IRS TECHNICAL ADVICE MEMORANDUM 9528002
(Federally Subsidized Building)

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Section 42
Low-Income Housing Credit

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ISSUE:

Under the specific facts of this case, are all six buildings in Taxpayer's multi-building project federally subsidized for purposes of section 42(b), or did Taxpayer properly qualify three of the six buildings as new buildings that are not federally subsidized?

FACTS:

In c, Taxpayer, a limited partnership, acquired six buildings (the Project) for d. Three of the buildings are located at Address A (the North buildings), and three of the buildings are located at Address B (the South buildings). The Project was rehabilitated into e low-income housing units. In addition to historic rehabilitation credits and other federal and state subsidies, each building's rehabilitation expenditures qualify as a separate new building eligible for the low-income housing credit under section 42(e)(3). Each building's rehabilitation expenditures were placed in service in f.

There are three sources of funding for the Project that total g: the equity capital contributions of the partners that total h; a nonrecourse loan of i that is secured by a first mortgage on the six buildings and that is funded by debt obligations the interest on which is exempt from tax under section 103 (Bond proceeds); and nonrecourse loans of j that are secured by a second mortgage on the six buildings and that are funded in part (k) by a non-Federal grant and in part (1) by certain federal funds loaned at a below market rate of interest (Federal Loan proceeds).

The bond documents and the loan documents provide that the Bond proceeds and the Federal Loan proceeds (hereinafter "federally subsidized funds" when referred to without distinction) are to be used on all six buildings in the Project. A tracing of the federally subsidized funds would, in fact, reveal that the funds were used on all six buildings in the Project.

On its f federal income tax return, Taxpayer treated the federally subsidized funds as predominantly attributable to the South buildings and the nonfederally subsidized funds as attributable to the North buildings. To the extent that there was an overage of federally subsidized funds, Taxpayer excluded these amounts from the eligible basis of the South buildings. Taxpayer claimed an applicable percentage having a present value equal to 70 percent of the qualified basis of the North Buildings, and an applicable percentage having a present value equal to 30 percent of the qualified basis of the South Buildings. Only one Form 8609, Low-Income Housing Credit Allocation Certificate, was filed for the three North buildings, and only one Form 8609 was filed for the three South buildings.

LAW:

Section 42(b)(2) provides that a new building that is not federally subsidized for the tax year is eligible for a 70-percent present value credit, whereas a new building that is federally subsidized for the tax year is eligible for a 30-percent present value credit.

Section 42(i)(2)(A) provides that a new building shall be treated as federally subsidized for any tax year if, at any time during such tax year, or any prior tax 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 used (directly or indirectly) with respect to the building or the operation thereof.

Section 42(i)(2)(B) provides that a loan or tax-exempt obligation shall not be taken into account in determining whether a building is federally subsidized if the taxpayer elects to exclude from the eligible basis of the building (1) in the case of a loan, the principal amount of such loan, and (2) in the case of a tax-exempt obligation, the proceeds of such obligation.

A below-market federal loan is defined in section 42(i)(2)(C) to mean 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 section 1274(d)(1) (as of the date on which the loan is made).

Section 103(a) provides that, except as provided in section 103(b), gross income does not include interest on any state or local bond. Section 103(b)(1) provides that subsection (a) shall not apply to any private activity bond that is not a qualified bond within the meaning of section 141. Section 141(e)(1)(A) provides that an "exempt facility bond" is a qualified bond.

Section 142(a)(7) 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 1.42-1T(f)(1)(ii) of the temporary Income Tax Regulations provides that for purposes of determining the portion of proceeds of an issue of tax-exempt bonds used to finance (A) the eligible basis of a qualified low-income building, and (B) the aggregate basis of the building and the land on which the building is located, the proceeds of the issue must be allocated in the bond indenture or a related document (as defined in section 103-13(b)(8)) n a manner consistent with the method used to allocate the net proceeds of the issue for purposes of determining whether 95 percent or more of the net proceeds of the issue are to be used for the exempt purpose of the issue. If the issuer is not consistent in making this allocation throughout the bond indenture and related documents, or if neither the bond indenture nor a related document provides an allocation, the proceeds of the issue will be allocated on a pro rata basis to all of the property financed by the issue, based on the relative cost of the property.

ANALYSIS:

A. BONDS

To utilize the 70-percent present value credit, Taxpayer takes the position that nothing in section 42 prohibited Taxpayer from allocating, at the time of filing its f federal income tax return, the nonfederally subsidized funds used in the Project to cover the entire cost of the North buildings.

