each homeowner assumes from the E-Sponsor, on a nonrecourse basis, a portion of the Enforcement Note and Lien attributable to the purchased unit.

THE DEVELOPER PROGRAMS

Under the Developer Programs, the City typically transfers money to a developer for the acquisition and rehabilitation of City-owned multifamily housing projects. Upon completion of the rehabilitation, the housing units are rented to low-income or otherwise disadvantaged persons at rates subject to low-income housing statutes and regulations. The subsidy from the City enables the developer to realize a positive cash flow despite the low rental rates. As a condition to receiving the advances from the City, the developer executes an Enforcement Note and Lien in favor of the City for the amount of the advance. The purpose of the Enforcement Note and Lien is to insure that the housing continues to be made available to the targeted individuals.

Under Program F, the City contracts with a for-profit developer to renovate and operate City-owned, multifamily, low-income housing projects (the "Projects") acquired by the City through tax foreclosures. The City provides funds for renovation, and later may sell the Projects to the developer. The opportunity to purchase the Projects at a price below the fair market value of the buildings is an incentive for the developers to participate in Program F. If the City does decide to sell to the developer, the purchase price of the Project is arbitrarily set at $2,500 per dwelling unit, an amount less than the appraised value.

The developer grants an Enforcement Note and Lien to the City on each unit in an amount equal to the excess of the appraised value of the unit over $2,500. No interest or principal is due on the Enforcement Note during its 10-year term. After 10 years, the entire amount of the Enforcement Note is due. However, if during the 10-year term the developer has complied with certain covenants imposed by the Lien, the entire amount of the Enforcement Note is forgiven. If the developer fails to comply with any of the covenants, repayment is accelerated and the City may require payment of all or part of the amount due under the Enforcement Note. The covenants include compliance with the City's rent stabilization regulations and an agreement not to convert the Project into a co-operative or condominiums.

In Program G, the City advances money to not-for-profit developers to acquire and rehabilitate single room occupancy buildings. After rehabilitation, the units are rented to low income persons at rates subject to low income housing statutes and regulations.

The advance to the developer is evidenced by an Enforcement Note and Lien. The Enforcement Note is nonrecourse, bears interest at one percent, and matures in either 15 or 30 years. No payments of principal or interest are required until maturity, and no prepayments are permitted. The amount of the Enforcement Lien is reduced ratably to zero during the last five years of the term of the Enforcement Note and Lien, as long as the developer continues to make the housing available exclusively for low income persons referred to it by the City. Upon any default of the developer's covenants, all principal and accrued interest on the Enforcement Note and Lien are immediately due and payable. The covenants include requirements that vacancies be filled by persons who are homeless, have a low income, or are otherwise disadvantaged, and that rents comply with low income housing statutes and regulations.

Program H is similar to Program G. The features of the Enforcement Note and Lien for this program are the same as those used for Program G, except the Enforcement Note bears no interest.

Under Program I, a not-for-profit developer buys City-owned buildings for one dollar each and gives the City an interest free 20- year Enforcement Note and Lien for the value appraised before rehabilitation. The developer is liable for payment of the Enforcement Note during rehabilitation. After rehabilitation, the developer retains ownership of the land but sells the building to the homeowners, who assume liability under the Enforcement Note and Lien. The principal amount of the Note will be forgiven in the twentieth year if the developer and the homeowners comply with certain program requirements. The most important requirement is that any resale or re-rental of a unit must be limited to households with incomes at or below 80 percent of the area median adjusted for family size. If a purchaser meets the income restrictions, that purchaser may assume the Enforcement Note and Lien; if not, the amount of the Enforcement Note and Lien becomes immediately due and payable.

The developer is also subject to additional restrictions in a regulatory agreement. These restrictions last for the full 20-year term of the Enforcement Note and Lien and are covenants that run with land. The restrictions require the developer to abide by the resale and re-rental restrictions, to certify annually the total family annual income of all tenants or owners, and to refrain from discrimination.

Law AND ANALYSIS

Under section 103(a) of the Code, gross income does not include interest on any state or local bond. However, section 103(b)(1) states that section 103(a) does not apply to any private activity bond that is not a qualified bond. Section 141(a) of the Code defines a private activity bond as any bond issued as part of an issue (1) that meets both the private business use test and the private security or payment test, or (2) that meets the private loan financing test.

The private business use test is found in 141(b)(1) of the Code. An issue meets this test if more than 10 percent of its proceeds are to be used for any private business use.

The private security or payment test is found in section 141(b)(2) of the Code. An issue meets this test if principal or interest payments on more than 10 percent of the issue's proceeds are directly or indirectly (A) secured by any interest in property used or to be used for a private business use, (B) secured by any payments in respect of property used or to be used for a private business use, or (C) derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used or to be used for a private business use. Security or payment may be found under the terms of the issue or in any underlying arrangement.

The private loan financing test is found in section 141(c)(1) of the Code. An issue meets this test if the amount of the issue's proceeds to be used (directly or indirectly) to make or finance loans to nongovernmental persons exceeds the lesser of five percent of the issue's proceeds or $5,000,000.

In the Conference Report for the Tax Reform Act of 1986, 2 H.R. Conf. Rep. No. 841, 99th Cong. 2d Sess. II-692 (1986), 1986-3 (Vol. 4) C.B. 692, the Conference Committee stated that for purposes of the private loan restriction of section 141(c) of the Code, the determination of whether a loan is made depends on the substance of a transaction and not its form.

