

## Private Letter Ruling 9729012, IRC Section 42

Date: April 14, 1997

Dear \*\*\*

This letter responds to your letter of May 8, 1996, submitted on your behalf by your authorized representative, requesting a ruling under section 42(h) of the Internal Revenue Code. The Taxpayer is a nonprofit corporation organized under the laws of State A. The Taxpayer's sole corporate member is Corporation B, a State A nonprofit corporation. The Taxpayer uses an annual accounting period ending on December 31 and uses an accrual method of accounting. The District Director in City C has audit jurisdiction over returns filed by the Taxpayer.

### FACTS

The Taxpayer is organized exclusively to increase the supply of State A's affordable rental housing, by providing a consistent and dependable source of equity funding for affordable rental housing throughout State A. These goals are achieved by the creation of equity fund limited partnerships, in which the Taxpayer raises capital for investment in statewide affordable rental housing projects.

The Taxpayer serves as the general partner in these partnerships and the capital investors are the limited partners. The first fund, Fund D was closed on a, and raised b from c financial institution investors. As Fund D is depleted through the investment in projects, a second fund will be created, and so on.

The Taxpayer is working with County E in the development of Project F to provide affordable rental housing for low-income families and individuals in the County. Project F will be located on d and consist of e low-rise buildings comprising f studio units, g two-bedroom units, h three-bedroom units, and i four-bedroom units. The Project will also include a community center, including day care, and j laundry buildings. Total occupancy is projected at k to l people.

The Project will be maintained as affordable permanent rental housing for households earning 60 percent or less of the median annual income of County E for the m-year term of the land lease with additional years subject to negotiation at the end of the initial lease. Projected rents will be substantially below maximum allowable rents for households earning 50% or less of the median income for County E. The projected costs of the Project (not including financing costs) are around n, excluding land which will be contributed by County E.

Projected financing sources for Project F include tax- exempt private activity bonds issued by County E that are subject to the private activity volume limitation of section 146 of the Code (the "Bonds"), a

Rental Housing Trust Fund ("RHTF") award, a grant from the County, a HOME program grant, a possible award from a private foundation, and equity investment representing the purchase of limited partnership interests in the partnership owning the Project, Partnership G.

The Taxpayer is the general partner in Partnership H. c financial institutions (the "Limited Partners") in State A, all members of Corporation B, have purchased limited partnership interests in Partnership H for an aggregate investment amounting to about o. Partnership H will be the limited partner in Partnership G. Partner I, a wholly owned subsidiary of the Taxpayer, will be one of the general partners in Partnership G. A second general partner of Partnership G, who will oversee operations, has yet to be selected. Partnership G will be structured (and Partnership H has been structured) so that the vast majority of the income and capital interests relating to Project F will be properly allocable under federal tax principles to the Limited Partners.

Partnership G is expected to apply to the State A housing credit agency for low-income housing tax credits under section 42 with respect to Project F. It is also expected that more than 50 percent of the total basis in Project F will be financed with the Bonds. It is further expected that, because of the marginal financial status of Project F, the Bonds will not be able to be marketed to the general public or that purchasers of the Bonds would demand such a high rate of interest that Project F could not support the debt service on the Bonds. Accordingly, it is expected that some of the members of Corporation B, including some of the Limited Partners, will purchase the Bonds. As the economics of Project F improve, the bondholders will, of course, be free to resell the bonds to the public.

The Bonds, which will be issued by County E, will be used to finance a loan (the "Loan") to Partnership G for the purpose of financing Project F. The Loan will be designed to amortize the principal of the debt on a roughly level debt service basis over a term of approximately 30 years. All principal payments made with respect to the Loan will be used within a six-month period to pay scheduled principal on the Bonds or to redeem Bonds. The Bonds, which will be private activity bonds under section 141 of the Code, will receive an allocation of the State's private activity bond volume ceiling under section 146. Bond counsel will deliver an opinion to the effect that the interest on the Bonds will be excluded from federal income tax pursuant to sections 103 and 142(d) of the Code, except when the Bonds are held by persons who are "substantial users" of the Project, within the meaning of section 147(a).

A ruling is requested that none of State A's housing credit ceiling under section 42(h) of the Code will need to be allocated to Project F for Project F to be eligible for low-income housing tax credits, if at least 50 percent of the aggregate basis of Project F is financed with the Bonds and that Project F otherwise qualified for the low-income

housing tax credit under section 42.

## LAW

Section 38(a) of the Code provides for a general business credit against tax that includes the amount of the current year business credit.

Section 38(b)(5) of the Code provides that the amount of the current year business credit

includes the low-income housing credit determined under section 42(a). The low-income housing credit that may be claimed in any year is subject to the general business tax credit limitation of section 38(c).

