INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

May 04, 2004

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Index (UIL) No.: 42.00-00
CASE-MIS No.: TAM-111858-04, CC:PSI:B05

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No.:
Years Involved:
Date of Conference: N/A

LEGEND:

Taxpayer =
General Partner =
Participating Jurisdiction =
Bank A =
Bank B =
State =
City =
County =
Date =
b =
c =
d =
e =
f =
g =

ISSUES:

1. Whether the purported loan of HOME Investment Partnerships Act (HOME) funds between General Partner and Taxpayer should be treated as a grant under § 42(d)(5)(A) of the Internal Revenue Code or a loan under § 1.42-3(a) of the Income Tax Regulations.

2. Whether the purported loan of Affordable Housing Program (AHP) funds between General Partner and Taxpayer should be treated as a grant under § 42(d)(5)(A) or a loan under § 1.42-3(a).

CONCLUSIONS:

1. The purported loan of HOME funds between General Partner and Taxpayer is treated for purposes of § 42 as a below market Federal loan under § 42(i)(2)(D).

2. The purported loan of AHP funds between General Partner and Taxpayer is treated for purposes of §42 as a below market loan under § 1.42-3(a), and not as a below market Federal loan under § 42(i)(2)(D).

FACTS:

Taxpayer owns and operates a b-unit low-income housing project located in City (Project). The total cost of the Project was in excess of $c. Funding for the Project was provided by several sources, including HOME funds and AHP funds.

Participating Jurisdiction granted $d of HOME funds to General Partner, a State nonprofit organization. The terms of the grant required the funds to be used in the construction of the Project and that the Project would have to comply with certain rent income limitations as required by the Department of Housing and Urban Development's HOME program rules. General Partner is not required to pay back any of the HOME funds unless it does not comply with the rent limitations. General Partner made a non-interest bearing second mortgage loan of $d to Taxpayer. The loan is nonrecourse. No payments are due for a period of e years. General Partner prepared and Taxpayer executed a mortgage promissory note document and a mortgage document. The promissory note provides that the loan is due and payable on Date, and there is no provision that would provide for forgiveness or cancellation of the loan under any circumstance. The mortgage was filed with the county clerk (and the mortgage tax paid) of County, and the documents complied, in all respects, with the legal requirements of an enforceable promissory mortgage note and mortgage.

General Partner also received a grant of AHP funds in the amount of $f from the Bank A AHP. The funds were disbursed by Bank B. The agreement for these funds is contained in a promissory note between Bank B and General Partner. The note provides that the entire indebtedness will be forgiven if General Partner and Taxpayer comply with the terms of the agreement for a period of g years from the date of

execution of the note. There is no intent to repay this debt. The terms of the promissory note required that the funds be used in the construction of the Project. General Partner used the funds to make a non-interest bearing third mortgage loan to Taxpayer with no payments due for e years. This loan is also nonrecourse. The promissory note provides that the loan is due and payable on Date, and there is no provision in the promissory note that would provide for forgiveness or cancellation of the loan under any circumstance.

Taxpayer represents that the value of the Project will at all times exceed the debt secured by the Project.

Taxpayer intends to sell the Project as soon as practicable after the end of the 15-year compliance period. Prior to the sale, General Partner holds a right of first refusal to purchase the Project for a minimum purchase price as determined under § 42(i)(7).

LAW AND ANALYSIS:

Section 42(a) provides, in general, that for purposes of § 38, the amount of the low-income housing credit determined under § 42 for any taxable year in the credit period is an amount equal to the applicable percentage of the qualified basis of each qualified low-income building.

Under § 42(b)(2)(B)(i), for buildings placed in service after 1987, the 70 percent present-value credit applies to new buildings which are not federally subsidized for the taxable year. Under § 42(b)(2)(B)(ii), for buildings placed in service after 1987, the 30 percent present-value credit applies to new buildings which are federally subsidized for the taxable year and existing buildings.

Section 42(d)(5)(A) provides that if, during any taxable year of the compliance period, a grant is made with respect to any building or the operation thereof and any portion of the grant is funded with Federal funds (whether or not includible in gross income), the eligible basis of the building for the taxable year and all succeeding taxable years is reduced by the portion of the grant which is so funded.

Section 42(i)(2)(A) provides that, except as otherwise provided in § 42(i)(2), a new building will be treated as federally subsidized for any taxable year if, at any time during the taxable year or any prior taxable year, there is or was outstanding any obligation the interest on which is exempt from tax under § 103 or any below market Federal loan, the proceeds of which are or were used (directly or indirectly) with respect to the building or the operation thereof.

Section 42(i)(2)(D) provides that the term “below market Federal loan” means 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 § 1274(d)(i) (as of the

date on which the loan was made). Such term shall not include any loan which would be a below market Federal loan solely by reason of assistance provided under § 106, 107, or 108 of the Housing and Community Development Act of 1974 (as in effect on the date of enactment of this sentence).

Section 42(i)(7)(A) provides that no Federal income tax benefit will fail to be allowable to the taxpayer with respect to any qualified low-income building merely by reason of a right of first refusal held by the tenants (in cooperative form or otherwise) or resident management corporation of the building or by a qualified nonprofit organization (as defined in § 42(h)(5)(C)) or government agency to purchase the property after the close of the compliance period for a price which is not less than the minimum purchase price determined under § 42(i)(7)(B).

Section 42(i)(7)(B) provides that for purposes of § 42(i)(7)(A) the minimum purchase price is an amount equal to the sum of (i) the principal amount of outstanding indebtedness secured by the building (other than indebtedness incurred within the 5-year period ending on the date of the sale to the tenants), and (ii) all Federal, State, and local taxes attributable to the sale.

Section 1.42-3(a) provides that a below market loan funded in whole or in part with funds from an AHP established under section 721 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 is not, solely by reason of the AHP funds, a below market Federal loan as defined in § 42(i)(2)(D). Thus, any building with respect to which the proceeds of the loan are used during the tax year is not, solely by reason of the AHP funds, treated as a federally subsidized building for that tax year and subsequent tax years for purposes of determining the applicable percentage for the building under § 42(b).

In the instant case, we believe that we should first determine whether the notes between General Partner and Taxpayer constitute grants or loans. Under the facts, the terms of both notes between General Partner and Taxpayer require repayment in full, as each promissory note is due and payable on Date, and neither note allows for forgiveness or cancellation under any circumstance. Also, under the facts, the value of the Project will at all times exceed the debt secured by the Project. Thus, we conclude that both notes are loans. After making that determination, the source of the funds becomes relevant for purposes of § 42(d)(5), § 42(i)(2), and § 1.42-3. The source of the second mortgage note is directly from a grant of HOME funds to General Partner. The source of the third mortgage note is directly from the grant of AHP funds to General Partner.

Consequently, based solely upon the above facts and Taxpayer's representations as set forth above, we conclude that for purposes of § 42: (1) the purported loan of HOME funds between General Partner and Taxpayer is treated as a below market Federal loan under § 42(i)(2)(D), and (2) the purported loan of AHP funds between General Partner and Taxpayer is treated as a below market loan under

§ 1.42-3(a), and not as a below market Federal loan under § 42(i)(2)(D).

CAVEAT(S):

No opinion is expressed or implied regarding the application of any other provision of the Code or regulations. Specifically, no opinion is expressed or implied regarding whether the Project qualifies for the low-income housing credit under § 42, the application of the at-risk rules under § 42(k) to the Project's financing, or the application of § 42(i)(2)(E)(i) to the HOME loan. A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.