We disagree. Section 1.42-1T(f)(1)(ii) of the temporary income tax regulations requires that in determining the use of tax-exempt bond proceeds used to finance (A) the eligible basis of a qualified low-income building, and (B) the aggregate basis of the building and the land on which the building is located, the proceeds of the issue must be allocated in the bond indenture or a related document in a manner consistent with the method used to allocate the net proceeds of the issue for purposes of determining whether 95 percent or more of the net proceeds of the issue are to be used for the exempt purpose of the issue. In the present case, the proceeds of the issue were allocated in the bond indenture and related documents in a manner consistent with the method used to allocate the net proceeds of the issue for purposes of determining whether 95 percent or more of the net proceeds of the issue were to be used for the exempt purpose of the issue. A review of the bond documents indicates that the Bond proceeds were to be used to finance the acquisition, rehabilitation, and equipping of the Project. These documents clearly describe the Project as containing all six buildings. The bond documents did not provide that the Bond proceeds were to be allocated to any specific item of property in the Project. In fact, the Bond proceeds were used on all six buildings in the Project. Whether one views the language in the bond documents as specifying that the Bond proceeds were to be allocated to

all the property in the Project, as we do, or as too general to be attributable to any specific item of property in the Project, the result under section 1.42-1T(f)(1)(ii) is the same. The Bond proceeds must be allocated on a pro rata basis to all the property financed by the issue, based on the relative cost of the property.

Taxpayer argues that section 1.42-1T(f)(1)(ii) applies only to situations where credit allocated to a building is attributable to basis financed by tax-exempt bond proceeds, and that no portion of the credit allocated to any of the buildings in the Project is attributable to basis financed by the Bond proceeds.

We are not persuaded by this argument. First, section 1.42-1T(f)(1)(ii) reflects both the general rule for determining the use of tax-exempt bond proceeds in the section 42 context and guidance for dating the use of bond proceeds in the section 142 context. See e.g. section 1.150-1(c)(2)and (3); *Rev. Rul. 79-321, 1979-2 C.B. 37.* That is, absent a specific exception, the rules for determining the use of tax-exempt bond proceeds outlined in section 1.42-1T(f)(1)(ii) apply whenever the proceeds of tax-exempt bonds are used (directly or indirectly) with respect to a building or the operation thereof, regardless of whether credit allocated to the building is actually attributable to basis financed by the tax-exempt bonds. We find no justification for recognizing a rule that is different from the rules for determining the use of tax-exempt bond proceeds under section 1.42-1T(f)(1)(ii) in situations where the use of the tax-exempt bond proceeds are not attributable to the basis of the property upon which credits are allocated.

Second, Taxpayer only filed two Forms 8609 for all six buildings in the Project. While the failure to file the correct number of Forms 8609 is a distinct problem that is outside the scope of this technical advice request, we cannot assume that, had the correct number of Forms 8609 been filed, they would have revealed that no portion of the credits allocated to any building in the Project were attributable to basis financed by the Bond proceeds.

Taxpayer also argues that the literal language of section 1.42-1T(f)(1)(ii) requires the application of that section on a building-by-building basis. We disagree. The rules for determining the use of tax-exempt bond proceeds under section 1.42-IT(f)(1)(ii) (whether or not the use of tax-exempt bond proceeds are actually attributable to the basis of property upon which credits are allocated) apply to the project as a whole. Section 1.42-1T(f)(1)(ii) requires that if the issuer is not consistent in making an allocation throughout the bond indenture and related documents, or if neither the bond indenture nor a related document provides an allocation, the proceeds of the issue will be allocated on a pro rata basis to ALL OF THE PROPERTY FINANCED BY THE ISSUE . . ." (emphasis added) The bond proceeds financed, in part, the acquisition, rehabilitation, and equipping of the Project. By definition and in actuality the Project consists of all six buildings. Thus, contrary to Taxpayer's position, the application of section 1.42-1T(f)(1)(ii) can apply to both a single-building-project and a multi-building project.

B. LOANS

In determining whether a new building is federally subsidized under section 42(i)(2)(A), the proceeds of tax-exempt bonds and the proceeds of below market federal loans should be treated similarly. It is consistent therefore to apply rules similar to the rules under section 1.42-1T(f)(1)(ii) when determining the use of below market federal loan proceeds. Accordingly, absent a specific exception (e.g., tax-exempt bond financing assumed upon the acquisition of an existing building), or unless a loan document clearly states that the loan proceeds will be used to finance specific items of property in a project (and the taxpayer and the issuer act consistently with this allocation), rules similar to the rules for determining the use of tax-exempt bond proceeds under section 1.42-1T(f)(1)(ii) should apply when below market federal loan proceeds are used (directly or indirectly) with respect to a building or the operation thereof, regardless of whether credit allocated to the building is actually attributable to basis financed by the below market federal loan. These rules, likewise, apply to a multi-building project.

Applying the loan rules to the present case we find that, as with the Project bond documents, the Project loan documents indicate that the Federal Loan proceeds are to be used to finance the acquisition, rehabilitation, and equipping of the Project. These documents also describe the Project as containing all six buildings. A tracing of the Federal Loan proceeds would, in fact, reveal that the proceeds were used on all six buildings in the Project. Accordingly, the Federal Loan proceeds must also be allocated on a pro rata basis to all the property in the Project, based on the relative cost of the property.