Section 42(a) of the Code provides that, for section 38 purposes, the amount of the low-income housing credit determined under section 42 for any taxable year in the credit period 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(h)(1) of the Code provides that the amount of credit determined under this section for any taxable year with respect to any building shall not exceed the housing credit dollar amount allocated to such building under this subsection.

Section 42(h)(3) of the Code provides that the aggregate housing credit dollar amount which a housing credit agency may allocate for any calendar year is the portion of the state housing credit ceiling allocated under this paragraph for such calendar year to such agency.

Section 42(h)(4)(A) of the Code provides that section 42(h)(1) does not apply to any portion of the credit otherwise allowable under section 42(a) which is attributable to eligible basis financed by any obligation the interest on which is exempt from tax under section 103 if – (i) such obligation is taken into account under section 146, and (ii) principal payments on such financing are applied within a reasonable period to redeem obligations the proceeds of which were used to provide such financing.

The Conference Report (the "Conference Report") to the Tax Reform Act of 1986, 2 H.R. Rep. No.841, 99th Cong., 2 Sess. II-98 (1986), 1986-3 (Vol. 4) C.B. 98, states:

Generally, credits subject to the State credit authority limitation include any credits

attributable to expenditures not financed with tax-exempt bonds subject to the new

private activity bond volume limitation.

Section 42(h)(4)(B) of the Code provides that, if 50 percent or more of the aggregate basis of any building and the land on which the building is located is financed with such tax exempt bonds, section 42(h)(1) does not apply to any portion of the low-income housing credit.

Section 103(a) of the Code provides that, except as provided in section 103(b), gross income does not include interest on any State or local bond. Section 103(b) provides that subsection (a) shall not apply to any private activity bond which is not a qualified bond within the meaning of section 141.

Section 141(e) of the Code provides that a private activity bond is a "qualified bond" if the bond is an exempt facility bond, the bond issue meets the volume cap requirement of section 146, and the applicable requirements of section 147 are met.

Section 141(e)(1)(A) of the Code provides that the term "qualified bond" includes any private activity bond that is an exempt facility bond.

Section 142(a)(7) of the Code provides that the term "exempt facility bond" includes any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide qualified residential rental projects. Section 142(d) defines the term "qualified residential rental project" to mean any project for residential rental property if, at all times during the qualified project period, the project meets one of the income limitations (elected by the issuer) specified in section 142(d)(1)(A) or (B). Identical income limitations apply for purposes of qualifying tenants as income eligible under section 42(g). However, low income units must also meet a rent-restriction test under section 42(g) to qualify for the low-income housing credit. Section 146(a) of the Code provides that a private activity bond issued as part of an issue meets the volume cap requirements if the aggregate face amount of the private activity bonds issued pursuant to such issue, when added to the aggregate face amount of tax-exempt private activity bonds previously issued by the issuing authority during the calendar year, does not exceed such authority's volume cap for such calendar year.

Section 147(a) provides that except as provided in section 147(h), a private activity bond shall not be a qualified bond for any period during which it is held by a person who is a substantial user of the facilities or by a related person of such a substantial user.

## DISCUSSION

We note that the Bonds are tax-exempt private activity bonds subject

to the volume gap

limitations under section 146 of the Code. To the extent the Bonds are initially sold to the

Limited Partners, they will nonetheless be subject to the section 146 limitations. While the Bonds are held by the Limited Partners who are substantial users of the Project within the meaning of section 147(a), interest on the Bonds will be includible in the gross income of the Limited Partners. Interest on the Bonds will be tax-exempt once the Bonds are no longer held by substantial users or related persons.

The Bonds will be issued as tax-exempt obligations under section 103 of the Code and will require an allocation of volume gap regardless of whether they are initially sold to the Limited Partners. As indicated by the Conference Report, the emphasis in section 42(h)(4)(A) is on whether the bonds are taken into account under the volume gap provisions of section 146.

We therefore conclude that bonds which otherwise qualify as tax-exempt obligations under section 103 of the Code subject to an allocation of volume cap under section 146 may be treated for purposes of section 42(h)(4)(A) as obligations the interest on which is exempt from tax under section 103, even though the bonds are held by substantial users or related persons. Accordingly, for purposes of section 42(h)(4)(B), to the extent that 50 percent of the aggregate basis of Project F is financed with the Bonds, and Project F otherwise qualifies for the low-income housing tax credit under section 42, section 42(h)(1) shall not apply to any portion of the credit allowable under section 42(a) with respect to Project F.

Under the power of attorney on file, you are sending a copy of this letter to your authorized representative.

No opinion is expressed or implied regarding the application of any other provisions of the Code or regulations. Nor is any opinion expressed or implied regarding whether Project F otherwise qualifies for the low-income housing credit under section 42.

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

Sincerely yours,

Walter H. Woo

Senior Technician Reviewer

Branch 5

(Passthroughs and Special Industries)

