

Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Date: January 27, 2005

LEGEND

Taxpayer =

Bank =

City A =

City B =

City C =

Dear :

This letter responds to Taxpayer's letter dated September 21, 2004, and subsequent correspondence from Taxpayer's authorized representative, requesting a ruling that a Section 538 Guaranty on two loans from Bank to Taxpayer will not, in and of itself, result in the loans being below market Federal loans under § 42(i)(2)(D) of the Internal Revenue Code. The Internal Revenue Service Office that will have examination jurisdiction over Taxpayer is located in City A.

The relevant facts as represented in these submissions are set forth below.

FACTS

Taxpayer is a limited liability company engaged in the business of acquiring, constructing, rehabilitating, developing, repairing, improving, maintaining, operating, managing, leasing, disposing of and otherwise dealing with a low income housing project eligible for low-income housing credits under § 42. The project is located in City B. As part of the financing for the project, Bank intends to make two loans to Taxpayer using subsidized funds provided through the Federal Home Loan Bank of City C's Affordable Housing Program (AHP). Thus, the proceeds of the loans will be provided through an AHP established under § 721 of the Financial Institution Reform, Recovery, and Enforcement Act of 1989 (FIRREA). Each loan will carry a rate of interest that will be below the applicable Federal rate (AFR) in effect for the month the loans are issued.

It is further expected that the two loans will be guaranteed by the Rural Housing Services' (RHS') Section 538 program. The Section 538 program allows RHS to guarantee loans made by private lenders for the development of affordable rural rental housing. The Section 538 program will guarantee a maximum of 90 percent of the unpaid principal and interest of the loans. The Section 538 Guaranty will be between RHS and Bank. No assistance in the form of an interest credit under the Section 538 program will be made in connection with the loans.

RULING REQUESTED

Taxpayer requests the Service to rule that the Section 538 Guaranty will not, in and of itself, result in the two loans being below market Federal loans under § 42(i)(2)(D).

LAW AND ANALYSIS

Section 38(a) provides for a general business credit against tax that includes the amount of the current year business credit. Section 38(b)(5) provides that the amount of the current year business credit includes the low-income housing credit determined under § 42(a). Section 42(a) provides that the amount of the low-income housing credit for any taxable year in a 10-year credit period is an amount equal to the applicable percentage of the qualified basis of each qualified low-income building.

Section 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 the percentages that will yield over a 10-year period amounts of credit that have a present value equal to: (i) 70 percent of the qualified basis of new buildings that are not federally subsidized for the taxable year (70-percent present value credit), and (ii) 30 percent of the qualified basis of new buildings that are federally subsidized for the taxable year and existing buildings (30-percent present value credit).

Section 42(c)(1)(A) provides that the qualified basis of any qualified low-income building for any taxable year is an amount equal to (i) the applicable fraction (determined as of the close of the taxable year) of (ii) the eligible basis of the building (determined under § 42(d)).

Section 42(i)(2)(A) provides that a new building is treated as federally subsidized for any taxable year if, at any time during that 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) defines the term “below market Federal loan” as any loan funded in whole or in part with Federal funds if the interest rate payable on such loan is less than the AFR in effect under § 1274(d)(1) (as of the date on which the loan is made). The term “Federal funds” is not defined by § 42, nor is the term’s meaning addressed in the legislative history to § 42.

Section 1.42-3(a) of the Income Tax Regulations provides that a below market loan funded in whole or in part with funds from an AHP under § 721 of FIRREA is not, solely by reason of the AHP funds, a below market Federal loan as defined in § 42(i)(2)(D). As such, any building on which the loan proceeds are used during the taxable year is not, solely by reason of the AHP funds, treated as a federally subsidized building for that taxable year and subsequent taxable years for purposes of determining the applicable percentage for the building under § 42(b).

Under the present facts the two loans from Bank, although expected to have interest rates below the AFR at the time the loans are made, are being funded from an AHP under § 721 of FIRREA. Under § 1.42-3(a), the AHP funding will not, in and of itself, result in characterizing the loans as federal subsidies under § 42(i). Further, the Section 538 Guaranty is not funding the loans but is guaranteeing Bank that a certain portion of the loans will be paid directly by RHS to Bank in the event Taxpayer defaults on the loans, a contingency which may or may not occur.

Accordingly, based on Taxpayer’s representations of fact concerning the transaction and applicable law, we rule that the Section 538 Guaranty will not, in and of itself, result in the two loans being below market Federal loans under § 42(i)(2)(D).

No opinion is expressed or implied regarding the application of any other provision in the Code or regulations. Specifically, no opinion is expressed or implied regarding whether the loans will be treated as federal subsidies for any other reason under § 42, nor the affect, if any, that utilization of a Section 538 interest credit may have under § 42.

This ruling is directed only to the Taxpayer which requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent. A copy of this letter should be filed with the federal income tax return for Taxpayer and its partners for the first taxable year in which the low-income housing credit for the building(s) in the project is claimed.

Sincerely yours,

Harold E. Burghart
Senior Advisor, Branch 5
Office of Associate
Chief Counsel
(Passthroughs and Special
Industries)

Enclosures(2): Copy of this letter
Copy for § 6110 purposes

cc: