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LEGEND

Authority =

Partnership =

State =

City =

Federal Act A =

Federal Agency =

Federal Program =

Savings =

Federal Act B =

Federal Act C =

Agreement =

Plan =

Year 1 =

Year 2 =

Date 1 =

a =

b =

c =

d =

Dear :

This letter is in response to a letter dated January 31, 2005 and subsequent correspondence submitted on behalf of Authority and Partnership requesting a ruling under § 42 of the Internal Revenue Code (Code).

Authority represents that the relevant facts are as follows:

FACTS

Authority is a body corporate and politic existing under the laws of State. Authority's primary mission is to facilitate the development of under-utilized property in City with a special emphasis on affordable housing. Authority serves as City's lead agency for financing the development of affordable housing and administers a range of federal and state funds available to City for the purpose of preserving and expanding City's affordable housing supply. Authority also has the power to issue tax-exempt bonds to finance affordable housing projects.

Prior to Year 1, Authority financed various affordable housing projects through the issuance of tax-exempt bonds under Federal Act A, which were guaranteed by Federal Agency. These projects included a financing adjustment factor under Federal Program. Authority loaned the proceeds of the bonds to various affordable housing project partnerships, and the partnerships made principal and interest payments with respect to such loans out of operating income generated by the projects and Federal Program subsidy payments.

In Year 2, Authority refunded the bonds through the issuance of refunding bonds. The refunding bonds were issued at reduced interest rates that would permit Federal Agency to recapture Federal Program funds used to subsidize the affordable housing projects. The interest rates on the loans from Authority to the project partnerships were not decreased upon the issuance of the refunding bonds; rather, the projects partnerships continued to make the same debt service payments out of tenant rents and Federal Program subsidy payments. As a result, the Savings were calculated as the difference between the annual amount of contract rent that Federal Agency would have been required to subsidize through Federal Program payments under the annual contributions contract for each project if the interest rate on Authority's loan to such project had been reduced upon the issuance of the refunding bonds, and the annual amount of contract rent that Federal Agency was actually required to subsidize through Federal Program payments under the annual contributions contract for each project without the reduction in interest rate.

Pursuant to provisions of Federal Act B and Federal Act C, 50 percent of the Savings were to be remitted to Federal Agency and 50 percent were to be made available to Authority for its use in providing affordable housing to very low-income families or persons. Federal Agency entered into an Agreement with Authority with respect to each affordable housing project that was refinanced through refunding bonds. Pursuant to this Agreement, the escrow agent identified therein would collect the mortgage payments from the project partnership and would deposit the Savings in a separate account from which 50 percent would be disbursed to Federal Agency and 50 percent would be retained for disbursement on behalf of Federal Agency to Authority under the terms of the agreement and an accompanying escrow agreement.

As a condition to Federal Agency entering into the Agreement with Authority, Authority was required to submit to Federal Agency a Plan for use of the Savings setting forth the programs and purposes in furtherance of which Authority would use its portion of the Savings. The Plan identified certain existing programs that would be funded by Authority with the Savings, but reserved the Authority's right to develop new programs or modify existing programs, subject to satisfying the following standards: (1) the Savings must be used for the benefit of households of very low income (as defined in Federal Act A) and the beneficiaries must be certified as a very low-income person or family, (2) all housing subsidized with the Savings must meet the requirements of Federal Act B for a period of at least 10 years and all single-family housing subsidized with the Savings must be occupied, at the time such assistance is received, by a very low-income person or family, (3) Savings must be segregated by Authority and used only for purposes authorized pursuant to the Plan and the Agreement, and (4) the Savings must not be used by Authority to reimburse itself for its costs of developing and administering its housing program. In the event Authority defaults under the Agreement, Federal Agency may suspend disbursements to Authority until the default is cured. Upon failure to cure, Federal Agency may withhold all or a portion of the Savings

from Authority until it has recouped the amount of funds used otherwise than in accordance with Federal Act B.

The terms of each agreement entered into between Federal Agency and Authority were identical and each agreement had a copy of the Plan and escrow agent attached as exhibits.

In accordance with the Agreement and the Plan, Authority plans to use a portion of the Savings to fund loans to various affordable housing partnerships, including Partnership. Authority and Partnership entered into loan documents on Date 1 pursuant to which Authority will lend $a to Partnership with $b to be funded from the Savings. The rate of interest on the loan is c percent, the full amount of the principal is due d years from the date of the loan and the loan is secured by a first mortgage on the project.

Authority and Partnership requested the following rulings: (1) that the Savings received by Authority do not constitute federal funds under § 42(i) of the Code; (2) that loans made by Authority to various affordable housing partnerships, including the loan to Partnership, funded with the Savings at an interest rate that is below the applicable federal rate then in effect under § 1274(d)(1), will not constitute below-market federal loans under § 42(i)(2)(D) of the Code; and (3) the affordable housing projects to which loans funded with the Savings will not be deemed to be federally subsidized under §§ 42(b) and 42(i)(2) of the Code.

LAW AND ANALYSIS

Section 42(a) of the Code provides a tax credit for investment in low-income housing buildings placed in service after December 31, 1986. For any taxable year in a ten-year credit period, the amount of credit is 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, § 42(b) provides, in part, that the term applicable percentage means the appropriate percentage prescribed by the Secretary for the month applicable under § 42(b)(2)(A)(i) or (ii). 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 qualified basis of new buildings that are not federally subsidized for the taxable year and (ii) 30-percent of the qualified basis of existing buildings, and of new buildings that are federally subsidized for the taxable year (30-percent present value credit).

Section 42(c) provides that the qualified basis of any qualified low-income building for any taxable year is an amount equal to the applicable fraction (defined in section 42(c)(1)(B)) of the eligible basis of such building. In general, under § 42(d) the

eligible basis of a new building is its adjusted basis as of the close of the first taxable year of the credit period.

Section 42(i)(2)(A) provides in part 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) provides in part that a below-market federal loan is any loan funded in whole or in part with federal funds if the interest rate payable on the loan is less than the applicable federal rate in effect under section 1274(d)(1) (as of the date the loan was made).

The term “federal funds” is not defined under § 42 or the regulations thereunder. The legislative history to § 42 provides that a federal loan under the Farmer’s Home Administration section 515 program is an example of a federal subsidy, as is a reduced interest rate loan attributable in part to a federal grant. 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-91 (1986), 1986-3 (Vol. 4), C.B. 91.

In this case, Authority’s use of the Savings arises pursuant to the Agreement between it and Federal Agency which authorizes the escrow agent to make disbursements to Authority on behalf of Federal Agency. The Savings are subject to the terms imposed by Federal Agency under the Plan and Federal Agency retains the ability to oversee the use of the Savings and maintains authority to withhold disbursements.

Authority and Partnership argue the Savings are not federal funds or funds from a federal program similar to the examples mentioned in the legislative history. The Savings represent compensation to the Authority for its efforts in refinancing the prior bonds for which it was under no obligation to do under the original bond documents. Nevertheless, the Savings are available for Authority’s use under the Agreement with Federal Agency which was entered into pursuant to the provisions of Federal Act B and Federal Act C. Consequently, the Savings constitute federal funds for purposes of § 42(i)(2)(D).

Accordingly, based solely upon the law and above facts represented by Authority and Partnership, we rule as follows:

The Savings constitute federal funds for purposes of § 42(i)(2)(D). Because the loan from Authority to Partnership is funded in part with federal funds and the interest rate payable on the loan is less than the applicable federal rate in effect under section 1274(d)(1) (as of the date the loan was made), the loan is a below-market federal loan as defined in § 42(i)(2)(D). Therefore Partnership’s project will be treated as federally

subsidized under § 42(i)(2)(A) and is eligible to apply for the 30-percent present value credit under § 42(b)(2)(B).

No opinion is expressed or implied regarding the application of any other provision of the Code or regulations. Specifically, we express no opinion regarding whether Partnership's project is eligible to receive credits under § 42.

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

Sincerely,

Susan Reaman
Chief, Branch 5
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)