

Below-market loans; exempted loans; second mortgage loans under the MAHRA Act. A below-market second mortgage loan made under the Multifamily Assisted Housing Reform and Affordability Act of 1997, by the Department of Housing and Urban Development (HUD) to the owner of a multifamily low-income rental property in connection with restructuring the existing first mortgage on the property, is exempted from section 7872 of the Code.

Rev. Rul. 98-34

ISSUE

If the Department of Housing and Urban Development (“HUD”) makes a below-market second mortgage loan in accordance with the Multifamily Assisted Housing Reform and Affordability Act of 1997, 111 Stat. 1384 (“MAHRA Act”), is that loan exempt from § 7872 of the Internal Revenue Code?

FACTS

Limited partnership *PRS* owns a multifamily low-income rental property subject to a first mortgage that secures a nonrecourse first mortgage note with an outstanding principal balance of \$100x (the “Existing Mortgage loan”). The Existing Mortgage loan is insured by the Federal Housing Administration (“FHA”). *PRS*, as owner of the property, receives both rental payments from the property’s tenants and, under a project-based assistance contract, certain additional payments from HUD. (Collectively, the payments are referred to as “Contract Rents.”) The Contract Rents exceed the rents that would be received with respect to comparable unassisted rental properties in the same housing market (“Street Rents”). If the project-based assistance from HUD were reduced so that Contract Rents reflected Street Rents, *PRS* would not be able to satisfy its debt service obligation on the Existing Mortgage loan.

Congress enacted the MAHRA Act to reduce the federal government’s cost of rental subsidies, to minimize FHA mortgage insurance risks, and to ensure the continued viability of multifamily rental housing projects. See § 511(b) of the MAHRA Act; H.R. Conf. Rep. No. 297,

105th Cong., 1st Sess. 137-39 (1997). To achieve these goals, the MAHRA Act permits owners of eligible multifamily housing projects with expiring project-based assistance contracts to enter into mortgage restructuring and rental assistance sufficiency plans with HUD or a participating administrative entity acting on behalf of HUD.

In accordance with the MAHRA Act, the following actions occur:

(1) Project-based assistance payments to *PRS* are reduced so that the Contract Rents received by *PRS* reflect Street Rents.

(2) HUD makes a \$35x cash payment to the holder of the Existing Mortgage loan on behalf of *PRS* to reduce the outstanding principal balance of the Existing Mortgage loan to \$65x.

(3) The terms of the Existing Mortgage loan are modified, resulting in a new first mortgage loan with an outstanding principal balance of \$65x (“New First Mortgage loan”). The New First Mortgage loan provides for interest above the applicable Federal rate under § 1274(d) (“AFR”). Debt service on the New First Mortgage loan is supportable by the reduced Contract Rents.

(4) In consideration for the payment in step (2), *PRS* executes a nonrecourse note to HUD (the “Second Mortgage loan”) secured by a second mortgage. The Second Mortgage loan has a principal balance of \$35x, provides for interest below the AFR, and qualifies as indebtedness under general principles of federal income tax law. The Second Mortgage loan is made in accordance with § 517(a)(1)(B) of the MAHRA Act.

LAW AND ANALYSIS

In general, § 7872 defines a below-market loan as any loan on which the interest rate charged is less than the AFR. Section 7872(b) provides that the borrower of a below-market term loan is treated as having received from the lender, on the date the loan is made, cash in an amount equal to the excess of the amount loaned over the present value of all payments required under the loan (the “imputed transfer”). Section 7872(b) further provides that a below-market term loan is treated as having original issue discount (“OID”) in an amount equal to the imputed transfer, which is in addition

to any other OID on the loan determined without regard to § 7872(b).

Section 1.7872-5T(a)(1) of the temporary Income Tax Regulations provides that, notwithstanding any other provision of § 7872 and the regulations thereunder, § 7872 does not apply to the loans listed in § 1.7872-5T(b) because the interest arrangements of those loans do not have a significant effect on the federal tax liability of the borrower or the lender. Section 1.7872-5T(a)(2) provides, however, that if a taxpayer structures a transaction as a loan exempt under § 1.7872-5T(b) and one of the principal purposes of so structuring the transaction is the avoidance of federal tax, then the transaction will be recharacterized as a tax avoidance loan under § 7872(c)(1)(D).

Section 1.7872-5T(b)(5) provides an exemption for loans that are subsidized by a federal, state, or municipal government (or any agency or instrumentality thereof), and that are made available under a program of general application to the public.

Under § 1.7872-5T(b)(15), other loans described in revenue rulings or revenue procedures may be exempted from § 7872 if the Commissioner finds that the factors justifying the exemption for those loans are sufficiently similar to the factors justifying the other exemptions listed in § 1.7872-5T.

The legislative history of § 7872 indicates that most government-subsidized loans, such as government-insured residential mortgage loans, were intended to be exempt from § 7872. See 1 Senate Comm. on Finance, 98th Cong., 2d Sess., Deficit Reduction Act of 1984: Explanation of Provisions Approved by the Committee on March 21, 1984, at 482 (S. Prt. 169).

The factors justifying exemption of the Second Mortgage loan from § 7872 are similar to the factors justifying the exemption for government subsidized loans made available under a program of general application to the public, which are exempt from § 7872 under § 1.7872-5T(b)(5).

The MAHRA Act was enacted as a reform measure to reduce HUD’s cost of renewing project-based assistance contracts on multifamily low-income rental properties while ensuring the continued viability of these multifamily rental housing pro-

jects. The interest arrangements of the Second Mortgage loan to *PRS* are, therefore, not structured with a principal purpose of avoiding federal tax.

HOLDING

The Second Mortgage loan is exempt from § 7872.

DRAFTING INFORMATION

The principal authors of this revenue ruling are David B. Silber and Tina Jannotta of the Office of Assistant Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and Treasury Department partici-

pated in its development. For further information regarding this notice, contact Tina Jannotta on (202) 622-3940 (not a toll-free call).