C. CROSS-COLLATERALIZATION

Independent of the rules for determining of the use of federally subsidized funds is the issue of cross-collateralization. To the extent that the North buildings are collateralized by other property in the Project financed by federally subsidized funds, the North buildings are federally subsidized. Thus, even if Taxpayer had arranged and applied the Project financing to avoid the pro rata application of the above allocation rules, the cross-collateralization of the two blanket mortgages representing the federally subsidized funds results in the indirect use of federally subsidized proceeds on the North buildings. As a result, the North buildings are federally subsidized under section 42(i)(2)(A).

Thus, under these facts, at the time Taxpayer filed its f federal income tax return, the Bond proceeds and the Federal Loan proceeds should have been allocated pro rata across all the property in the Project based on the relative cost of the property. To avoid the federally subsidized characterization of the North buildings Taxpayer could have elected under section 42(i)(2)(C) to redeem the tax-exempt bond and repay the below market federal loans before the buildings were placed in service. Taxpayer could also have elected under section 42(i)(2)(B) to reduce the eligible basis of the North buildings to the extent of (A) the pro rata portion of the federally subsidized funds that were attributable to each of the North buildings, and (B) the full amount of the federally subsidized funds used on other property in the Project (minus an adjustment for federally subsidized funds attributable to the acquisition cost of the South buildings) that were used as collateral to secure the North buildings. Taxpayer chose neither option.

Instead, in effect, Taxpayer argues that it had a third option -- namely, an unrestricted ability to allocate, at the time of filing Taxpayer's first federal income tax return claiming the credit, the federally subsidized funds to any property in the project.

To support its position, Taxpayer refers to rules and cases in the tax-exempt bond area and language in the legislative history to section 42. For example, Taxpayer cites rules and cases in the tax- exempt bond area where the Service allows a specific allocation to property after the property is placed in service. We have reviewed the rules and cases cited by Taxpayer and agree that the Service generally has permitted issuers to determine where proceeds are allocated, and, has not required an issuer to prorate all of its revenues and expenditures. We also agree that the rules and cases cited by Taxpayer reflect this point. However, those rules and cases are distinguishable from the present case. Nothing in the authority cited by Taxpayer suggests a taxpayer can represent in the bond documents that the bond proceeds are being allocated to specific property of an exempt facility, and at a later date treat the bond proceeds as if they were allocated to different property. Such is the case here.

Taxpayer also cites language in the legislative history of section 42 to support its position that it had discretion to allocate, at the time of filing the first federal income tax return claiming a credit for the project, the federal subsidies among the various Project property. This language provides that "The determination of whether rehabilitation expenditures are federally subsidized is made without regard to the source of financing for the construction or acquisition of the building to which the rehabilitation expenditures are made. ." See H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. at II-91 (1986). Taxpayer reasons that the application of this language precludes the imposition of rules requiring that federal subsidy proceeds be applied on a pro rata basis over an entire project. We do not read such an expansive interpretation. This language merely reflects congressional intent that any federally subsidized funds used in connection with the acquisition or construction portion of a substantially rehabilitated building will not, by itself, result in a federally subsidized taint of the "new" building represented by the rehabilitation expenditures. This language does not prohibit, as Taxpayer suggests, the application of rules that determine the use of federally subsidized proceeds within the context of a single, or multi-building project. Thus, if the federal subsidy is clearly attributable to acquisition costs (such as a below-market federal loan or tax-exempt bond financing that is continued or assumed upon purchase of an existing building, or earmarked for acquisition in the loan documents) or if the federal subsidy is used to finance the construction (i.e., rehabilitation) of the rehabilitated building and is redeemed or repaid before the building is placed in service, the federal subsidy will not taint the rehabilitation expenditures of the building.

Because Congress has specified that federally subsidized acquisition costs of a building will not, in and of themselves, operate to taint the rehabilitation expenditures of the building, these same federally subsidized acquisition costs will not, under a theory of cross collateralization, operate to taint as federally subsidized, the rehabilitation expenditures of that SAME building. However, if the building is collateralized by other federally subsidized property, the rehabilitation expenditures of the building will be deemed to be federally subsidized.

To conclude, we stress that Taxpayer's position is inconsistent with the statutory framework of section 42(i)(2). The result sought by Taxpayer would create, in effect, a new exception to the definition of a federally subsidized building under section 42(i)(2). This new exception could only apply to a multi-building project. If the facts in the present case were applied to a single-building project, a building owner could not elect under section 42(i)(2), when filing the first federal income tax return claiming a credit for the project, to allocate all the federally subsidized funds to non eligible basis building costs in order to remove the "federally subsidized" taint from the building. Such an election would make virtually senseless the two statutory exceptions under section 42(i)(2) for removing a federally subsidized taint from a building. Taxpayer should not be permitted to achieve in a multi-building project what the statute prohibits in a single-building project.

CONCLUSION:

We conclude that, under these facts, all six buildings in the Project are federally subsidized for purposes of section 42(b).