Courts have looked to many different factors to determine whether an advance of money is a loan. No single factor is determinative, and many factors must be considered. The mere presence of a note is insufficient to establish a bona fide loan; it must be supported by other persuasive factors. The intent of the parties is important.

One important principle is that no debt exists unless there is an unconditional obligation of another to pay a definite sum of money. In Gilman v. Commissioner, 53 F.2d 47 (8th Cir. 1931), the taxpayer sold land and received certain rights under a sales contract. The taxpayer assigned these contract rights as gifts to his wife and children. One year later he transferred new notes to his wife and children in exchange for the rights under the contract. The new notes bore 5% interest and were void if his wife or children died. They could not be transferred, negotiated, or pledged. Holding that the taxpayer could not deduct the interest paid on the new notes, the court reasoned that the new notes were not evidences of debt because they were contingent on the payees being alive at maturity. The court found that the taxpayer was merely providing for his family.

In Frierdich v. Commissioner, 925 F.2d 180, (7th Cir. 1991), the taxpayer claimed that $100,000 he received from the executor of an estate was a loan and not compensation to him as the attorney for the estate. The note provided for interest at eight percent per annum and was due at the closing of the estate. The court found that there was no loan. The transaction was not bargained for at arm's length, the interest rate was well below the prevailing rates at the time, and the note did not provide security or payment schedule. Furthermore, the note provided that repayment was due when the estate closed. Because the taxpayer was the attorney for the estate, he controlled the timing of the estate's closing and, therefore, controlled the time for repayment. The court found that, in substance, the $100,000 was really compensation for services rendered.

In the Homeowner Programs and Developer Programs, the Enforcement Notes and Liens bear no interest and have no debt service schedule. They are subordinate to any purchase money mortgage. Program G provides for one percent interest, but this is added to the principal balance to be paid at maturity and decreases to zero over time. In seven of the nine programs, the entire principal amount stated in the note (and the entire interest component in Program G) is either reduced to zero over time or forgiven upon maturity of the note. Thus, with the passage of time and compliance with all terms, the amount due under the note is reduced to zero. In the other two programs, Programs D and E, there is no maturity date, so no repayment will ever be made if all conditions are met. Thus, like the taxpayer in Gilman, whose debt was extinguished if the payee died before the maturity date of the note, the homeowners and developers in the Homeowner and Developer Programs have debt that will be extinguished if certain events occur.

In all of the Homeowner Programs, the amount of the advance will never be repaid if the housing unit is (i) never sold by the original owner or anyone who received the home by gift, devise, or descent; (ii) continuously occupied as a primary residence for the requisite period of time; (iii) is never sold at a profit; or (iv) is not refinanced (refinancing will not trigger repayment in Program E). Only two events outside the control of the homeowner may trigger repayment, a condemnation of the property or destruction by fire generating proceeds in excess of the amount needed to satisfy the mortgage obtained to purchase the home (condemnation will not trigger repayment in Program E). However, these events are remote. In the Developer Programs, the amount of the note before reduction to zero or forgiveness is due only if the Developer violates certain conditions, such as not maintaining the housing units or not making the units available to low or moderate income individuals in a nondiscriminatory fashion. In Frierdich, the taxpayer controlled only when repayment occurred. Here, the homeowners and developers control not only when but also whether a repayment occurs.

The City has represented that in its financial statements it treats the Enforcement Notes and Liens under the Homeowner and Developer Programs in the same manner as grants and that this treatment is in accordance with generally accepted accounting principles. The City has also represented that it does not treat the Enforcement Notes and Liens as assets of the City and does not include in its budget any payments it receives under the Enforcement Notes and Liens.

Based on the documents and representations, we conclude that the portion of the Bonds used to finance the transfers made under the Homeowner Programs and Developer Programs are, in substance, grants. Thus, they are not used to make or finance loans for purposes of section 141(c) of the Code. Furthermore, the City neither expects nor needs any payment on the Enforcement Notes and Liens to pay debt service on the Bonds, and no other facts cause us to conclude that there is an underlying arrangement to pay debt service on the Bonds. Therefore, any payments received from an Enforcement Note and Lien must be characterized as a forfeiture of a grant resulting from a failure to fulfill the conditions of the grant rather than as payments with respect to property. Accordingly, any amounts received by the City under the Enforcement Notes and Liens are not payments in respect of property or borrowed money used or to be used for private business use within the meaning of section 141(b)(2).

HOLDINGS

(1) The transfers described in the Homeowner Programs and the Developer Programs are not loans within the meaning of section 141(c) of the Code.

(2) Any payments received under the Enforcement Notes and Liens created under the Homeowner Programs and the Developer Programs are not payments in respect

of property or borrowed money used for private business use within the meaning of section 141(b)(2)

(3) Because (i) the transfers of Bond proceeds under the Homeowner and Developer Programs are not loans within the meaning of section 141(c) of the Code, and (ii) any payments received under the Enforcement Notes and Liens are not payments in respect of property or borrowed money used for private business use within the meaning of section 141(b)(2) of the Code, interest earned on the Bonds will be excludable from gross income under section 103(a) of the Code.

Except as specifically provided above, no opinion is expressed on the tax consequences of this transaction under any Code section including sections 103 and 141 through 150.

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

Sincerely yours,
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Enclosures: